Features of Private and Public Investments and Markets

The private markets pathway for the Level III CFA exam focuses on asset classes that trade in private markets rather than public market investments, which are defined as debt or equity securities that are traded either on a public exchange or among dealers in an over-the-counter market.

By contrast, private investments are claims on companies that either cannot issue securities in public markets or have chosen not to. These private debt and equity securities are often non-standardized contracts that result from direct negotiations with a company's owners. The categories of private market investments that will be covered in this pathway are:

- Private equity
- Private debt
- Private special situations
- Private real estate
- Private infrastructure

While public market investments are defined in a way that is largely identical to the definition of traditional asset classes that has been used throughout the CFA curriculum, it is important to note the distinction between private investments and alternative investments. Most, if not all, forms of private investment can be considered alternative investments. However, some alternative asset classes are accessible through public market vehicles, such as exchange-traded commodity derivatives and REITs. There are also publicly-traded high-yield bonds that have been issued by private companies.

The key areas of difference between public and private investments are summarized in the table below and then covered in more detail.

	Public Investments	Private Investments
Asset prices	- Observable - Market-determined	- Estimated - Determined by negotiation

	Public Investments	Private Investments
Performance measurement	- Periodic - Stable cash flows - Short holding periods	- Compounded - Uncertain cash flows - Long holding periods
Liquidity	- Highly liquid securities - Small position sizes	- Illiquid assets - Large position sizes
Investment process	- Open-end structure - Minimal influence	- Closed-end structure - Significant influence
Managerial skills	- Company financial analysis - Industry analysis	- Specific experience/expertise - Identifying hidden value
Portfolio diversification potential	Based on observed correlations	Based on specific risk exposures and unique assets

Asset Prices

Public market investors have immediate access to current and historical price data, allowing them to take positions based on their views on which securities are over- or undervalued. Positions can be combined into portfolios that have been optimized according to historical return, volatility, and correlation data.

In private markets, asset pricing is not transparent or timely, making the data less useful for asset allocation purposes. Valuations are infrequent and often subject to delays. Investors estimate prices based on recent comparable transaction data or by using relative valuation techniques or discounted cash flow methods.

Performance Measurement

The performance of a public market investment typically involves an initial outlay at the time of purchase followed by predictable periodic cash flows (i.e., coupons, dividends) and a terminal cash flow at the end of a relatively short-term investment horizon.

Private market investment performance is more challenging to predict and measure because cash flows are less predictable and positions are held for longer. Often, more than one outflow is required and there is greater uncertainty over the amount and timing of inflows. Returns are typically compounded over multiple periods.

Liquidity

Public market securities are highly liquid with low transaction costs. The positions taken by investors are small relative to daily trading volume and issuers are typically mature stage companies with relatively stable cash flows. All of this makes it easy for investors to actively buy and sell positions based on their estimates of fair value.

The liquidity of private market securities is severely limited by the inability to trade them on a public exchange or in a dealer-driven OTC market. Liquidity is further limited by the fact that private market investments are often significant minority or controlling positions.

Investment Process

Because of transparent pricing and high liquidity, public market investment vehicles are typically structured as open-end funds with very low minimum capital requirements. Managers of these funds focus on identifying mispriced securities. They do not take controlling positions in companies and have little influence over them beyond exercising their voting rights.

Private market investments involve larger (often controlling) positions that must be held over longer periods in order to realize their full value. A *J-curve* pattern is observed over the phases of the private asset investment cycle, with an initial period of negative returns before investors receive capital distributions. This dynamic lends itself to a closed-end fund structure that restricts the ability of investors to withdraw their funds early in the cycle and compensates the manager based on investment performance.

Manager Skills

The manager of a public market investment fund is expected to be able to identify undervalued companies using standard analytical techniques. While fund managers should be able to evaluate important industry dynamics, it is not necessary for them to have expertise in a specific industry. They are passive investors in the sense that they do not become active participants in the operations of their portfolio companies. The value creation responsibility is largely delegated to the companies' executive teams.

Private market investment managers have a comparatively broader range of opportunities and tend to focus on the specific areas in which they have specialized expertise. For example, venture capital managers will not attempt to apply their analytical techniques to buyout-stage companies. Managers are expected to identify target companies with hidden value and then take an active role in the value creation process, often by drawing on their networks of expert contacts. Because of the lack of standardized contracts, there is a greater emphasis on legal analysis.

Portfolio Diversification Potential

Public market investments are diversifying to the extent that they have low correlations with a portfolio's other assets. While this principle also applies to private market investments, their correlations are much more difficult to estimate due to the lack of observable market pricing, illiquidity, and longer holding periods. However, private market investments still offer significant diversification potential with risk-return profiles that differ significantly from those of public market securities, which are typically issued by mature stage companies.

Three key sources of potential diversification offered by private market investments are:

1. Access to companies in different phases of their life cycle than the typical mature-stage publicly traded company. Notably, venture capital funds provide exposure to rapidly growing startups and early-stage companies.

2. Different return dynamics over the investment life cycle. Specifically, private equity buyout funds can provide enhance returns with investments in mature companies that are taken private to be restructured and optimized. Additionally, private special situations funds seek to profit from unique event-driven strategies, such as distressed investing and merger arbitrage.

3. Alternative asset classes that offer different risk-return profiles than traditional public market debt and equity. Private real estate and infrastructure investment vehicles provide the best opportunities for this form of diversification.

While private market investing has historically been limited to large institutional investors with the capital and specialized in-house knowledge needed to pursue these opportunities, accessibility has increased in recent years with the emergence of new vehicles that are available to a wider pool of investors.