Abstract:

Listed private equity (LPE) provides investors with a liquid means of considering private equity in their portfolios. This paper presents a first-order autoregressive Markov-Switching model (ARMS) which is able to capture the characteristics of the asset classes bonds, stocks, and LPE, such as heavy tails and autocorrelation. Optimizing a portfolio between bonds, stocks, and LPE shows that an investor benefits from including LPE due to the high diversification effects, which also holds for a very risk-averse investor. Allocating a portfolio with the presented Markov-Switching optimization can help to significantly outperform a portfolio which is optimized assuming an underlying Geometric Brownian Motion (GBM) - even during the financial crisis: The terminal value of a portfolio of a model investor with medium risk aversion was on average 8.7% higher over the three years 2007 until 2009 than the GBM portfolio.