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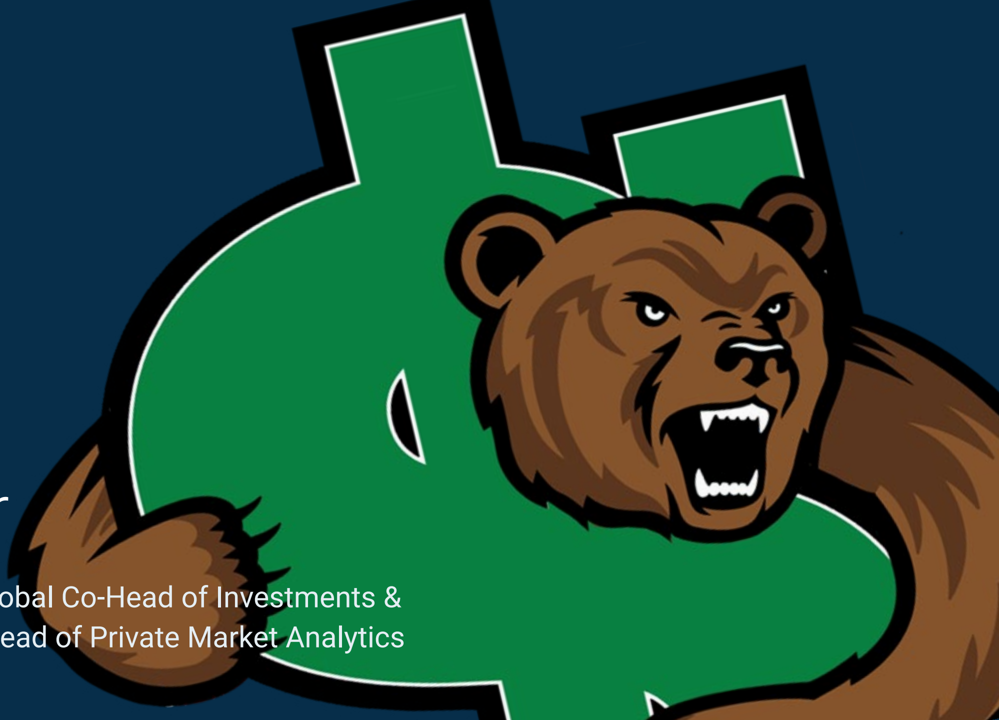


Loaded for Bear

July 10, 2022 | Drew Schardt, Global Co-Head of Investments &
Bryan Jenkins, Head of Private Market Analytics

Take a deep breath. As an investor, it's easy to feel overwhelmed by current market conditions complete with sharp daily swings in the public markets, pesky inflation issues, geopolitical uncertainties and a growing risk of recession on the horizon. But, remember, we all knew this day would come. While timing and magnitude of the correction are always a challenge to predict, the good times of low rates with lots of liquidity made it an eventual certainty that things must pull back in the other direction. So now what? As usual, we got you.

Sometimes the biggest hurdle to overcome has less to do with the tangible financial or economic issues in front of us, and more to do with what's happening between our own two ears. The psyche of the investor can be a fragile and confounding state of affairs. Especially in a climate such as this where, for many, the natural tendency is to pull back. What past cycles have shown us (and we will get to the data in a minute) is that this is generally the wrong reaction. When others are leaning out is precisely the time one should look for the right way to lean into certain areas. Otherwise, you run the risk of mistiming the market opportunity and/or missing out on the return benefit as things recover.

