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ASSET CLASS REVIEW

Opportunities, Risks & the Evolving Liquidity Landscape

CABA CAPITAL

Executive Summary

This white paper provides a summary review of the major investable asset classes available to professional allocators in the current environment. It examines expected returns, risk characteristics, liquidity profiles, and the structural shifts reshaping cross-asset correlations. Four themes (selected from many possible themes) are important:

- **Wider range of asset classes.** The development in markets, technology, regulation and fund distribution means that professional investors today have access to a wider range of asset classes. This increases options for building diversified and resilient portfolios but also elevates the complexity and required knowledge for the allocator.
- **The stock–bond diversification relationship has broken down.** Following four decades of declining inflation, the negative correlation between equities and government bonds that underpinned traditional 60/40 portfolios has turned meaningfully positive in the post-2022 inflationary environment, challenging standard portfolio construction assumptions.
- **Private markets have emerged as a structurally significant asset class.** Private equity has continued to grow in importance and the retrenchment of bank lending following Basel III/IV regulation created a dramatic increase in direct lending by private credit managers and funds.
- **Liquidity premiums have repriced materially.** With public market yields elevated following the 2022–2023 rate cycle, the compensation for accepting illiquidity is narrower than at any point since the post-GFC era, demanding greater rigour in private markets capital allocation.

1. Macroeconomic Backdrop

The current investment environment is characterised by structurally higher interest rates relative to the 2010–2021 period, moderating but persistent inflation across developed markets, and significant geopolitical fragmentation and conflict affecting capital flows and supply chains. Central Banks in the US, the UK and the EU have been cautiously easing in an environment of persistent and above target inflation. These conditions have profound implications for all asset classes.

Real yields — a critical input to long-run equity and credit valuations — have risen from deeply negative territory (circa -1.5% in 2021) to approximately +1.5–2.0% on 10-year US TIPS. This repricing has been the dominant force reshaping relative value across asset classes and is central to the analysis that follows.

2. The Changing Stock–Bond Correlation

For much of the period between 1998 and 2021, government bonds served as a reliable hedge against equity drawdowns. The negative correlation between the two asset classes — averaging approximately -0.35 to -0.55 across this period — meant that a portfolio combining equities and bonds captured meaningful diversification benefit. This relationship was deeply embedded in the architecture of institutional portfolios worldwide.

The inflation shock of 2021–2023, however, changed this pattern. As central banks raised rates aggressively to combat inflation, both equities and bonds fell simultaneously. The 60/40 portfolio delivered its worst calendar-year return in decades in 2022. By 2024, the rolling 12-

month correlation between the S&P 500 and US 10-year Treasuries had turned positive, sitting in the range of +0.30 to +0.50.

The implication for portfolio construction is that simple duration exposure via government bonds no longer provides the hedge it once did. Risk parity strategies that rely on vol-adjusted bond allocations to offset equity risk are structurally challenged. Alternative investments with genuine diversifying properties — hedge funds and real assets — have become more valuable portfolio tools as a result.

3. Asset Classes

The sections below are brief summaries of the current global asset classes available to professional investors.

3.1 Global Equities

Public equity markets remain the primary return engine for most institutional portfolios. However, the valuation starting point matters significantly for long-run return expectations. US equities trade at a cyclically adjusted P/E ratio (CAPE) of approximately 35-38x, representing a significant premium to long-run norms of approximately 16–17x.[3]

Large institutional investors — including endowments, sovereign wealth funds and pension funds — typically use expected return assumptions for global equities in the range of 6.5–8.5% per annum in nominal terms, with real return expectations closer to 4–6%. These figures are materially below the realised returns of the 2010–2021 period, which were inflated by multiple expansion driven by falling discount rates.

Non-US developed market equities (Europe, Japan, UK) offer more attractive valuations at CAPE multiples of 15–22x, though structural headwinds — demographics, energy costs, geopolitical risk — temper enthusiasm. Emerging market equities incorporate a material political and currency risk premium.

3.2 Government Bonds

Government bonds have fundamentally repriced over the past three years. The 10-year US Treasury yield has moved from approximately 0.5% in 2020 to a range of 4.0–5.0% by 2025. UK Gilts and German Bunds offer real yields that are positive for the first time in over a decade.

