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Graziella Scassillo: Strategic asset allocation or SAA, sets target allocations for various asset classes based on factors such as risk tolerance, duration and target returns. Recent studies suggest that SAA can play a big role in portfolio performance, but building a private markets portfolio presents unique challenges. What are some of these challenges? Can private markets be efficiently integrated with traditional asset allocations? You're listening to R.P.M. Reflections on Private Markets, the podcast that explores the world of private markets. I'm your host, Graziella Scassillo, and coming up on today's show, Stepstone head of risk, Christian Frei that would discuss with us strategic asset allocation and risk management. Hi Chris, and welcome to R.P.M.

Christian Frei: Hi, Graziella. Thanks for giving me the opportunity to contribute to our podcast series.

GS: So Christian, I would like to start our podcast today with a brief definition of strategic asset allocation, in one of your recent papers, you compare it with a battle plan, right?

CF: That's right. And we make this comparison specifically with respect to private markets, SAA and, like for liquid markets, the SAA is the starting point that defines a targeted allocation, which is supposed to have a high likelihood to achieve an institution's investment objectives. But private markets allocation take considerably more time to be implemented. You need to identify suitable investment targets. You need to perform due diligence. You need to secure capacity. So the availability of suitable investments not necessarily matches your original timeline when you design the allocation. So, like a battle plan, then the SAA in private markets provides a decision making framework that helps you stay on track even when things are not exactly going your way. And like with battle plans an SAA is most effective when everybody is on the same page. So, we believe that the private markets SAA should be integrated with the investment execution and portfolio management processes to generate the optimal private markets portfolio.

GS: So it's like the ancient Romans that made sure all roads lead to Rome, right?

CF: Well, as a member of the Rome office, you can definitely get away with this interpretation.

GS: Christian, that actually sounds like a lot of work: how long could it take to build a market portfolio?

CF: That's not an easy question. And I suspect that you won't let me off the hook by just answering "it depends", but it does depend and it depends on factors like strategy mix, the size of the portfolio, the implementation, the pacing strategy. And to illustrate that, let me give you a couple of examples. So there's a difference in how quickly an allocation can be built in private debt compared to an allocation in venture capital. It also depends on whether you want to build your portfolio purely from primary investments or whether you want to build your portfolio from a combination of primary investments and co-investments. Obviously, the second one typically is, you know, much faster. Of course, it also depends on whether you already have a portfolio from where you can start. But if you push me for a number, a concrete number, I would say three to maybe five years is a reasonable time horizon to get the private markets portfolio done.

GS: Well, that there was a lot of work indeed

CF: It is. But it is also what makes working in private markets fun.

GS: So let's say the right process is structured. Some research suggests that SAA can explain more than a third of a private market portfolio performance. How did the role of SAA change over time?



CF: Investors have been increasing their allocations to private markets over the recent decades, and, as allocations increase, they start to contribute more meaningfully to the risk of an overall portfolio. And that trend makes it important to shift from treating private markets as satellite allocation to considering them as strategic components of a portfolio. In parallel, it's important also to note that the private markets industry has considerably involved and collected a lot of data on private market investment systematically, but also academic started to dedicate increased research efforts to private markets. So and today we also have better methods, and, just to name one, the PME method available that allows us to better evaluate the performance of private market investments.

GS: If the trend continues, this should increase, the interest and studies around private markets?

CF: Definitely.

GS: Chris, and now, what are the differences between the traditional approach to portfolio construction and the one used instead for private markets?

CF: Our approach to SAA is a process and not just the output of an optimization that we follow blindly. Everybody who has worked with portfolio optimization tools knows that they are sensitive to input parameters and bear the risk of suggesting unintuitive and concentrated portfolios at times. So, we always take a step back and ask ourselves “are there more intuitive portfolios with comparable risk and return characteristics?” and I would say, given the limited amount of data and therefore the higher uncertainty about the parameters that go into an SAA, this step of stepping back is more important than private markets than in traditional markets.

GS: I understand. It's a bit like a recipe that you deliberately tweak to figure out if you like that alternative taste.

CF: Yeah, I like that interpretation.

GS: Christian, if we look back to Stepstone in 2018 white paper on SAA, we see that something has changed earlier this year. The focus now is on determining the optimal allocation to private markets and public markets in conjunction with one another.

CF: Yeah, I mean, at the end we are a private market specialist. So, our initial focus naturally was to develop tools to determine an asset allocation within private markets. But as we've discussed before, as allocations to private markets increase, the interaction with the rest of the portfolio becomes more and more important. And on the other hand, general consultants are not necessarily best positioned to model the private markets part of a portfolio. So investors have increasingly turned to us to opine on the fate of private markets and their traditional portfolio. And so we felt that we should also dedicated some work to that topic.

