KEYNOTE INTERVIEW

Readying for risk

In these volatile times, technology can help asset owners understand their exposures and respond accordingly, while also preparing for future shocks, says BlackRock's Melissa Ferraz

Q Just how risky are private markets?

It is important to view portfolio risk through multiple lenses – that's good risk management practice in general, regardless of whether you are talking about public or private markets and it's especially true in times of heightened volatility.

However, because holding periods tend to be longer in private markets, asset owners need to evaluate that time horizon in the context of the liquidity options available to them. Recent bank failures have highlighted the importance of mark to market valuations. It is crucial that institutional investors re-evaluate GPs and fund valuation methodologies and strive for greater transparency.

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Q How do risk considerations differ by asset class and strategy?

On a micro level, it is clear that certain industries are playing a role in the evolution of the most recent banking crisis. Early-stage tech firms and commercial real estate investment have tended to be heavily dependent on small and medium-sized regional banks, receiving favourable terms that may not continue in the future.

By contrast, later-stage buyout strategies have been less exposed because underlying portfolio companies – typically larger in size and more mature – are more likely to have their cash operations at major banks.

While different strategies have exposures to different types of underlying risk, all are exposed to tightening financial conditions. No matter the stage, all investors are exposed to industry-based challenges like supply chain and operational risks.

Q What risks are rising to the top of asset owners' agendas and how can they proactively manage those?

Increased volatility in public markets over the past six months or so has resulted in private markets allocations increasing in size, meaning many of our clients are hitting the limits of their defined investment policy statements and

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thereby facing the denominator effect.

Then there is a knock-on impact in terms of new commitment activity, resulting in increased liquidity risk. This is due to the long holding periods in private markets and because asset owners are heavily exposed to indirect investments, meaning they don't have a choice about getting out unless they sell on the secondaries market.

Asset owners facing deviation from target allocations and tightened liquidity under new interest rate regimes across the globe require appropriate cashflow forecasting models to capture volatility, as well as capital calls and distributions, so they can address the pacing risk associated with changes in the market cycle. The top priorities now are concerns on overallocation and volatility in capital calls and distributions, coupled with liquidity challenges with respect to underlying GPs and portfolio companies.

Q What is the ripple effect of macroeconomic shocks on private markets?

The first ripple effect is total portfolio risk, driven by interest rate hikes, the banking crisis and various sovereign factors. Then you have the denominator effect putting pressure on investors as they hit the upper limits on allocations within their plans. This requires adequate liquidity management technology to forecast cashflow and stress test capabilities so you can predict where issues are likely to crop up in the future.

In addition to those two impacts, we are also seeing a direct impact on portfolio companies banking with these distressed banks, leading to interruptions in operations and a hit to the bottom line. Meanwhile, a prolonged deterioration in financial conditions and increased borrowing costs are expected to result in declining deal volume and a repricing in private markets.

However, we are also seeing opportunity because of the macroeconomic environment, not only in terms of these distressed regional banks, but more generally across various industries. We believe there will be an increased opportunity for private markets players to deploy capital in distressed assets, potentially resulting in strong returns.

Q What have asset owners learned from the covid era about responding to the unexpected?

Asset owners are now more acutely aware that they need to understand exactly what they are exposed to, and to do that they need granular data on the funds they hold – in addition to pacing models versus market timing. Meanwhile, investors tend to take comfort in fund managers they know, while also pivoting towards large, well-established managers rather than new entrants.

Q Have asset managers learned lessons as well?

In streamlining the exchange of information between asset managers and asset owners, we are seeing a significant increase in memos from asset managers during the current banking crisis, communicating how funds and portfolio companies are exposed to at-risk banks and then detailing their ability to extract funds from those banks. That inbound communication reflects a degree of proactivity we haven't seen before, even during covid, and so could certainly be seen as a lesson learned.

Q What role can technology play in risk management?

Clearly, understanding total portfolio risk is critical. Technology, like the Aladdin® platform, when combined with eFront®, offers a whole portfolio view. We have developed a full set of risk factors to evaluate public and private exposure, and to show how stress testing can be used to understand market volatility and support decision-making around diversification and hedging against those risks. That is important because it is not just about understanding risks, it is also about making decisions to protect against the downside.

Technology also has a role to play when it comes to valuation models and underlying capital markets assumptions to assess the attractiveness of a rapidly changing opportunity set. In other words, technology allows investors to understand their total plan risk while also providing them with the tools and data needed to make important decisions.

But it goes beyond technology alone. Robust risk management also requires the availability of a first-class data clearinghouse during market turmoil. To that end, our technology and analytics teams worked alongside renowned researchers and policy experts within the firm to help clients digest and understand possible market scenarios and potential outcomes.

Q How can asset owners better prepare for shocks in the future?

It's all about having the right technology and operational risk management plans in place to help protect against the potential market downturns. That is vital for preparing for the future shocks we know are inevitably going to happen. Investors should also ask for more information from asset managers to mimic a mark to market approach, to understand what is driving those valuations and to ensure they are being marked appropriately.

Technology is critical in this – providing transparent access to data to support the monitoring of potential exposures that are affected by macro and market shocks. A recent survey we conducted found that greater transparency around reported performance was a priority for all types of asset owners, from large institutional investors to high-net-worth individuals, as they seek to manage through periods of shock and rebalance their portfolios. ■

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