

Private Investing: A More Thoughtful Approach When Public Markets are Volatile

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Gen Xers all over are quick to boast of the greatness that was the 1980s. Despite the rise of MTV and Cabbage Patch Kids, it wasn't all royal weddings, Rubik's Cubes and Atari game systems... Inflation levels were near record highs in the early part of the decade.

But here we are in 2022. Risk assets throughout the world have been significantly repriced, investors are grappling with a more hawkish Federal Reserve Bank and the war in the Ukraine is driving up energy costs. As inflation continues to rise, it may feel like we're pumping 1.21 gigawatts into a DeLorean and going *Back to the Future*.

For the past few months, we've written at length about the benefits of certain alternative investment strategies in this environment. The ramifications of the dramatic pull back of public equities and fixed income positions could be seen in some of the private investment fund raising numbers. It might be smart to be cautious. And while private investments can mitigate much of the immediate volatility in the public markets, there is no hiding from the inevitable write-downs in private position valuations to reflect the current exit environment.

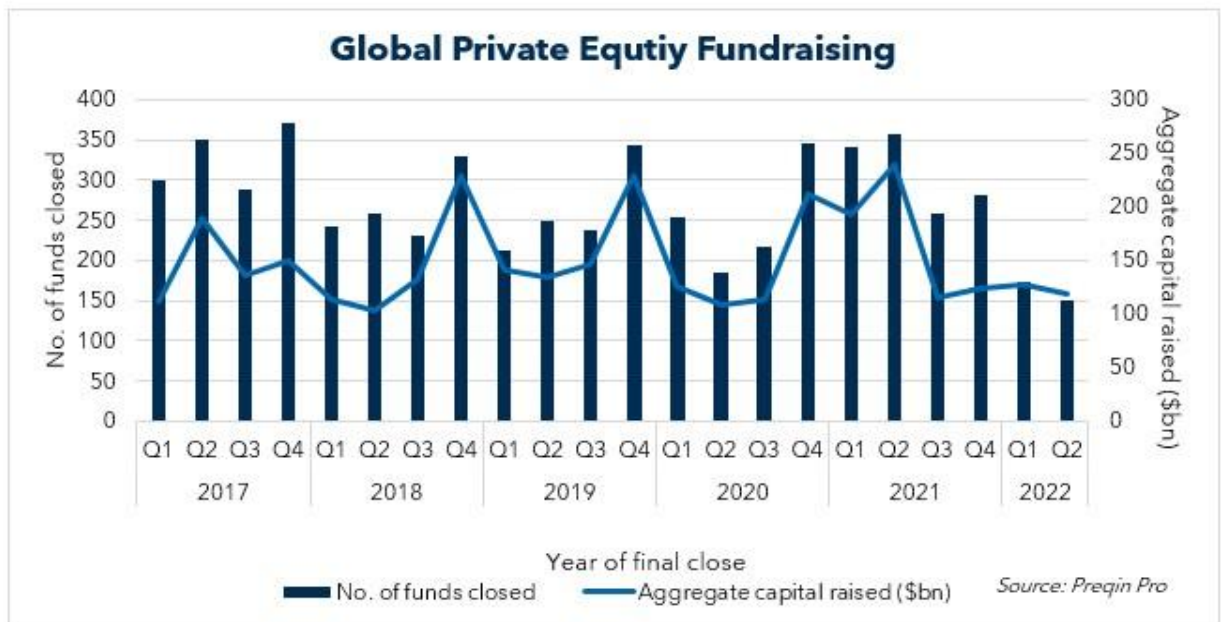


Private investments give the fund manager the discretion to value their portfolio companies. In times of market stress, it often becomes more art rather than science. It's true that public comparable metrics are a significant factor in these valuations. One of the benefits of private investing is the ability for managers to take a more thoughtful approach to their company valuation metrics. Fundamentals and business growth can more accurately represent a company's value rather than noise in the public markets—much like we are hearing now. For now, it's a waiting game. Until an exit event happens, all managers can do is estimate that exit value. As we are currently seeing, nobody is going to voluntarily exit into an unfavorable market environment.

With all of that and public markets repricing, the denominator effect on private portfolios likely has impacted the fund-raising numbers for alternative managers so far in 2022. New fund flows across private equity, private credit and real estate managers are down significantly. Compared to their public equivalents, these positions are valued less frequently, and the mark-downs tend to be more measured. The result is the private allocation percentage being pushed upward in most portfolios, leaving less room for new private allocations in the immediate future.

