

Private Equity and Venture Capital in Institutional Portfolios

From Asset-Class Labels to Exposure-Based Allocation

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Abstract

Private equity and venture capital are widely treated as asset classes within institutional portfolios, providing a convenient framework for allocation, reporting, and benchmarking. However, this classification masks substantial variation in underlying exposures, liquidity characteristics, and governance requirements across strategies. While institutional investors are generally aware of this heterogeneity, allocation and evaluation frameworks continue to rely on simplified labels, creating a persistent gap between how capital is categorized and how it behaves in practice.

This paper examines whether private equity and venture capital function as coherent asset classes, or whether they are better understood as implementation channels through which distinct exposures are accessed. By analyzing risk, return dispersion, liquidity constraints, and governance demands, the paper shows that outcomes in private markets are driven less by the asset-class label and more by strategy selection, manager access, and institutional capability.

Reframing private equity and venture capital as implementation channels provides a more precise foundation for portfolio design. It shifts the focus from category-based allocation toward exposure-based decision-making, improving alignment between investment objectives, portfolio construction, and realized outcomes. The paper concludes that while asset-class labels remain useful for communication and governance, effective institutional investing requires a more explicit understanding of the exposures they represent.

Keywords: private equity; venture capital; institutional asset allocation; portfolio construction; illiquidity; governance; manager selection; return dispersion; investment strategy; asset classes; portfolio design; institutional investing

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1. Introduction — The Asset-Class Framing Problem

Institutional portfolios commonly treat private equity and venture capital as asset classes. In most policy portfolios, they appear alongside public equities, fixed income, and other broad categories, each assigned a target allocation and evaluated against long-term expectations. This framing is practical — it supports reporting, benchmarking, and communication with boards and stakeholders. However, it also compresses a wide range of fundamentally different strategies into a single label.

Private equity, as used in institutional contexts, typically encompasses buyout funds, growth equity, venture capital, distressed strategies, and hybrid approaches (Kaplan & Strömberg, 2009; Metrick & Yasuda, 2010). These strategies differ not only in investment approach, but in underlying economic exposures, use of leverage, cash flow characteristics, and outcome distributions. Venture capital expands this range through early-stage investments characterized by high uncertainty and return profiles driven by a small number of extreme outcomes (Gompers & Lerner, 2004). Despite these differences, allocations are often made and evaluated at the aggregate level.

Institutional investors are well aware of the heterogeneity within private markets. Allocation and reporting frameworks continue nonetheless to rely on simplified asset-class labels — creating a persistent gap between how capital is categorized and how it behaves in practice. This gap is not primarily a matter of knowledge, but of how investment decisions are structured, reported, and governed (Ang, 2014). Even sophisticated institutions that understand the differences across strategies continue to allocate capital using aggregated categories and evaluate outcomes against asset-class level expectations.

The persistence of this framing reflects operational convenience more than analytical precision. Asset classes provide a common language for investment committees and consultants, enabling aggregation and comparison across portfolios (Swensen, 2009; Ang, 2014). When the classification does not map cleanly to underlying exposures, the asset-class label becomes less useful for understanding portfolio behavior and can lead to allocation decisions that do not align with the risks being taken.

This paper examines whether private equity and venture capital function as coherent institutional asset classes, or whether they are better understood as heterogeneous implementation channels that deliver distinct exposures. It builds on the framework developed for hedge fund allocation — where the same question of category versus exposure applies across liquid alternative strategies — and applies it to the specific structural, liquidity, and governance demands of private markets (Sing, 2018). The objective is not to redefine terminology, but to address the gap between how capital is categorized and how it behaves in practice, and to improve how allocation decisions are made as a result.

2. What Makes an Asset Class Useful to an Allocator?

For institutional portfolios, an asset class is not simply a category of investments — it is a decision-making tool. Its value lies in its ability to translate an allocation decision into a reasonably stable and interpretable set of exposures, risks, and expected behaviors within a portfolio (Ang, 2014). When a CIO allocates capital to an asset class, the implicit assumption is that the allocation will produce outcomes broadly consistent with the role that asset class is intended to play.