Investor Sentiment Lifecycle

Source: Barclays

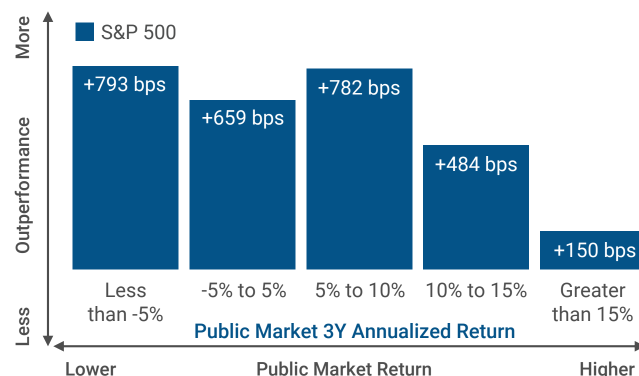
It doesn't mean there aren't risks. As we detailed in some previous pieces on inflation last year [read Part I and Part II to refresh your memory], the changing tide for investors means there will be more of a thematic and 'deal-pickers' market going forward. In other words, strategy, sector, geography and manager selection criteria will be even greater determinants of how portfolios perform relative to their collective impact over the past 13 years given a 'rising tide' for most asset classes. [As a side note, those previous papers featured detail on performance by strategy in a rising rate environment, which we will not cover here.]

Reality Check

Here are a couple of other realities. Returns — across all asset classes — will likely be lower going forward. It is a near statistical certainty. However, keep in mind that if we lined up and ranked the ***average*** private equity net returns over the last 30 years, four of the last five vintage years would be ranked #1, #2, #3 and #4 in that order. So, the average private equity returns, which had been hovering in the 25%-40% net IRR range over the past five vintage years, may revert to more "pedestrian" levels—in line with longer-term averages. What does that mean? The data suggests that net private equity returns on newly-invested capital over the next 5-10 years will still generate performance in the mid-to-high teens range. Still not too shabby. (And exhale...).

And how will that performance stack up to other asset classes, including the public equity markets? We would wager that private markets will meaningfully outperform public asset classes. But let's turn to the data on that point. While ***absolute*** levels of returns may come down, the ***relative*** outperformance of private market average returns is actually better when public returns are lower. The chart to the right illustrates this point: The outperformance gap that private markets have generated historically over public market equivalents tends to be higher when the public market returns (x-axis) are lower. It's in these types of market conditions where the private market strategies have the potential to outperform the most.

All PE Average 3Y Excess Return by S&P 500 Return Regime



Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2022)

Why does private equity tend to outperform during choppy markets? Skeptics would argue that GPs are delusional, are not truly marking assets to market and would point to secondary market discounts as evidence. There is probably some truth to that. But we would argue that there are more significant factors at play. Company quality could certainly be a factor, though that is difficult to measure systematically. In some cases, GP marks are already conservative, and companies may have been on the books at lower valuations than traded comps (remember that GPs tend to exit their companies at a premium to holding value). There are also structural mechanisms that allow GPs to support their companies during times of stress that public companies don't have access to (ex. calling more capital from their LPs, better access to capital markets) that may justify higher valuations. And some would argue that the price for a highly negotiated, majority stake transaction between a small number of parties should not necessarily be the same as the price for instant liquidity of a small minority position.

Still searching for reasons to be pessimistic? Well, just pick up the newspaper or scroll through a few headlines online. The challenge for investors, and what makes periods like this so difficult, is that we are still in a climate ripe with uncertainties. Spoiler alert: Many of these uncertainties — geopolitical risks, magnitude of rate rises, timing of valuation pivots, lingering impact of COVID — are not going away anytime soon.

For the financial markets, arguably the biggest focal point continues to be on the impact of inflation/rising interest rates on asset prices and a potential recession looming on the horizon. First, one must acknowledge that the macroeconomic environment in Europe is meaningfully different than in other developed markets given first-order impacts from Ukraine. However, the U.S. and the Fed will likely be primary drivers of policy and approach toward tackling inflation. In that regard, the Fed is indicating that it will take whatever measures necessary to address inflation, announcing a significant 75bps rate hike in June, and with another of similar magnitude likely this week. The Fed is taking those steps even if they translate into a short, near-term recession.

Past Peak Inflation?

