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CIO Viewpoint Special Report

Private assets, public appeal – will these investments weather rising rates?

Investment Solutions

18 May 2022

As stock markets tumble and interest rates rise, investors fear private equity is set for a fall. Yet we see plenty of reasons to include private assets as part of a diversified, long-term investment strategy.

Will private markets follow where public markets lead? Major stock indexes have lost between a sixth and a quarter of their value year-to-date[1]. Concerns over rising US interest rates and slowing growth are being compounded by persistent inflation, following Chinese lockdowns and the war in Ukraine. Markets fear trouble ahead for privately held companies with larger debt loads than their publicly listed peers.

Private equity – which makes up the largest portion of the 'private assets' market (in blue, see chart 1, page 2) has certainly had a stellar run in recent decades. Both fund-raising and leveraged buyouts reached a record level of around USD1.2trn in 2021. Rising allocations from pension plans, sovereign wealth funds and university endowments (see chart 2, page 2), have driven the growth of the asset class. Almost three quarters of this type of 'institutional' investor plans to further increase private asset allocations over the next five years, according research from brokerage Numis. It is easy to understand why: academic research suggests top quartile private equity investments have historically outperformed those in public markets[2]. Recent years have proved no exception. At end-2021, McKinsey calculates that median annual returns for private equity funds raised between 2008 and 2018 were 19.5%. This is calculated as the net internal rate of return (IRR), or the annual growth the investment is expected to generate.

High inflation and rising rates – the end of the party?

Is this successful model about to come crashing down? High inflation and rising rates will likely lower the valuations of existing private equity portfolios. Falling stock markets can make it more difficult to list firms when funds want to exit their investments. Current high levels of 'dry powder' or unspent capital could tempt

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- Investors fear problems ahead for private assets, amid falling stock markets and rising interest rates
- The impact of market corrections can be lower for private assets. Some can provide active inflationary hedges
- Private equity funds launched in difficult markets have historically performed strongly – indicating now might be a good time to consider investing, or upping allocations
- We favour a multi-year investment strategy, across private asset classes, for potentially enhanced returns, lower volatility and portfolio diversification – including access to a wider range of companies in today's economy.

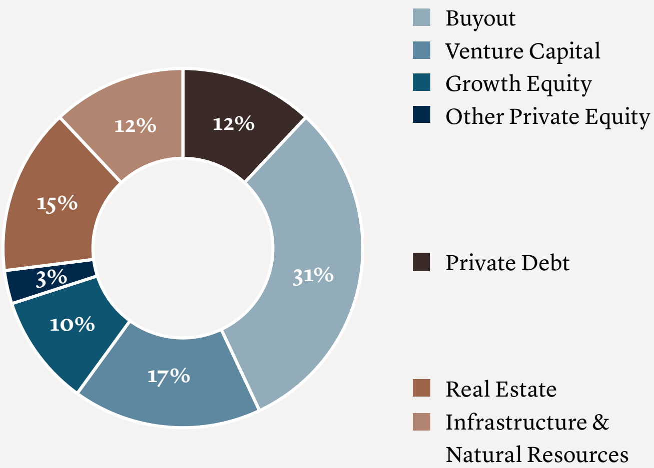
Investments in private assets (private equity, real estate, infrastructure investment and private debt) might not be suitable for all types of investors, or available in all jurisdictions.

[1] Year-to-date performance for S&P500 -17%, Nasdaq -27%, Shanghai Composite -15%, DAX -12% as of 13 May

[2] Private Equity Performance: What do we know? Harris, Jenkinson, Kaplan

1. Private assets universe

Private market assets under management



Private Equity

Capital for private companies. Private equity funds are raised to fund start-ups, to inject working capital into growing companies, or to acquire mature companies. They can also be used to strengthen a private company's balance sheet.

Private Debt or Credit

Private debt includes any debt held by or extended to privately held companies, real estate or infrastructure. It comes in many forms, but most commonly involves non-bank institutions making loans to private companies.