This requires a stable mapping across four dimensions. The asset class should have identifiable risk drivers — public equities, for example, are primarily driven by economic growth, corporate earnings, and market sentiment (Ilmanen, 2011). It should exhibit a recognizable return structure, allowing allocators to form expectations about long-term performance. It should have a well-defined liquidity profile, including both the timing and certainty of cash flows. And it should impose governance requirements that are understood and manageable within the institution's capabilities.

These dimensions — risk, return structure, liquidity, and governance — interact to define the role an asset class plays within a broader portfolio (Ang, 2014; Ilmanen, 2011). The usefulness of an asset class lies not in its label, but in the consistency of these relationships over time. When an allocation reliably produces a particular combination of exposures and constraints, the category becomes meaningful for portfolio construction.

When these dimensions vary widely within a category, however, the asset-class label loses analytical usefulness. Aggregation masks important differences, and allocation decisions become less precise (Ang, 2014). Strategies grouped under the same label may have fundamentally different liquidity profiles, risk drivers, and governance demands, yet be treated as interchangeable within a single allocation bucket. The category functions as an organizational convenience rather than a reliable decision framework.

This distinction is often understood conceptually but not consistently applied. Institutions recognize that private markets are heterogeneous, yet allocation decisions, reporting structures, and performance evaluation continue to rely on aggregated categories. The result is a disconnect between how portfolios are described and how they behave — most visible when allocation decisions do not translate into expected outcomes.

3. Private Equity and Venture Capital: One Label, Multiple Exposures

Private equity encompasses a wide range of strategies that differ materially in underlying exposures, risk profiles, and portfolio roles (Kaplan & Strömberg, 2009; Metrick & Yasuda, 2010). The label remains constant, but what it represents varies significantly depending on how capital is deployed.

Within private equity, buyout strategies typically involve acquiring controlling stakes in established businesses, often with the use of leverage. The resulting exposure combines equity

ownership with financial structuring, with returns driven by operational improvements, multiple expansion, and capital structure optimization (Axelson et al., 2013). Growth equity involves minority investments in companies that are scaling but not yet mature, with less reliance on leverage and a different balance between risk and upside.

Venture capital, often treated institutionally as a subset of private equity, introduces a further shift. Early-stage investments are characterized by high uncertainty, limited operating history, and return distributions driven by a small number of outsized outcomes (Gompers & Lerner, 2004; Korteweg & Nagel, 2016). The economic exposure is tied less to current cash flows and more to the potential for future market adoption or technological leadership. Even within venture capital, differences between seed, early-stage, and late-stage investing create materially different risk-return profiles.

Distressed and special situations strategies add another layer of variation, often overlapping with credit markets and involving restructuring or turnaround scenarios. These strategies can behave differently from both buyout and venture capital, particularly in terms of downside protection and sensitivity to economic cycles.

Despite this range, institutional allocations are frequently made under a single "private equity" or "private equity and venture capital" category. Two portfolios with the same percentage allocation to private equity may have materially different underlying exposures depending on their mix of buyout, venture, growth, and distressed strategies. The variation within private equity and venture capital can exceed the variation between traditional asset classes — a portfolio concentrated in early-stage venture capital is fundamentally different from one focused on large buyout funds, not only in expected return, but in volatility, liquidity, and dependence on manager selection (Harris et al., 2014).

The issue is not that the label is incorrect, but that it is incomplete. It captures a broad category of investments, but does not provide sufficient clarity on the underlying exposures that ultimately drive portfolio outcomes.

4. Risk and Return: Dispersion, Leverage, and Outcome Uncertainty

The risk and return characteristics of private equity and venture capital are often summarized at the asset-class level. Long-term return expectations, historical performance ranges, and benchmark comparisons are commonly used to inform allocation decisions. These summaries fail to capture the fact that outcomes are actually driven by factors that vary significantly across strategies and managers.