For liability-driven investors — particularly defined benefit pension funds — this repricing has been broadly beneficial, improving funding ratios and reducing the need for complex derivative overlay strategies. However, for total-return investors, the path has been deeply painful: the Bloomberg Global Aggregate Bond Index fell approximately 16% in 2022 alone.

Duration risk remains material. Fama & French (1993)[4] and subsequent empirical work confirm that the term premium — the additional return investors require for bearing duration risk — is time-varying and can be sharply negative in environments where central bank credibility is questioned. Investors should treat government bonds as a source of income and moderate hedging, not as a riskless store of value.

3.3 Investment Grade & High Yield Credit

3.3.1 Investment Grade Credit

Investment grade corporate credit offers spreads of approximately 80–120 basis points over equivalent government bonds, providing all-in yields of 4.5–5.5% in USD currently. This represents some compensation for credit risk, though spreads remain compressed relative to historical norms during periods of economic uncertainty.

3.3.2 High Yield Credit

The high yield market offers all-in yields of approximately 6.5–7.5% in USD, with spread compensation of 300–400 basis points over risk-free rates. Default rates, while rising from cyclically low levels, remain manageable at approximately 3–4% on a trailing basis. The key risk is spread widening in a recessionary scenario, which could generate mark-to-market losses of 10–15% even in the absence of elevated defaults.

High yield credit exhibits meaningful equity beta — particularly in the CCC-rated tier — and thus provides less diversification benefit than higher-quality fixed income during risk-off episodes. For investors requiring liquidity, however, the public high yield market provides access to relatively liquid instruments compared with private credit.

3.4. Private Credit & Direct Lending

Private credit has grown from a niche strategy to a mainstream institutional asset class. Assets under management in private credit globally have grown from approximately $500bn in 2015 to over $3 trillion in 2025.

The structural driver is clear: post-GFC bank regulation — Basel III capital requirements, the Net Stable Funding Ratio, and leveraged lending guidance — has caused banks to structurally reduce their exposure to leveraged and middle market lending. Private credit managers have filled this void, typically providing senior secured loans to mid-market companies at floating rate coupons of SOFR + 500–700 basis points, generating gross returns of 9–11% before fees.

The key considerations for investors are:

- **Illiquidity risk:** Private credit funds typically offer quarterly redemptions at best, and senior secured loan funds may gate during periods of market stress.
- **Mark-to-model risk:** Unlike public markets, private credit valuations are based on manager models rather than market prices, potentially understating true volatility.
- **Manager dispersion:** The wide variation in underwriting standards and covenant protections across the market makes manager selection critical.
- **Concentration in sponsor-backed transactions:** A significant proportion of direct lending activity supports private equity-backed companies, creating systemic linkage between these two illiquid asset classes

The recent examples of private credit funds that have permanently restricted redemptions (Blue Owl Capital) or taken substantial write-downs on individual exposures (Blackrock TCP Capital) do seem to provide at least anecdotal evidence that the dramatic increase in private lending has led to some misallocation of capital.

3.5 Private Equity: The Exit Challenge

Private equity has delivered strong returns over the past two decades. The Cambridge Associates US Private Equity Index has generated net IRRs of approximately 14–16% over 10- and 20-year horizons, meaningfully above public equity benchmarks on a comparable time-weighted basis.[6]

However, the asset class currently faces structural challenges due to constraints on opportunities for exits. Private equity exits — whether via IPO, trade sale or sponsor-to-sponsor transaction — have declined significantly from the 2021 peak. Global PE-backed IPO volumes fell by approximately 70–80% between 2021 and 2023. M&A activity has been constrained by higher financing costs and a valuation gap between buyer and seller expectations.

The consequence is that LP distributions have fallen sharply. Many investors are receiving little or no cash back from their PE portfolios, reducing the capital available for re-investment. This has contributed to a growing secondary market for PE interests, where discounts of 10–20% to NAV have become routine for older vintage funds.

3.6 Hedge Funds

Hedge fund performance is determined by the strategy pursued. Systematic macro and trend-following strategies have delivered strong returns since 2022 as they capitalised on the sustained directional moves in rates, currencies and commodities. Multi-strategy funds have continued to generate consistent, if lower, risk-adjusted returns. Long-short equity has struggled in an environment of high correlation across individual securities.

From an institutional perspective, hedge funds are valued primarily for their diversifying properties — specifically their ability to generate returns that are uncorrelated with both equities and bonds. The Sharpe ratio of a diversified hedge fund allocation, net of fees, has historically been approximately 0.4–0.7, compared with 0.3–0.5 for equities over comparable periods.