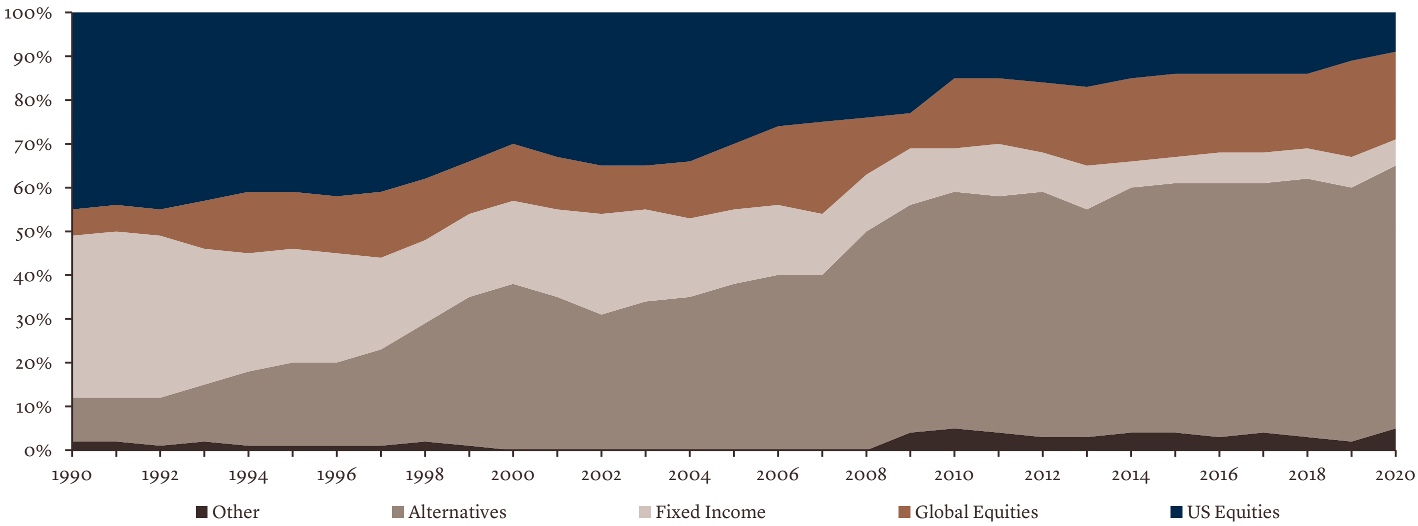
Real Assets

Investment in real estate and infrastructure can provide two sources of returns: income in the form of rent, and the potential for capital appreciation.

Source: McKinsey Global Private Markets Review 2021

2. Not so alternative

US endowments' asset allocations 1990-2020



Sources: Yale, Morgan Stanley, Financial Times

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private equity funds to relax investment discipline in search of new deals. Fund managers could potentially face greater scrutiny and regulation as more money flows into the sector. The most prevalent concern relates to private equity funds' use of borrowed money to buy companies.

19.5%

median annual returns for private equity funds raised between 2008-2018

In the 1980s, this comprised up to 90% of the value of a buy-out. This level has fallen to below 50% today, but is still the highest relative to firms' earnings before interest, tax, depreciation and amortisation in 20 years, according to calculations by the Economist. Higher interest rates increase the cost of servicing debt, raising concerns that some firms will struggle to meet interest payments. Private firms face the same difficult conditions as publicly listed ones: slowing growth tempering demand for products and services, and profit margins dented by any higher input costs that cannot be passed on to consumers.

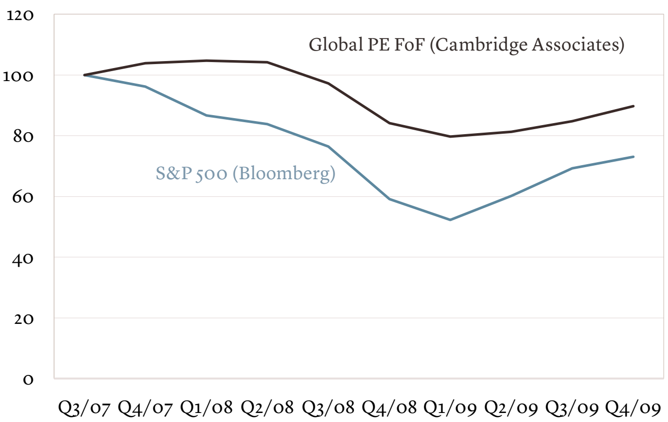
A less bumpy ride

Yet higher interest rates and inflation need not be a disaster for private assets. The impact of market corrections can be much lower for privately owned companies, and the slowdown can be smoothed over multiple years with a private equity fund or fund of funds (which aggregates investments from different managers). The S&P500 fell around 52% from peak to trough during the Global Financial Crisis (GFC) from 2007-2009. Private equity fund of funds lost just under half that value, notes Cambridge Associates. The asset class registered a similar, lower fall during the Covid crisis (see chart 3).