A defining feature of private markets is the degree of dispersion in outcomes. The difference between top-quartile and bottom-quartile funds can be substantial, with median outcomes providing only a limited representation of the range of possible results (Kaplan & Schoar, 2005; Harris et al., 2014). Institutions do not experience "average" private equity or venture capital

returns. Outcomes are driven by manager selection, access, and the ability to construct a diversified program across vintages and strategies.

Access to top-performing managers is structurally uneven. Institutions with established relationships and consistent commitment programs are more likely to access top-tier funds, while others are limited to a different segment of the opportunity set. This unequal access to top-performing managers is not reflected in asset-class level return expectations.

In buyout strategies, leverage plays a central role in shaping both returns and risk. Financial structuring can amplify returns in favorable conditions but increases sensitivity to credit markets and economic downturns (Axelson et al., 2013). Buyout risk cannot be understood solely in terms of underlying business performance — it also reflects capital structure decisions and market conditions at entry.

Venture capital introduces a different form of uncertainty. Return distributions are highly asymmetric, with a small number of investments accounting for a disproportionate share of total returns (Korteweg & Nagel, 2016). Many investments fail or generate modest outcomes, while a few successful companies drive overall performance. This dynamic requires a different approach to diversification and risk management than buyout strategies or public equities.

Asset-class level return expectations can therefore be misleading — they imply a level of stability and comparability that is not reflected in realized outcomes. Allocations are often justified using aggregate performance data, but realized outcomes are driven by decisions made at a more granular level. Over time, this can lead to persistent mismatches between expected and actual performance, particularly for institutions that lack the governance capacity or access required to build top-tier private market programs.

5. Liquidity: Illiquidity Is Not a Single Risk

Illiquidity is often cited as a defining characteristic of private equity and venture capital. It is commonly associated with an "illiquidity premium," where reduced flexibility is exchanged for higher expected returns. This framing treats illiquidity as a single attribute when it consists of several distinct risks (Ang, 2014; Ilmanen, 2011).

Private market investments typically involve long holding periods structured through closed-end funds. Capital is committed upfront but drawn down over time, creating uncertainty around deployment. Distributions are similarly uncertain, depending on the timing of exits influenced by market conditions, company performance, and strategic considerations. This introduces not only duration risk, but also variability in cash flow timing that is difficult to model precisely (Ang, 2014).

These characteristics differ across strategies. Buyout funds focused on more mature businesses tend to have more predictable capital deployment and exit pathways, even if timing varies with market cycles. Venture capital involves greater uncertainty in both timing and magnitude of outcomes. Early-stage investments may take longer to mature, and exits are often dependent on

broader technological and capital market developments. The liquidity profile of venture capital therefore differs fundamentally from that of buyout strategies, despite being grouped under the same label.

Secondary markets and continuation vehicles have introduced additional flexibility, but they do not eliminate liquidity risk. Secondary transactions are often opportunistic and may occur at discounts to net asset value, particularly in stressed environments (Preqin, 2020; McKinsey & Company, 2021). These mechanisms provide optionality, not certainty, and their availability varies across market conditions.

Treating illiquidity as a uniform premium can lead to misaligned expectations. The risks associated with long-duration commitments, uncertain cash flows, and limited exit optionality are not identical across strategies, nor are they consistently compensated (Phalippou & Gottschalg, 2009). The premium may be offset by fees, dispersion in manager performance, or adverse market timing.

These differences become most visible during periods of market stress, when liquidity constraints limit flexibility precisely when it is most needed. Institutions that rely on aggregate assumptions about private market liquidity may find that actual cash flows diverge significantly from expectations when distributions slow and capital calls continue. Illiquidity should therefore be treated not as a single risk factor attached to an asset-class label, but as a set of distinct constraints that vary across strategies and over time.