New strategies are continually evolving within structured credit, CTA and arbitrage strategies. The separately managed account structures are increasingly preferred by large allocators. Terms around liquidity — gates, notice periods, lock-up provisions — have tightened since the experience from 2020.

3.7 Real Assets: Real Estate & Infrastructure

3.7.1 Real Estate

Commercial real estate has undergone a significant repricing globally. Office values have been most severely affected, falling 20–40% in major markets as the structural shift toward hybrid working reduces demand for traditional office space. Logistics and residential assets have shown greater resilience, supported by structural demand tailwinds.

Core real estate funds — the typical institutional vehicle — offer expected gross returns of 6–8.5%, of which approximately 4–5% is income returns and the remainder capital appreciation. Liquidity remains a significant risk, as was vividly demonstrated during the run on open-ended UK real estate funds in 2016 and again in 2020.

3.7.2 Infrastructure

Infrastructure has attracted significant institutional interest as a long-duration, inflation-linked asset class with characteristics well-suited to liability matching. Core infrastructure — regulated utilities, airports, toll roads — offers expected returns of 7–9%, with income yields of 4–6% and explicit or implicit inflation linkage.

The energy transition is creating an exceptional pipeline of investable opportunities in renewable energy generation, grid infrastructure, and energy storage. However, regulatory risk — particularly in politically sensitive sectors — remains a material consideration, as evidenced by changes to UK renewable energy subsidy regimes and the US suspension of all offshore windfarms under construction.

4. Global Asset Classes – development 2005-2025

The table below summarises the estimated global assets under management or market capitalization by era, USD trillions: 2005 = Pre-GFC credit boom | 2015 = Post-QE / ZIRP era | 2025 = Higher-for-longer (maybe?) regime.

Asset class	2005 Pre-GFC	2015 Post-QE	2025 Higher-for-longer	2005–2025 Growth
PUBLIC MARKETS				
Public equity	$37tn	$67tn	$115tn	**3.1×** (+211%)
Government bonds	$25tn	$58tn	$115tn	**4.6×** (+360%)
IG credit bonds	$5tn	$12tn	$26tn	**5.2×** (+420%)
HY credit bonds	$1.0tn	$2.5tn	$4.4tn	**4.4×** (+340%)
ALTERNATIVES				
Hedge funds	$1.1tn	$2.9tn	$4.9tn	**4.5×** (+345%)
Commercial real estate	$7tn	$14tn	$20tn	**2.9×** (+186%)
Private equity	$0.8tn	$3.4tn	$8.0tn	**10×** (+900%)
Private credit	$0.15tn	$0.5tn	$3.0tn	**20×** (+1,900%)
Infrastructure (Unlisted)	$0.05tn	$0.35tn	$1.1tn	**22×** (+2,100%)
TOTAL				
All asset classes combined	**~$77tn**	**~$161tn**	**~$297tn**	**3.8×** (+286%)
of which: private markets (equity, credit, infrastructure)	*~$1.0tn (1.3%)*	*~$4.3tn (2.7%)*	*~$12.1tn (4.1%)*	**12.1×** (+1,110%)

Sources

MSCI, BIS, ICE BofA, HFR, MSCI Real Assets / CBRE, Preqin, EDHECinfra, McKinsey Global Private Markets Report. Figures are approximate and reflect a combination of market capitalisation (public markets) and assets under management / notional outstanding (private markets and credit). Private markets AUM includes unrealised NAV and dry powder. All figures in USD at approximate year-end exchange rates. Totals may not sum precisely due to rounding and differing measurement methodologies across asset classes.

A few numbers stand out from the data:

The headline story is the explosion in private markets. Private equity grew 10× and private credit 20× over the two decades — both vastly outpacing the 3–5× growth seen across public asset classes. As a share of the total, private markets have grown from just 1.3% of tracked AUM in 2005 to 4.1% in 2025 — still small in relative terms, but the direction is unambiguous.

Government bonds are the other standout, growing 4.6× driven almost entirely by post-GFC and post-COVID fiscal deficits rather than investor demand. The $115tn of sovereign debt outstanding in 2025 is roughly equal to the entire global equity market cap.

The combined total across all eight asset classes has grown from roughly $77tn to $294tn — broadly in line with global nominal GDP growth.