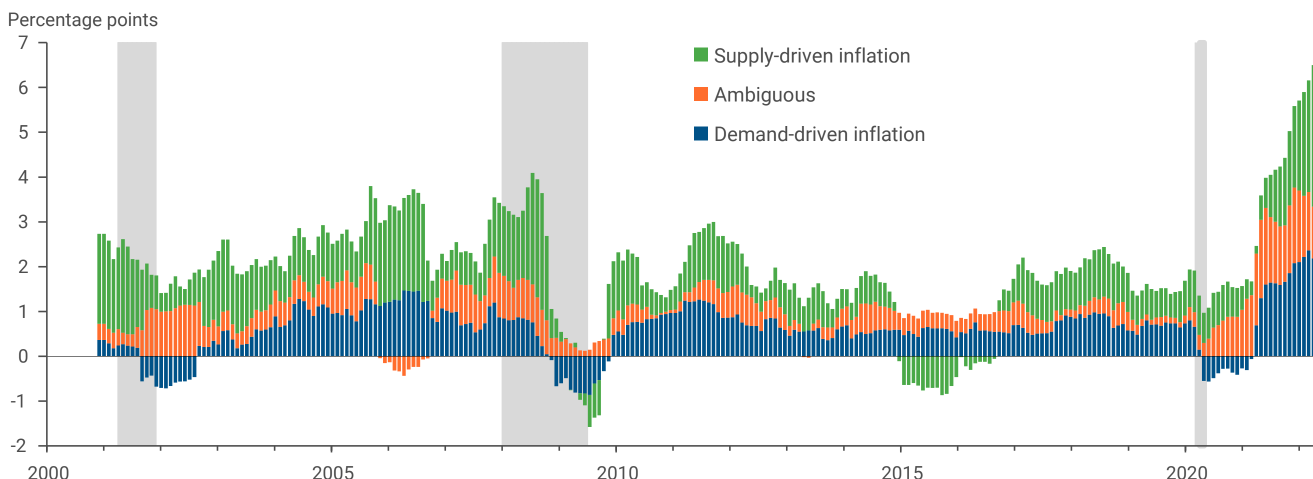
As we continue to breathe in and out, it is worth also keeping in mind that inflation is a lagging indicator. We have yet to see the full impact of monetary policy actions undertaken earlier this year. Commodity prices, mortgage applications and the like have already shown signs of retreating modestly in recent weeks. At the same time, other factors related to supply-driven disruptions — including inventory levels, container/freight shipping rates, transportation issues and a reopening of China — are similarly showing some early signs of easing.

As shown in the chart below from a recent Fed paper on inflation, supply-related issues currently account for more than half of the record inflation levels experienced through Q2. These areas also tend to be less 'sticky' relative to things like wage pressure, and so could also unwind more quickly. A reversal of this trend combined with a general slowdown on the demand side would point to more moderated inflation in the near term. Therefore, one could make the argument that peak inflation is now behind us and that actions to tighten are already starting to have the desired effect.

Fundamentals vs. Valuation Issues

Generally speaking, corporate business fundamentals — including earnings growth, margins and free cash flow — are also currently at historical highs. More broadly, private companies have continued to produce financial performance outpacing the growth of the public markets. This is not to say some of these fundamentals will not slow down. In many cases, it will be quite the opposite, in fact, and that is exactly what the Fed and others are hoping for. However, as an example, the majority of Hamilton Lane direct portfolio company holdings are still expecting at least high-single-digit earnings growth on average over the next 12 months. Balance sheets (for both businesses and the consumer) are

Supply-driven and demand-driven contributions to year-over-year PCE inflation



Note: Gray shading indicates NBER recession dates. Source: FRBSF Economic Letter, 2022-15 (June 21, 2022)

also in a good spot within the historical context. In other words, businesses today have a better starting point and more cushion to weather a pending economic storm.

Furthermore, the data shows that despite a persistent rising valuation multiple environment over the past decade, private equity transactions were still purchased, on average, at a discount to public market comparable multiples.