GS: That's interesting. So, Chris, so far from what you just told us, it sounds like setting up an effective process requires access to quite specific data: at Stepstone I know that we have our proprietary database called SPI that stands for Stepstone Private Market Intelligence which includes 14,000 managers and 35,000 funds. Thanks to this comprehensive database, sounds to me that we should be ideally positioned to use this data to create asset class models that go into SAA.

CF: Yes, we have been systematically collecting data on private markets for over a decade and we are still adding even historic data to these databases. SPI and OMNI, as you point out, our proprietary analytics platforms, hold cash flow data on more than 120,000 private transactions. And this includes cash flows on fund level as well as cash flows on underlying investments. And with this data source, we don't have to solely rely on commercially available indices or index data to do the modeling, but we can actually, you know, you go to a granularity that we think is appropriate or that makes sense for our client. And by having access to cash flow level data, we can

navigate around valuation-based methods that suffer from the well-known smoothing problem. As a modeler, of course, I wish I had more data to build more accurate models, but what we have, I think, certainly puts us in a good position.

GS: That is a really precious resource of data, I guess. And talking about the data from a statistical point of view, since the asset classes returns are not normally distributed, how does this affect the optimization methodology, and which are the benefits of having a private market specialist?

CF: That's a good question. If one is interested in the distribution of long-term outcomes of a portfolio, the importance of normality is reduced and SAA at the end is about long-term outcomes. That does not mean that investors might not, or should not, care about short term P&L fluctuations. So, what we do in such situations, we typically treat drawdown limits as additional portfolio constraints when we do the portfolio construction.

GS: So you're basically saying that returns are more normally distributed over longer horizons?

CF: Yes, I do.

GS: So remaining now in the statistical field, how does Stepstone build and consider the efficient frontier for the composition of an optimal portfolio with constraints?

CF: Yes, to answer that we must remind ourselves what an efficient frontier is. The frontier provides the minimum risk one has to accept for a given level of return, and it's the result of a mathematical optimization. And this optimization process squeezes, so to speak, the allocation into the most optimal corner it can find in the space of all possible portfolios. And such portfolios might appear overly concentrated to small assets or a small number of asset classes. And in our approach, we therefore systematically explore regions near those mathematical optimums in order to achieve diversification that goes beyond the pure mathematical definition of diversification.

GS: That's very interesting, also because we're now entering the time of the year where many LPs are beginning to think about their SAA for the upcoming year. What have you heard from LPs regarding changes to their strategic asset allocation as a result of Covid-19?

CF: Yes, LPs to ask us questions about asset allocation implications post Covid, and the questions are as much strategic as occasionally also tactical. And one example on the strategic level is that they're asking us, you know what the implication of work from home experience on real estate might be. And in general, we think it's early or too early to fully understand the effects of such changes. But also, given that an SAA is about achieving long-term objectives and, given what we've discussed in terms of the battle plan, we also advise of not, you know, using short-term events as catalyst for completely changing the SAA, but stick to your guns. On the tactical level, they are typically looking to capture opportunities resulting from spread widening and stress situations. And here our investment teams are, of course, well positioned to suggest secondary or opportunistic investments in their respective asset class.

GS: And in making these tactical allocation decisions, would we expect an increase in secondary, distressed, and other investments that investors are often turning to when markets are down?

CF: We're not just expecting it, we're actually seeing it or experiencing it.

GS: I understand. And if you'll allow me, Chris, I would have also one more question about your role at Stepstone now, and I promise it is the last one. So, as had the risk at Stepstone, aside from reading more medical journals, I guess, how has your focus changed this year?



CF: Yeah, I have not just read more medical journals, it also reminded me a lot of my time as an analyst of biotech and health care hedge funds. Actually, on a more serious note, because one cannot easily trade in and out of private markets, risk management naturally has a longer-term perspective. It's more about risk budgeting, really, but with Covid, I would say we took a bit a shorter-term view when assessing the bigger picture, because the situation was so unprecedented, we felt the need for a more regular assessment of the implications of the pandemic on the market outlook.

GS: And in your opinion, are those changes here to stay?

CF: My expectation is that will be in that mode for maybe a couple of more quarters, but not for good.

GS: That's very good news, I think, for all of us. Christian, thank you for your time and for being with us today.

CF: It was a pleasure.

GS: That does it for this edition of R.P.M. Join us next time as my co-host, Michael Venne, discusses Real Estate with Kieran Farrelly. You can find us on Apple podcasts, Spotify, Stitcher, or wherever you get your podcasts. To learn more about Stepstone Group visit us at www.stepstoneglobal.com