Even if valuations of existing private equity portfolios are written down, fund managers do not have to sell at that price. One of the benefits of private equity is long-term ownership. With an overall lifespan of around 10 years from raising capital to closing the fund, managers can hold onto firms longer in order to achieve better outcomes, as they did around the GFC. Some managers are now trying to extend funds' lifespans further.

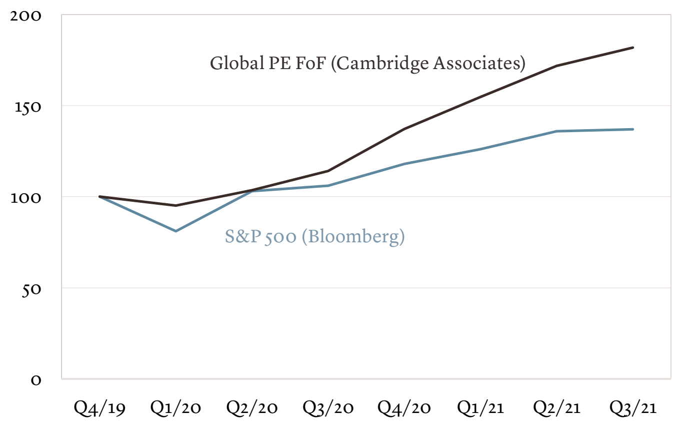
3. Performance during GFC

Quarterly performance of private equity funds of funds vs S&P 500



Performance during Covid-19

Quarterly performance of private equity funds of funds vs S&P 500



Past performance is not indicative nor a guarantee of future returns.

Sources: Cambridge Associates, Bloomberg

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Meanwhile, today's best-performing private equity managers create value not passively via the use of leverage, but actively via operational improvements that can be achieved faster in private ownership. Falling stock market valuations also mean public companies can be taken private more cheaply. Private equity funds already tend to acquire companies at lower prices than public market valuations, providing an additional downside buffer (see chart 4).

Private is the new public

Meanwhile investors not exposed to private assets risk missing out on a big chunk of economic growth and activity. In the US, close to 60% of revenues are generated by privately owned companies. Further growth could be ahead: the number of listed firms in the US has fallen by over a quarter in the last twenty years, notes consultancy McKinsey. As more firms stay private for longer, a new category of 'growth equity' has risen to finance growing companies in the stages before listing, adding to existing private equity strategies: venture capital for early-stage firms, and buyouts for mature ones.

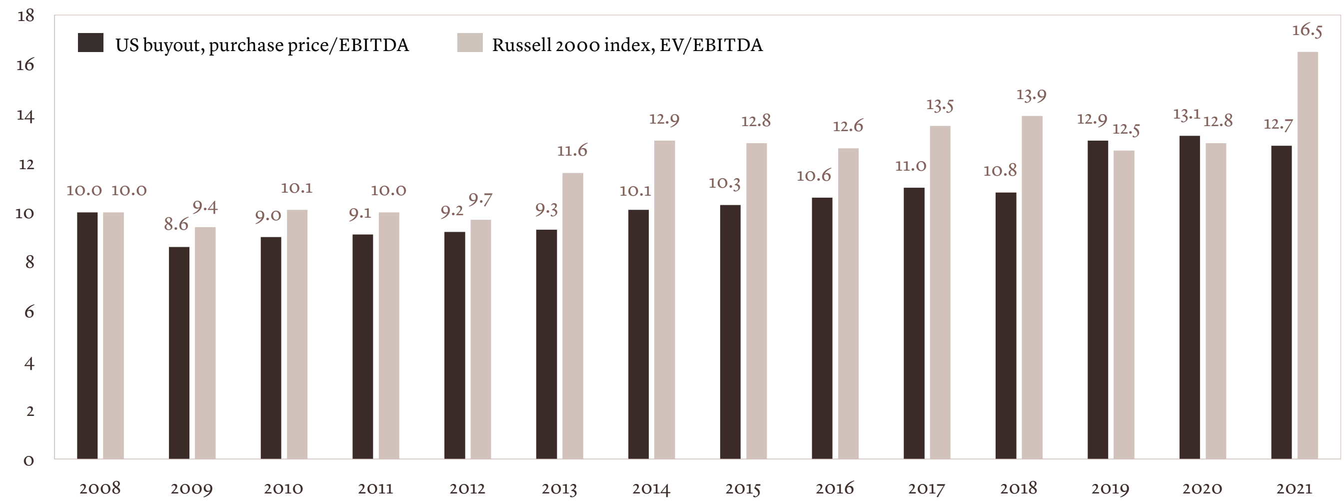
Early-stage, privately owned firms are also disproportionately the ones trialling new ideas and technologies. Investors not exposed to private companies could therefore be foregoing promising new areas of innovation and long-term economic growth drivers, particularly in the field of sustainability. Today, private equity firms are funding advances in software, deep tech and AI, clean technologies, 'telehealth' and green energy not yet embraced by listed firms.