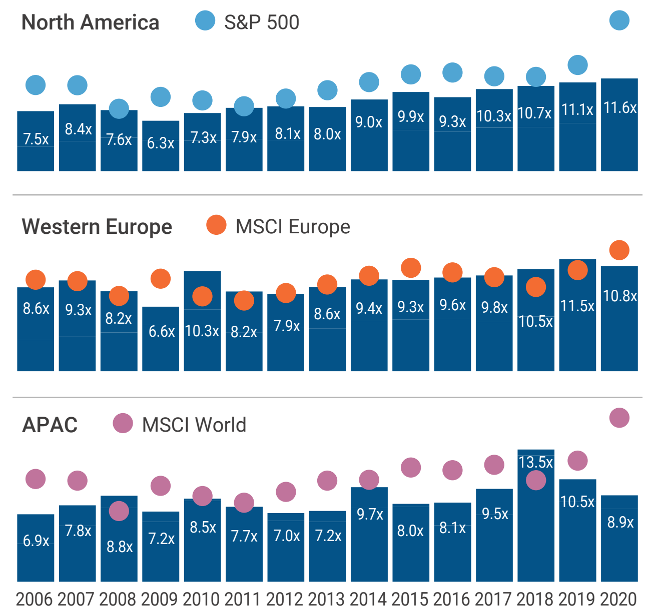
These two factors — strong relative earnings growth and discounted initial purchase price multiples — likely account for at least some of the 'lag' typically seen in valuation movements within private market portfolios through Q1 and in reading the tea leaves for Q2. On the latter point, early indications from GPs are that most private market portfolios are likely to be flat in their June 30 marks, but with notable differences across strategies (i.e., real estate portfolios will behave differently than buyout funds).

However, historical data would indicate that GPs' directional guidance about Q2 2022 valuations may be somewhat optimistic. We've studied how private markets valuations tend to change given movements in relevant public market indices, and our data would suggest that private equity strategies tend to have betas close to 0.4 relative to those indices. With listed equities trading down substantially in Q2 — the S&P 500 lost just over 16% of its value — the data would suggest most LP private equity portfolios to experience markdowns closer to 5%.

Peak-to-Trough and Trough-to-Peak Performance

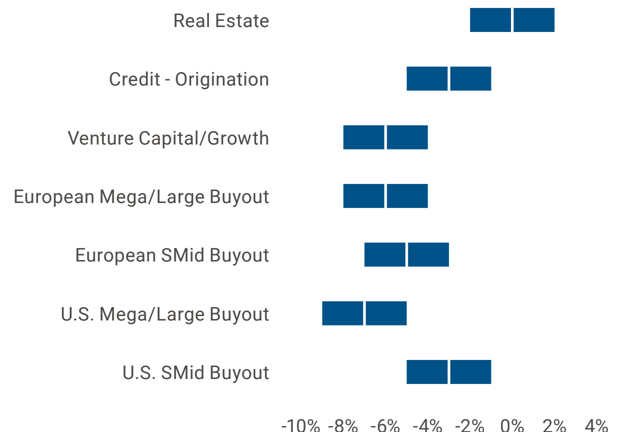
But what about a potential recession? The markets are currently pricing in a high probability of a recession in the U.S. sometime in mid-2023 and even sooner in Europe. So, should investors be stashing cash under their mattresses? If you can time the market perfectly, go for it. Safe haven assets, like Treasuries, have historically preserved value better than riskier assets during choppy market conditions. But timing the market is a risky and short-termist

Buyout Purchase Prices: Median EV/EBITDA by Deal Year



Source: Hamilton Lane Data, Bloomberg (January 2022)

2022 Q2 Estimated Returns by Strategy

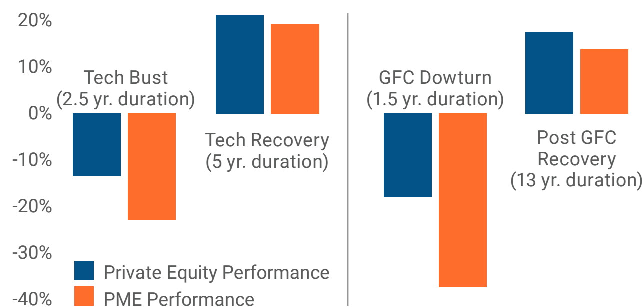


Source: Hamilton Lane Data (July 2022)
Please refer to endnotes.