6. Governance: The Hidden Cost of Allocation

Allocating to private equity and venture capital requires a level of institutional governance that differs materially from traditional asset classes. Public equities and fixed income can be accessed through liquid markets and standardized vehicles, whereas private market investments require manager selection, ongoing monitoring, and active portfolio construction decisions that place significant demands on institutional resources (Ang, 2014; Ambachtsheer, 2015).

In this context, governance refers to the operational and organizational capacity through which private market allocations are implemented and managed — encompassing manager selection, pacing discipline, portfolio monitoring, and the expertise required across strategy types.

Manager selection sits at the center of these demands. Outcomes in private markets depend heavily on access to top-performing managers, which depends on relationships, reputation, and the ability to commit capital consistently over time (Kaplan & Schoar, 2005). Unlike public markets, where exposure can be adjusted dynamically, private market allocations are built through commitments that lock in exposure for extended periods. Initial selection decisions are therefore particularly consequential.

Beyond selection, institutions must manage pacing and diversification across vintages, strategies, and geographies. Commitment decisions made in one period shape portfolio exposures for years, requiring forward-looking planning and coordination. Over-commitment can create liquidity

strain; under-commitment leads to persistent underexposure relative to policy targets. These dynamics are not captured in high-level asset allocation frameworks.

Governance requirements also vary across strategies. Venture capital requires deeper engagement with emerging sectors, higher tolerance for uncertainty, and longer investment horizons. Buyout strategies involve different considerations, including leverage, operational improvements, and exit timing. Distressed and special situations strategies introduce additional complexity, including legal and restructuring dynamics. Treating these strategies as a single asset class obscures the extent to which they require different forms of expertise and oversight.

Governance capacity is not simply a supporting factor — it is a primary determinant of how effectively private market allocations translate into realized outcomes. Institutions with greater governance capacity are structurally better positioned to build diversified programs, maintain relationships with top-tier managers, and manage pacing effectively (Ambachtsheer, 2015). Institutions with more limited resources face constraints that affect both access and execution.

A common and costly pattern is that governance requirements are underestimated at the allocation stage. Decisions are made at the level of target allocations, but the resources required — such as staffing, expertise, manager diligence, portfolio monitoring, and operational coordination — to implement those allocations are not fully accounted for. Over time, this produces persistent shortfalls between intended and realized exposures, as well as variability in outcomes across institutions with similar allocation targets.

7. From Asset Classes to Implementation Channels

The preceding discussion reveals a recurring pattern: private equity and venture capital are commonly approached through an asset class lens, yet their underlying characteristics vary significantly across strategies. A more precise framing treats them as implementation channels rather than coherent asset classes. The focus shifts from the label itself to the underlying exposures it aggregates. Private market structures — closed-end funds, long-duration commitments, and active ownership — serve as mechanisms through which capital is deployed, but they do not define a single, uniform economic exposure (Ang, 2014).

Private equity and venture capital are not exposures in themselves, but structures that package different underlying exposures. Buyout strategies are best understood as leveraged equity exposure, combining ownership of operating businesses with financial structuring (Axelson et al., 2013). Growth equity provides exposure to expanding companies with less reliance on leverage than buyout strategies, and with return profiles driven more heavily by growth execution, market adoption, and long-duration value creation. Venture capital represents exposure to innovation and optionality, where outcomes are driven by a small number of highly successful investments (Korteweg & Nagel, 2016). Distressed and special situations strategies may overlap with credit markets, combining elements of equity upside and downside protection through restructuring.

Viewed this way, variation within private equity and venture capital is not a source of noise to be simplified, but a defining feature that should inform allocation decisions. The same label can encompass exposures that differ in sensitivity to economic cycles, liquidity characteristics, and dependence on manager selection. Treating these exposures as interchangeable within a single allocation obscures how they contribute to overall portfolio risk and return.

This reframing does not imply that asset-class labels should be abandoned. Labels remain useful for communication, reporting, and high-level organization. For decision-making purposes, however, the relevant question shifts from "how much private equity" to "which exposures are being represented, and through which structures." This distinction matters particularly when integrating private markets into a broader portfolio, where overlaps with public equities, credit, and other asset classes can be significant (Ilmanen, 2011).