Inflationary hedges – private debt, real estate and infrastructure

Some private assets – including real estate, infrastructure and private debt – even provide active hedges against inflation.

4. Median US multiples

Buyout entry multiples and small-cap equities



Source: Cambridge Associates

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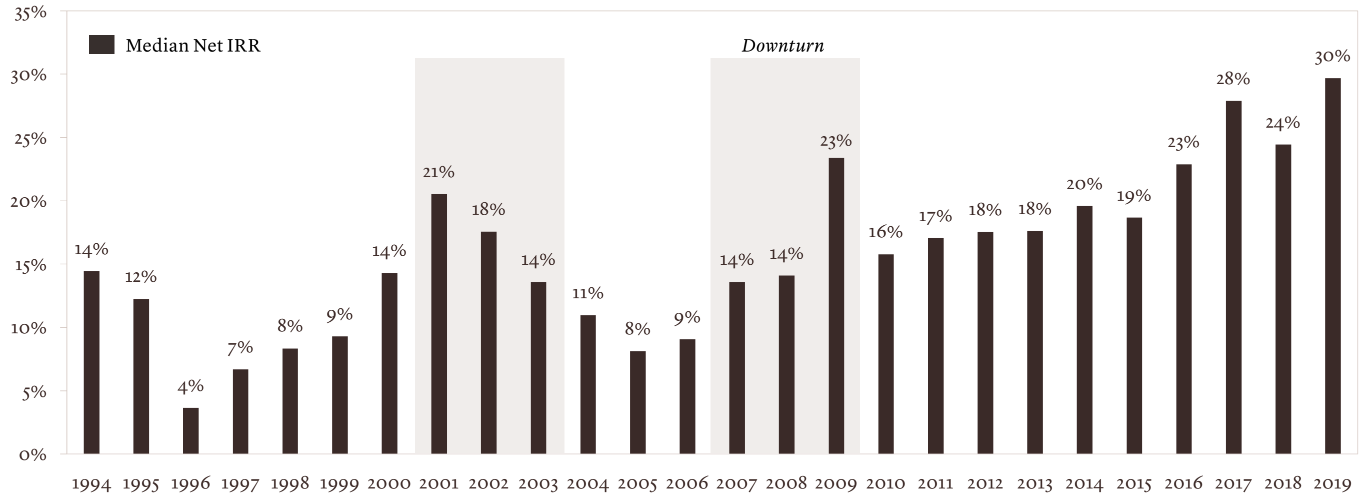
Property rents, particularly for commercial buildings, are typically linked to inflation, meaning they rise in line with rising prices: one reason why we currently favour an overweight to European real estate in client portfolios. Investments in infrastructure projects, including energy and water, transportation, logistics and telecoms networks, roads and hospitals, can also provide inflation-linked returns. Private debt, too, typically employs floating rates, that can be several basis points higher than that of similarly rated public debt – in part reflecting lower liquidity. This segment of private assets – which comprises loans extended to non-listed companies – can therefore also act as an inflationary hedge, as long as companies can meet interest payments. In recent years, the market for such loan origination has shifted, with private debt now issued overwhelmingly by asset managers – who sell a portion to other investors – rather than banks, which tended to keep it on their books. Private debt will be the fastest growing segment of private assets in coming years, forecasts industry experts Preqin.

Is it possible to time the market?

Given discretion in when to acquire and dispose of companies, one might expect fund managers to buy at low valuations, and sell at high ones. Yet when a fund's capital must be invested over multiple years, it can be difficult to time the market in this way. For their part, investors are dependent on the pace of managers' fund-raising and capital deployment. All the same, historical data indicates that private equity funds launched just prior or during periods of market dislocation have performed more strongly than vintages from other years (see chart 5). Such logic suggests that now might be a good time to increase private equity allocations, or for a first-time investor, to start private equity commitments.

