PGIM

BUILDING A BETTER PORTFOLIO

Webinar Recap

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Institutional investors are increasingly faced with the difficult choice between potentially higher returns and greater liquidity. Investors may also encounter often hard-to-predict liquidity demands due to adverse market movements and when general partners make capital calls stemming from prior commitments.

PGIM's Institutional and Advisory Solutions group recently joined with GIC's Economics & Investment Strategy department to model the interaction of top-down asset allocation with bottom-up private asset investing (GIC is the global investment firm established to manage Singapore's foreign reserves). We also looked at integrating liquidity management into the portfolio construction process. Here are excerpts from the webinar:

- **Finding balance and evaluating the tradeoffs between higher returns and ample liquidity:** Constructing multi-asset portfolios with both liquid and illiquid assets is a major challenge for chief investment officers around the world. Private assets come with unique cash flow patterns (including unexpected capital calls and distributions) and can be burdensome and costly to liquidate. Complicating portfolio construction is that investment officers must account for the risk of failing to meet liability obligations or failing to capture attractive opportunities during market dislocations.
- **Applying a framework across both public and private market assets:** Investors need to have a strong understanding of how the liquidity characteristics of private assets impact their portfolio. OASIS™ (Optimal Asset Allocation with Illiquid Assets) is an asset allocation framework that can help investors analyze how allocations to illiquid private assets, in combination with their commitment strategy, may affect their portfolio's ability to respond to liquidity demands. CIOs can also use OASIS to study how their portfolios are exposed to various liquidity events, examine how their portfolios behave in various market scenarios, and evaluate the consequences of changing their views on private asset performance relative to public markets.

  We start by simulating the returns and risk of public and private assets in a multi-asset portfolio. The simulation can incorporate an investor's own capital market assumptions and allows investors to express their views on future private asset performance along with their fund-selection skill, which can be an important performance driver. The framework also introduces private asset cash flow modeling which is consistent with the underlying market environment. Second, the framework uses the investor's portfolio structure that specifies a "waterfall" rule for sourcing liquidity: Which assets to sell to meet a liquidity demand, starting with those that are the least disruptive and costly. Finally, using the framework we show how an investor's asset allocation interacts with their private asset commitment strategy to determine their portfolio's expected performance and liquidity, thereby constructing an efficient frontier – given a level of desired portfolio liquidity what is the best expected return?
- **A case study:** Investors naturally worry about how their portfolios might perform differently in various market conditions, particularly during downturns. We study two different scenarios in our paper, both of which are appropriate in today's environment: A U-shaped and V-shaped recovery. The economic paths with one V-shaped recovery leads to expected portfolio return (11.3%), much higher than the ones with U-shaped recovery (6.6%). In addition, if within 10 years there is a U-shaped recovery, on average a capital call liquidity shortage occurs three times over the 10-year horizon, compared to no capital call event for economic paths with a V-shaped recovery.

PGIM IAS delivers comprehensive portfolio-level investment insights to institutional clients worldwide in partnership with the PGIM Institutional Relationship Group. To learn more visit PGIM IAS here.

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