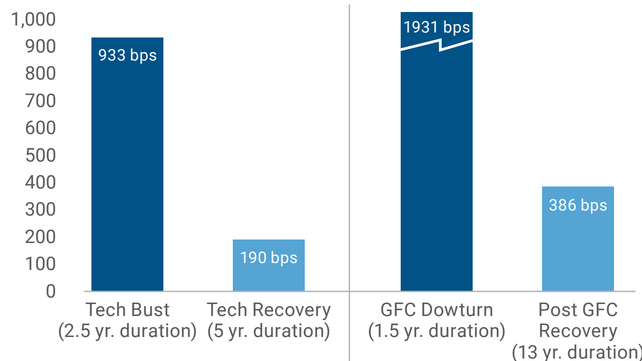
game. The challenge is that being off by a few quarters or mistiming the peak or trough can lead to less-than-optimal long-term returns compared to simply staying invested. This challenge is amplified for investments in private markets, where the rebalancing mechanisms are fewer and the lag time to restart a paused program can be significant. Also, and at the risk of stating the obvious, the shape, magnitude and duration of any potential recession will matter a great deal in terms of navigating the environment and ultimate outcomes.

We've already covered the record private equity returns generated over the past few years. Now, take a look at the point-to-point IRR analysis below comparing the peak-to-trough for private markets performance relative to the public equity equivalent. Private markets generally lag public market downturns by two quarters, and as the data illustrates, tend to exhibit less observed volatility through the cycle. In other words, the peak-to-trough performance is not as low for private equity strategies. Moreover, the longer-term recovery wave from trough-to-peak also shows that private equity outperforms the public side (though, admittedly, private equity is a little slower out of the gate during the first few quarters of recovery). Also notable is the duration of the downturn and recovery periods, with the former typically characterized by a shorter time horizon of ~1.5-2.5 years to experience the depth of the decline. Public markets generally recover more sharply, but longer-term performance back through the peak of the recovery period also favors private equity.

Point-to-Point IRR Performance



Private Equity Outperformance (bps)



History Never Repeats, but It Does Often Rhyme…

In our view, the current market dynamics look and feel much more like any potential recession will be similar to the 2000s tech/valuation reset, rather than the GFC. Here are a few reasons why:

- Similarities to 2000: Excess capital; innovation via tech enablement; FOMO in deal making; paper gains; too many companies chasing the same market; huge public market appetite for growth at any cost, defined by a valuation correction; heightened geopolitical risks characterized by major military events.
- Differences from 2000: More capital in various private market strategies; stronger business fundamentals — revenue, earnings, margins, transactions in high-quality businesses with long-term reasons to exist (relative to dot-com era companies).
- Why not GFC 2.0? Not a broader financial market stability issue; a financial crisis and debt default-driven cycle in 2007; better corporate and consumer balance sheets today.

Conclusion

It is more likely than not that we are headed for a moderate downturn. Importantly, we don't believe this will be a GFC-like recession with that caliber of carnage across nearly all sectors and asset classes. Rather, performance from here is likely to be driven by more specific and tactical investment considerations. The industry, geography and strategy profile will more meaningfully dictate delineation of returns as the tide goes out. The tried-and-true method of staying invested and not timing the market will also likely be the better longer-term path for most investors.
In other words, breathe deeply and stay the course. Over the long term, you will be happy that you did.

Source: Hamilton Lane Data, Bloomberg, and FRED St. Louis (June 2022)
All Private Equity is defined as Buyout, Venture Capital, and Growth Equity funds. PME Index used is MSCI World Index. Returns shown are point-to-point calculations. The point-to-point calculations listed are inclusive of all funds active during that time period. The PTP IRRs and PMEs are a demonstration of performance during the given recessions and expansion times. "Peak to Trough" represents the quarter of the lowest and highest MSCI World Index value over the given time frame. Tech bust from 4/1/2000 - 9/30/2002. Post-tech bust boom from 10/1/2002 - 9/30/2007. GFC from 10/1/2007 - 3/31/2009. Post-GFC Boom from 4/1/2009 - 12/31/2021.

