PRIVATE MARKETS OUTLOOK

By Chris Langner

The Federal Reserve indicated on more than one occasion during 2020 that it will keep interest rates at nearly zero for at least three years. Its counterparts in Japan and Europe have suggested they could keep rates negative for at least this long. While that may help restart the world economy after the Covid-19 pandemic-induced slump, it leaves investors with a conundrum: how can they get decent returns on their investments without incurring inordinate risks?

This question is being asked especially among some of the biggest asset managers in the world, such as pension funds and insurers. These bodies have statutory return requirements, to be able to cover their liabilities over time.

According to the US National Association of Retirement Administrators, last year, pension funds managing about US$4.8 trillion in assets had budgeted an average nominal return of 7.22% a year until 2060.

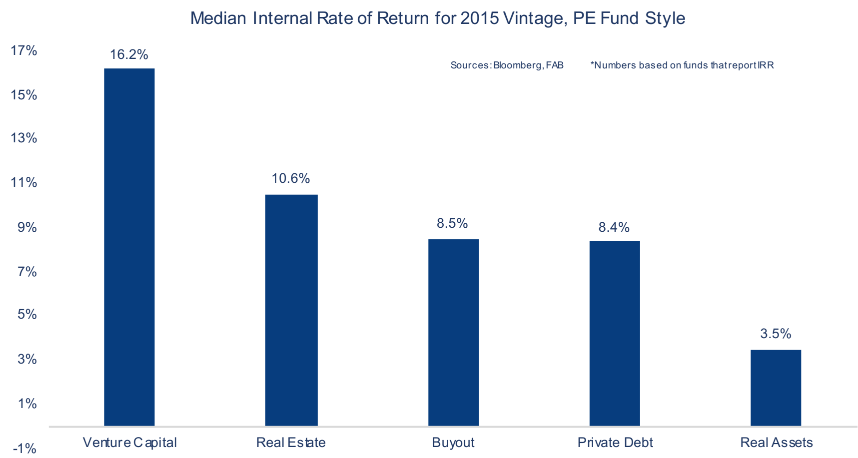
With 30-year US Treasuries bonds yielding 1.7%, the returns stated above could be hard to achieve unless these funds take more risk in their portfolios. Hence, asset allocation strategies have been shifting to add more risk, and this has put private market instruments in focus.

However, investors need to be prudent as to how they access this space. For example, historically, large institutional investors have predominantly focused on private equity firms with a long track record of good returns, and individual investors should probably follow their cue.

Research from Antti Ilmanen, PhD, managing director at AQR Capital Management, has shown how selecting the right managers improves the returns of investments made in private equity funds.

Nonetheless, these and other advantages of private markets help explain why they have become a mainstream investment for sovereign wealth funds, pension funds and insurance companies, and increasingly, wealthy private individuals. As a result, assets under management of private market firms have increased 170% in the past decade, compared to a 100% increase for public markets, according to consulting firm McKinsey. They had US$6.5 trillion under management as at 31 December 2019.

One area that has been particularly successful in attracting money has been venture capital, as these firms that target early-stage companies are perceived as holding the key to future unicorns.



According to McKinsey, buyout funds, which focus on acquiring companies at relatively cheap valuations to either list or resell them, have the lion's share of assets under management, with US$2.07 trillion at the end of 2019. Next come real estate funds, which are perhaps the most traditional private investment assets, with US$992 billion. Venture capital, which has come into focus over the past few years as technology companies have outperformed, however, is almost surpassing real estate. At the end of 2019 they held US$988 billion in assets, according to McKinsey.

However, venture capital carries a significant degree of risk, especially when it is focused on technology. Marc Andreessen, one of the founders of venture capital firm Andreessen Horowitz, last year said that the success rate of companies that get funding is about 7.5%, which means that less than eight out of every 100 companies raising early-stage capital go on to pay back investors.

Nonetheless, it only takes one exceptionally successful company to make up for all the failures, and that is the equation that venture capital firms rely on, and one which allows them to offer high prospective returns to their investors.

For example, in 2014, Sequoia Capital made US$3 billion from the sale of its stake in WhatsApp to Facebook, which was acquiring the messaging application for US$19 billion. Sequoia had invested US$60 million for its stake in 2011, which means it made 49 times its investment in only three years. Sequoia is a good example of why taking the time to research and select the right managers is so crucial in this asset class, and arguably more so than in public markets.

This need for proper manager selection has resulted in a concentration of capital flows to those with a strong track record of identifying future successes.

While venture capital has become increasingly popular, it continues to trail the more traditional private equity market. According to data company Preqin, private equity firms are expected to have ended 2020 with more than US$4.18 trillion in assets under management. That would be the first year in 10 that they saw net outflows, but that is expected to be reversed during 2021, when Preqin forecasts PE firms will have more than US$5.1 trillion under management. At the current rate of growth, Preqin forecasts that PE firms will have more than US$9 trillion of assets under management by 2025.

Within the wider private equity space, some areas came under the spotlight last year. Distressed debt and special situations funds received record inflows as investors tried to take advantage of what was expected to be a wave of defaults. That wave has yet to materialize to the extent forecast, though.

Similarly, private debt has also seen faster growth than the broader private equity space. This year, these vehicles which specialize in lending directly to companies reached about US$850 billion in assets under management, according to Preqin. The company predicts the amount under management by these funds could reach US$1.5 billion in five years, a 12% compound annual rate of growth, if the forecasts turn out to be accurate.

One part of this asset class has yet to recover from the hit taken in the first quarter of 2020. Issuance of collateralized

PE assets under management (US$)

loan obligations (CLOs) in Europe was still at US$22 billion equivalent by mid-November, 34% down from the previous year. In the US the pattern was similar, with CLO issuance down 36% year-on-year by the end of August, at US$54.2 billion, according to Bloomberg, after a flurry of downgrades shook the industry earlier in the year.

The market for leveraged loans, which is largely spurred by these CLOs, however, received a boost in November and was returning to normal. Aside from a series of new CLO issuances, the leveraged loan volume was increasing as the spreads paid by some of the riskiest borrowers reached an all-time low.

These instruments, that allow companies to disintermediate traditional loan markets and borrow directly from investors, have grown hand-in-hand with the private equity market, which often relies on them to fund some of its leveraged buyouts. The high returns and relatively stable structures involved in this sort of lending have attracted significant amounts of investment. On average, direct lending funds produced annual returns of approximately 13% between 2013 and 2018, according to DLP Capital Partners.

For borrowers, the lower rates now available in the private markets are making loans from that source more attractive. Those rates, however, remain higher than those obtained by investors in the public markets, which means the private markets are also more interesting for them. With these two interests converging, there is only one possible outcome: private markets are likely to continue to grow.