5. US buyout performance across vintage years

Net IRR across different vintage years



Note: For illustrative purposes only. Past performance is not indicative nor a guarantee of future returns.
Sources: Cambridge Associates, US Buyout Index, Vintage 1994-2019

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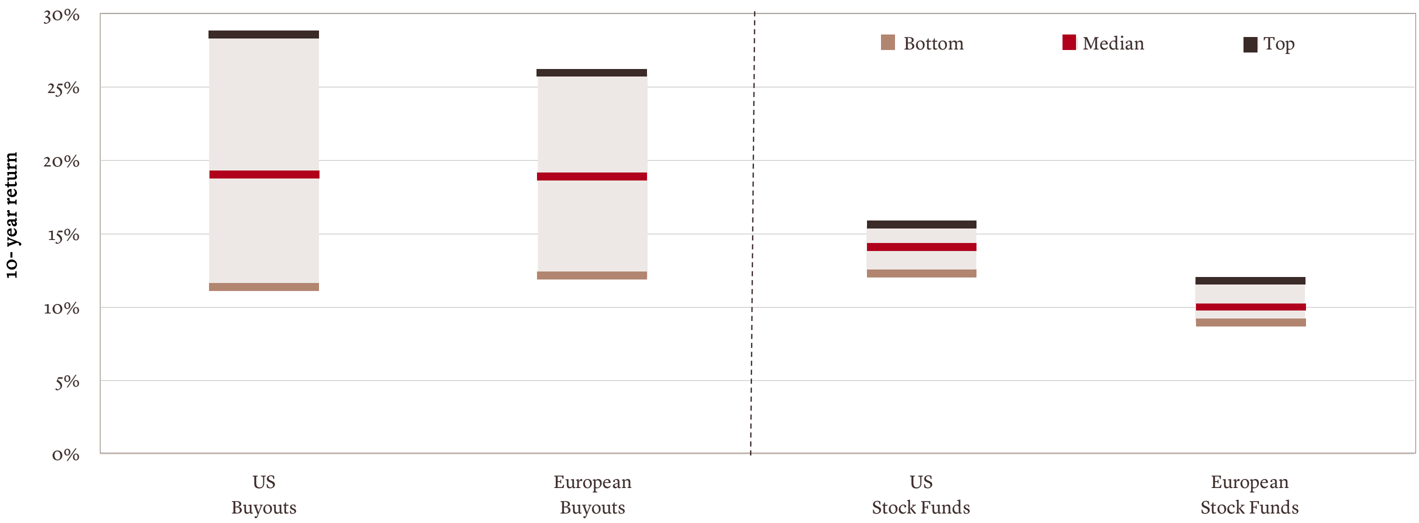
Designing optimal, long-term investment strategies

For investors considering adding an allocation to private assets to their overall portfolio, we typically suggest a multi-year strategy that spreads cash commitments over a number of different private equity 'vintages' of funds. Consistent deployment of capital over time spreads risk and avoids the possibility of missing out on returns from any particularly strong year. We also favour diversification across a range of strategies: from private equity and debt, to real estate and infrastructure investments, especially as the market for a wider range of strategies deepens.

The benefits of investments across a range of private assets can be manifold: enhanced returns versus public markets, lower volatility given lower exposure to short-term market movements, and greater diversification, via access to privately held firms that complement traditional equity allocations. Private asset investments do of course come with risks: loss of liquidity (capital can be 'locked up' for up to 10 years), and a risk of potential capital loss. Added to this, since private markets are less efficient than public ones, choosing the right fund managers is critical: the difference between strongly and poorly performing private equity funds can be up to 20 percentage points (see chart 6).

Yet we believe private assets have an important role to play in a diversified investment portfolio. Even after rapid recent growth in private assets, at just over USD10 trn, they only make up around 10% of global investable assets. The market could double in size by 2026, forecast industry experts Preqin[3]. As such, the appeal of private assets is likely to outlast the Fed's current hiking cycle.

6. Buyout funds vs stock funds performance



Sources: Morningstar (data as of 31 December 2021). Preqin (request as of January 2022, Vintages 2009-2019, Most up-to-date)

- The performance gap between upper and bottom quartile returns is wider in private equity than any other asset class
- Hence, manager selection is crucial to construct high-returning portfolios

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[3] 2022 Preqin Global Private Equity Report

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