ENDNOTES:

The projections published herein are based on a regression of quarterly public market index returns against quarterly private market index returns. This regression generates an alpha and a beta by strategy which can be used as inputs into the single-index model of pricing assets (Sharpe 1964, Lintner 1965). The formula for the single-index model is:

$$r_{Private\ Markets} = \alpha_{Private\ Markets} + \beta_{Private\ Markets}(r_{Public\ Markets} - r_{Risk\ Free}) + r_{Risk\ Free}$$

Where:

$r_{Private\ Markets}$ = Return of Private Markets
$r_{Public\ Markets}$ = Return of Public Markets
$\alpha_{Private\ Markets}$ = Alpha of Private Markets
$\beta_{Private\ Markets}$ = Beta of Private Markets
$r_{Risk\ Free}$ = Risk Free Rate

The regression formulas for Core and Non-Core Real Estate differ slightly from the single-index model in that the regressions are multi-index models, which include multiple betas and public market returns to better predict private market returns, such as the U.S. Regression Indicator Index.

Once all inputs are obtained, we create a 75% confidence interval for our expected returns. This should denote the inherent uncertainty in these sorts of predictions. In general, we expect to be accurate within a 400 basis point spread with 75% confidence in quarters of normal stock market volatility. During periods of outsized positive or negative returns in the public markets, we would expect to either be less accurate or for the confidence interval to expand meaningfully. We also expect individual portfolios to vary meaningfully from these projections, as individual portfolio returns vary from the industry's returns for many reasons, including concentration of assets, different investment pacing, and different strategy/geography makeups, to name a few. Larger and more mature portfolios should be expected to have a performance more similar to the market, and therefore more reflective of these estimates, than other portfolios might be.

To estimate the next quarter's valuation for a portfolio, you can apply the estimated quarterly growth rate associated with it. The quarterly growth rate should be applied after adjusting for all fund contributions and distributions made during the quarter, in accordance with the Simple-Dietz methodology for calculating returns. Note that all calculations shown in the document are in USD. Therefore, the formula for calculating $r_{Private\ Markets}$ shown above yields a return in USD. To apply the $r_{Private\ Markets}$ to a portfolio with valuation and cash flow information already in USD, use the formula below:

$$Predicted\ NAV_{Ending} = (NAV_{Beginning})(1 + r_{Private\ Markets}) + ((1 + r_{Private\ Markets})/2)(\text{Period Capital Calls} - \text{Period Distributions})$$

If the portfolio valuation and cash flow information is not in USD OR you wish to convert a USD return to a non-USD currency, an "FX Effect" factor must be applied. The formula should be adjusted as shown below:

$$Predicted\ NAV_{Ending} = (NAV_{Beginning})(1 + r_{Private\ Markets} + FX\ Effect) + (1 + (r_{Private\ Markets} + FX\ Effect)/2)(\text{Period Capital Calls} - \text{Period Distributions})$$

Strategy Definitions:

Credit: This strategy focuses on providing debt capital.
EU Buyout: Any buyout fund primarily investing in the European Union.
Mega/Large Buyout: Any buyout fund larger than a certain fund size that depends on the vintage year.
Real Estate: Any closed-end fund that primarily invests in non-core real estate, excluding separate accounts and joint ventures.
SMID Buyout: Any buyout fund smaller than a certain fund size, dependent on vintage year.
VC/Growth: Includes all funds with a strategy of venture capital or growth equity.

Index Definitions:

MSCI Europe Index: The MSCI Europe Index tracks large and mid-cap equity performance across 15 developed market countries in Europe.
MSCI World Index: The MSCI World Index tracks large and mid-cap equity performance in developed market countries.
S&P 500 Index: The S&P 500 Index tracks 500 largest companies based on market capitalization of companies listed on NYSE or NASDAQ.

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As of July 8, 2022

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