This framing also aligns more closely with how outcomes are experienced. Institutions do not realize returns from "private equity" in aggregate — they realize returns from specific exposures implemented through particular structures and managers. Viewing private equity and venture capital as implementation channels provides a clearer link between allocation decisions and portfolio outcomes, and reduces reliance on categories that do not fully capture underlying risks.

8. Implications for Institutional Portfolio Design

Reframing private equity and venture capital as implementation channels has direct implications for how institutional portfolios are constructed and managed. While asset-class labels may remain in place for reporting and governance, allocation decisions can be made with greater precision by focusing on underlying exposures. Labels should be treated as an entry point rather than a conclusion — useful for organizing communication, insufficient for disciplined decision-making.

Allocation sizing can be defined in terms of exposure rather than category. Instead of setting a target allocation to private equity as a single bucket, institutions can identify the exposures they seek — leveraged equity, growth-oriented equity, innovation-driven returns — and determine the mix of strategies required to achieve them (Ang, 2014). This improves alignment between portfolio objectives and the characteristics of the investments used to achieve them.

Diversification within private markets can be defined more explicitly. Diversification is often measured by the number of funds or managers in a portfolio, but this does not necessarily translate into diversification of underlying exposures. A portfolio concentrated in a single strategy across multiple managers may still be exposed to similar risks. Diversification across strategies — buyout, venture, and distressed — provides more meaningful differentiation in risk drivers, liquidity profiles, and return structures (Ilmanen, 2011).

Commitment pacing can be aligned more closely with liquidity characteristics. Illiquidity is not a single risk, but a combination of duration, cash flow uncertainty, and exit timing variability. Recognizing this allows institutions to design commitment strategies that manage capital calls

and distributions, balance commitments across vintages, and maintain flexibility in response to changing market conditions (Ang, 2014).

Integration with the broader portfolio becomes more transparent. When private equity and venture capital are viewed as implementation channels, their relationship with other asset classes can be assessed directly. Leveraged buyout exposure may overlap with public equity and credit risk; venture capital may provide differentiated exposure to innovation and technological change. Recognizing these overlaps improves portfolio-level risk management.

Governance considerations can be incorporated more explicitly into allocation decisions. Different strategies require different levels of expertise, resources, and access. Linking allocation decisions to governance capacity allows institutions to align their private market ambitions with their ability to execute effectively (Ambachtsheer, 2015) — influencing not only allocation size, but strategy selection and implementation approach.

The shift required is from allocating to categories toward defining target exposures first and selecting implementation strategies second. This introduces additional complexity at the design stage but provides a more consistent basis for decision-making and reduces the risk of misalignment between intended and realized outcomes.

9. Conclusion — From Categories to Exposure-Based Thinking

Private equity and venture capital play an important role in institutional portfolios, providing access to investment opportunities that differ from traditional public markets. As asset-class labels, they serve a genuine operational function — supporting communication, benchmarking, and governance (Swensen, 2009). But they do not function as coherent asset classes in the same way more traditional categories such as public equities or fixed income do. The variation within these categories — in risk drivers, return structures, liquidity profiles, and governance requirements — is substantial (Kaplan & Strömberg, 2009; Korteweg & Nagel, 2016).

Reframing private equity and venture capital as implementation channels shifts the focus from category to underlying exposure. This improves alignment between allocation decisions and portfolio objectives, and provides a clearer basis for managing risk, liquidity, and governance (Ang, 2014). Allocation decisions can be defined with greater specificity, diversification can be structured around exposures rather than categories, and governance considerations can be incorporated more explicitly into portfolio design.

For institutional allocators, the operative question is not whether a portfolio has an allocation to private equity or venture capital. It is what that allocation represents in terms of risk, return, liquidity, and governance — and whether the implementation chosen is capable of delivering results that align with expectations. Asset-class labels organize thinking. Exposure-based frameworks determine outcomes.

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