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INVESTING IN PRIVATE MARKETS: BEST PRACTICES FOR FAMILY OFFICES

A series for building and managing a private markets portfolio

This is the third of a four-piece series under the heading, "Investing in Private Markets: Best Practices for Family Offices." In the series, we focus on the unique challenges of investing in private markets and how family offices can most effectively address them. For other pieces in this series, please click here.

3. RETAINING PORTFOLIO LIQUIDITY WHEN INVESTING IN PRIVATE MARKETS

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The many advantages of private market investing come with a structural cost: illiquidity. Unlike public market allocations, private market commitments cannot be unwound on demand, and the consequences of underestimating liquidity requirements can be severe. Families that invest in private markets without a disciplined liquidity management framework may find themselves limited in their ability to respond to unforeseen demands, such as a major life event, a generational transition, or simply a shift in family priorities.

Family offices can manage this risk, but it typically involves a creative balancing act that allows families the benefits of private markets while protecting them from severe liquidity crunches. Maintaining this balance often requires sophisticated forecasting tools and a planning time horizon that may last decades. In this piece, we will identify best practices we see among family offices for managing liquidity risk.

A NEW RISK TO MANAGE: THE CASH FLOW DYNAMICS OF PRIVATE MARKETS

Private markets are subject to the same kinds of risks that public markets are – business failures, market declines, economic weakness, concentration risk, and the like. But liquidity risk is different, because of how much money needs to be committed to a private markets program and for how long. A private markets program is unlikely to be successful without sophisticated liquidity planning and management.

We believe effective liquidity management begins with a clear-eyed understanding of how private markets behave over time. Capital is not deployed at once; it is called gradually over an investment period that typically spans several years. During that period, in our experience, the portfolio is almost always cash-flow negative, meaning capital is going out and distributions back to the investor have not yet begun. This is the J-curve dynamic – there is no exit button, and allocation adjustments can take a long time to execute. For that reason, family offices need to think and plan well in advance, being highly cautious in their liquidity planning.

PREPARING FOR LIQUIDITY RISK

Best Practice #1: Develop a Pacing Plan for Capital Commitments

We believe a well-constructed pacing plan is the foundation of private markets liquidity management. The goal is to look holistically at the family's portfolio, mapping cash flows over a multi-year horizon. Pacing plans model expected capital calls and distributions for both existing and proposed new commitments. By comparing the pacing plan to known liquidity demands, the family office can lay out guidelines geared to the family's liquidity profile, and not just their return objectives.

These guidelines can be extremely useful in helping families avoid a common mistake: making too many capital commitments in strong markets. The temptation to do so can be strong, but pacing guidelines draw attention to liquidity risks that may become unacceptable down the road.

Best Practice #2: Ensure Pacing Plan Incorporates Planned Overcommitments

As we noted in piece #2 of this series, Tackling Private Market Portfolio Construction, overcommitment is a necessary best practice when building a private markets portfolio. In private market funds, capital is called gradually rather than deployed all at once. Overcommitment is the practice of making commitments that exceed your target allocation in nominal terms, so that not-yet-called capital isn't sitting idly on the sidelines.

In our experience, a pacing plan needs to incorporate an appropriate private markets allocation and the capital overcommitments needed to reach that allocation. Comprehensive pacing plans provide a needed dose of discipline. Plus, over time, the movement of capital into various funds and vintage years can be structured to ensure that the cadence of calls and distributions across a portfolio of funds will allow for the smoothing out of cash flow.

DETAILED FORECASTING

Best Practice #3: Detailed Liquidity Forecasting

While a pacing plan evaluates the cash flow dynamics of a portfolio, family offices can also benefit from looking at family cash needs and how they may evolve over the life of a private markets program. We believe regular, consistent liquidity forecasting is essential in that it captures both predictable family needs and unexpected tail risks.

Forecasting tools can vary widely in terms of capabilities and sophistication, and this is an area where sophistication is worthwhile. More advanced modeling tools can stress-test a portfolio against a range of scenarios – accelerated capital calls, simultaneous liquidity demands from other parts of the balance sheet, unexpected life events – and identify vulnerabilities well before they become problems.

Best Practice #4: Set Up Liquidity Guardrails

Establishing clear liquidity guardrails provides a disciplined framework that can prevent short-term pressures from forcing long-term mistakes. Guardrails can take many forms:

- Allocation-based guardrails, such as a ceiling on private markets as a percentage of total portfolio value.
- Cash or liquid asset floors, such as a minimum liquid asset ratio.
- Timing and pacing rules, such as a restriction on making new commitments within a defined window of a known liquidity event.
- Stress-test thresholds, such as a requirement that the portfolio can withstand an accelerated call scenario.
- Concentration limits, such as a limit on the share of commitments maturing or entering their active call period in any single year.

The most effective guardrails we have observed tend to be simple, agreed to in advance, and treated as binding. Their value is that they remove discretion in moments when the temptation to make exceptions is highest.

Best Practice #5: Build a Liquidity Cushion with a Line of Credit

Even the most carefully constructed pacing plans and liquidity forecasts cannot anticipate all liquidity risks. Family offices should ensure that liquid reserves are sized conservatively, erring toward more than seems necessary rather than less. The broader portfolio should also include a meaningful allocation to readily marketable assets that can be liquidated efficiently if needed. Acquiring and maintaining a line of credit is another option for family offices to consider. Using a credit line routinely can be costly, so preferably it should be used primarily as a backstop and an additional layer of flexibility. But having it in place can bridge the gap when liquidity demands and capital calls coincide.

THE VALUE OF THOUGHTFUL DESIGN

Liquidity risk in private markets is not a reason to avoid the asset class — it is a reason to approach it with discipline and foresight. In this piece, we have focused on building a sound pacing framework, maintaining rigorous liquidity forecasting, and holding appropriate reserves as key elements of managing liquidity risk in a private markets program. Other pieces in this series address further best practices, including manager selection, due diligence, and portfolio construction.

A well-designed private markets program is a powerful tool for family offices, but that power comes with complexity, and complexity rewards thoughtful design and consistent execution. The families who benefit most from private markets are those who approach it with patience, discipline, and a trusted partner like NEPC who can provide both the framework and the ongoing guidance to navigate it well.

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