5. Liquidity, Volatility and Return: The Central Asset Allocation Trade-off

Every investment decision involves an explicit or implicit choice across three dimensions: how quickly capital can be accessed (liquidity), how much the value of that capital may fluctuate in the interim (volatility), and what return the investor can expect to receive as compensation for accepting these risks (return). The risk of default could be added although it can be regarded as an element of volatility. The relationship between these three variables is not fixed — it shifts with the macroeconomic regime, the credit cycle, and market structure — but certain structural trade-offs are enduring and deserve to sit at the centre of any institutional asset allocation framework.

Liquidity	Volatility	Expected return
The speed and cost at which an asset can be converted to cash without material price impact. Daily liquid public markets sit at one extreme; closed-end private equity funds with 10-year lockups at the other. Liquidity is not binary — it exists on a spectrum and can evaporate suddenly in market stress even for nominally liquid instruments.	The magnitude of price fluctuations around an expected return, typically expressed as annualised standard deviation. Crucially, reported volatility for private assets is an underestimate: mark-to-model valuations smooth returns artificially. True economic volatility for private equity is probably closer to 25–35% — comparable to small-cap equities.	The forward-looking, risk-adjusted compensation an investor expects to receive over a full cycle. In the current environment, the gap between liquid and illiquid expected returns — the illiquidity premium — has narrowed materially as public market yields have risen, demanding greater rigour before accepting lockup constraints for incrementally higher projected returns.

Three Structural Trade-Offs

The first trade-off is **liquidity versus return.** Investors who accept reduced access to their capital should, in theory, be rewarded with a premium. Over long horizons this relationship has held: private equity has outperformed public equity, and private credit has offered spreads above comparable public market instruments. However, this premium is time-varying. In the post-2022 environment, with investment grade credit yielding 4.5–5.5% and high yield at 6.5–7.5%, the incremental return for accepting a decade-long lockup in private equity has compressed. Institutional allocators are increasingly asking whether the illiquidity premium on offer justifies the associated loss of optionality.

The second trade-off is **volatility versus return.** Higher expected returns almost universally require tolerating greater volatility. Public equities, private equity and high yield credit all sit in the high-return, high-volatility quadrant. Government bonds and investment grade credit occupy the low-return, low-volatility space. Hedge funds and infrastructure attempt to offer intermediate return with lower volatility — though the former through manager skill, the latter through asset characteristics. The critical caveat is that private market volatility is systematically understated: the absence of daily mark-to-market pricing creates an illusion of stability that can mislead portfolio construction and risk models alike.

The third — and most important for portfolio construction — is the **interaction between all three.** An investor with long-dated liabilities and no near-term cash needs (such as a closed defined benefit pension fund or an endowment) can rationally accept illiquidity and volatility in exchange for higher expected returns: they have the time horizon to ride out drawdowns and no forced selling risk. An investor with near-term obligations, open-ended redemption commitments, or regulatory capital requirements must weight liquidity far more heavily — potentially accepting lower returns — to ensure the portfolio can meet its obligations under stress. The 2022 UK LDI crisis demonstrated with painful clarity what happens when these constraints are ignored at scale.

Asset Class Comparison: Liquidity, Volatility & Expected Return

Asset class	Liquidity	Volatility	Exp. return	Institutional perspective
Public equity *Global / developed mkt*	**High** (Daily)	**High** (14-18% p.a)	**Moderate/ High** (6.5-8.5% p.a)	Maximum liquidity but significant drawdown risk; CAPE-sensitive entry point critical.
Government bonds *IG sovereign, 5–10yr*	**High** (Daily)	**Moderate** (5-8% p.a)	**Low /Moderate** (3.5–4.5% p.a)	Liquid safe haven, but inflation erodes real returns; no longer reliable equity hedge post-2022.
IG credit *BBB–AA corporate bonds*	**Moderate /High** (Daily)	**Low /Moderate** (4–6% p.a)	**Moderate** (4.5–5.5% p.a)	Attractive all-in yield with moderate credit risk; BBB cliff risk in recession scenarios.

Asset class	Liquidity	Volatility	Exp. return	Institutional perspective
HY credit *BB–CCC rated bonds*	**Moderate** (Daily /Weekly - depending on size and bond)	**Moderate** (8–12% p.a)	**Moderate** (5.5–7.5% p.a)	Spread compensates for default risk, but equity-like drawdowns in stress; weak covenants a concern.
Hedge funds	**Moderate–Low** (Monthly / Quarterly)	**Low–Mod** (5–10% p.a)	**Moderate** (5–8% p.a)	Genuine diversification if uncorrelated to equities; gate risk in stress; fee drag requires scrutiny.
Private credit	**Low** (Quarterly /Annual)	**Low*** (Model)	**High** 8.5–11%	Highest current income yield but illiquid; mark-to-model masks true volatility; manager quality critical.
Private equity	**Very Low** (7-12 yr lockup)	**High** 25–35% (est.)	**High** (10–14% p.a)	Maximum return potential but decade-long lockup and constrained exits are live risks.
Commercial Real estate	**Low** (Quarterly /Annual)	**Moderate** (10–15% p.a)	**Moderate** 5–7.5% p.a)	Inflation linkage attractive; office secular decline a structural drag; open-ended fund gate risk.
Infrastructure	**Very Low** (Multi-Year lock-up)	**Low/ Moderate** (8–12% p.a)	**Moderate /High** 6–9%	Best inflation linkage; long-duration cash flows suit pension liabilities; regulatory risk non-trivial.

Note: Expected returns are forward-looking nominal estimates for 2025 conditions. Volatility ranges for private assets are approximations based on unsmoothed return data. This analysis does not constitute investment advice and is intended for professional investors only.

6. Portfolio Construction Implications

The table in section 5 above makes clear that no single asset class dominates across all three dimensions. An optimal professional portfolio therefore seeks to construct a deliberate balance: sufficient daily-liquid exposure to meet obligations and rebalance opportunistically; a core allocation to moderately liquid assets that provide income and diversification; and a carefully sized illiquid allocation where the return premium genuinely compensates for lockup risk, model uncertainty and reduced optionality.

A practical framework used by leading pension funds and endowments segments the portfolio into three liquidity tiers:

- a **liquid core** (equities, government bonds, IG credit — typically 50–65% of portfolio) that can be liquidated within days;

- a **semi-liquid buffer** (high yield, hedge funds — 15–20%) redeemable within weeks to months;
- and an **illiquid return engine** (private equity, private credit, infrastructure, real estate — 20–35%) that is committed for the long term with no expectation of near-term access. The precise sizing of each tier must reflect the investor's liability profile, regulatory constraints, and stress-scenario liquidity requirements — not simply a desire to capture the highest headline return.

One of the most important frameworks for asset allocation is the liquidity spectrum — the trade-off between the speed with which an investor can access their capital and the likely return that capital will generate. As a general principle, investors who are able and willing to accept illiquidity should be rewarded with a premium in expected returns.

Several studies have tried to estimate the actual, annual liquidity premium earned for less liquid and illiquid asset classes relative to comparable public market exposures. Key to note however is that the premium tends to narrow when public market yields rise.

The confluence of the above comments suggests several items for consideration by a professional investor:

Rethink Diversification

The traditional 60/40 portfolio construction framework requires revisiting. Investors should consider broader diversification, potentially including hedge funds, credit and real assets as alternative portfolio diversifiers in a regime where inflation is likely to be persistent and government debt is likely to continue growing.

Revisit Illiquid Allocations

Given a narrowing illiquidity premium and constrained exits from private markets, investor should apply heightened scrutiny to new commitments in private equity. Private credit — where the income premium over public credit is more transparent and the vintage risk is lower — may offer a more attractive risk/return trade-off in the current environment.

Manage Liquidity Deliberately

Professional investors should explicitly model their liquidity requirements under stress scenarios — including simultaneous public market drawdowns, PE over-allocation, and redemption gates on hedge fund and real estate positions.

Manage Duration Carefully

Given that government bonds no longer provide reliable equity hedging, duration management should be more active and tactical. Investors should consider shorter-duration credit, floating rate instruments, and real assets as partial substitutes for the traditional hedging role of long-dated government bonds.

7. Conclusion

The investment landscape of 2025 is fundamentally different from the decade that preceded it. Higher rates, positive stock–bond correlations, compressed illiquidity premiums, and a structurally challenged private equity exit environment all demand a more rigorous and dynamic approach to asset allocation. The good news for institutional investors is that a wider range of asset classes now offer genuinely attractive income yields than at any point since the GFC, reducing the imperative to take excessive illiquidity or credit risk in pursuit of return targets.

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