In comparison to 2021, Chart 1 illustrates that Preqin has seen a significant drop in the number of fund closures and aggregate capital raised through Q2 2022.

Chart 1



It is important to put these numbers into context. Risk assets profited from accommodations of the record low pandemic-related interest rate environment and stimulus measures. The first and second quarters of 2021 were near record highs in both new closes and capital raised.

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Looking ahead, the appetite for private equity will be interesting to watch. Allocation budgets are likely to be smaller, but the asset class itself will continue to mitigate broader public market volatility as we’ve already highlighted. Also notable to watch, market dislocation has made valuations more attractive for all risk assets. The increased borrowing costs from the rapid interest rate moves will have the most impact on strategies that rely on significant leverage, such as buyouts.

In any event, the exit cycle will take some time to rebound. Investors would be wise to wait and see the economic ramifications of the Fed’s measures to tame inflation pressures. With an extended exit cycle likely, secondary funds will gain attention, as institutional LPs may look for earlier liquidity.

On a related note, private credit strategies have continued to draw interest from investors, especially in direct lending. As bank’s borrowing costs continue to rise, alternative lenders will likely see opportunities to play more prominent roles as a funding source for private businesses. Direct lending strategies typically pay

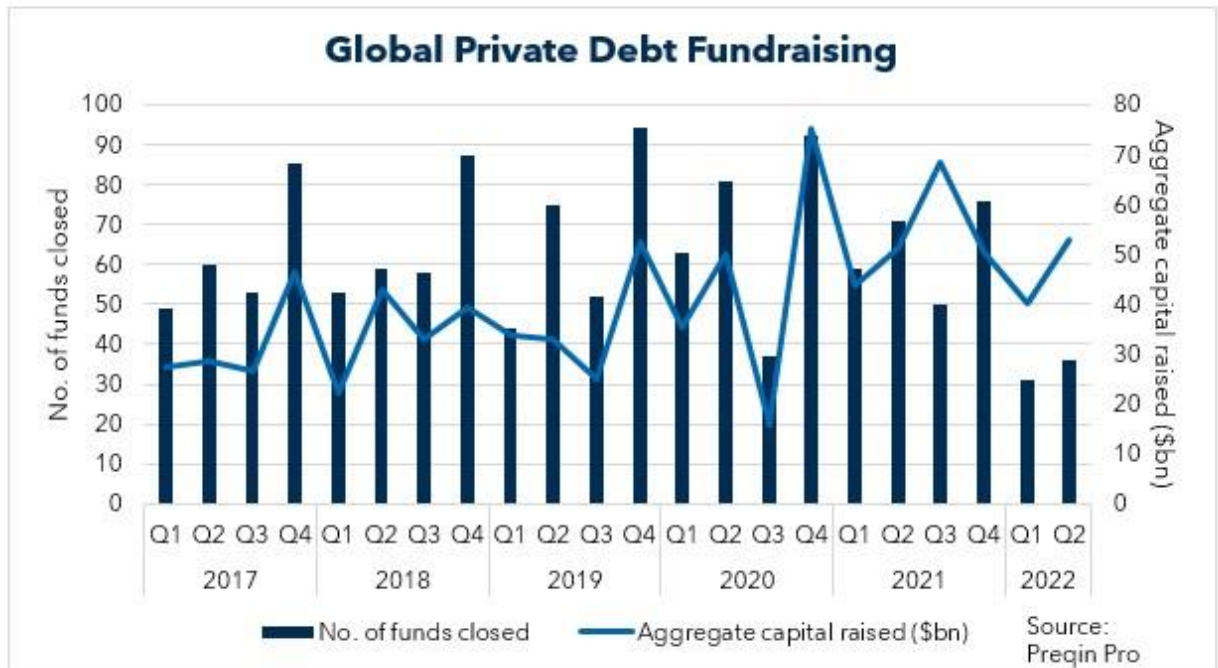
floating rate interest, so investors are not subject to the rising rate pressures that impact valuations of fixed-coupon-paying corporate or municipal bonds.

Accordingly, flows into private credit strategies while still down slightly, were more in line with prior periods. Yes, the number of closes were down sharply, however, the aggregate level of capital raised between the first half of 2021 and the first half of 2022 was effectively flat at just over \$90B (see Chart 2).

The increased rate environment and growing recessionary pressures could force weaker businesses into stress, putting the spotlight on private credit, inclusive of distressed debt and special situations. Many poorly run companies received a lifeline from the pandemic-related stimulus and artificially low interest rates. With those measures now over, there will be a growing number of opportunities for distressed debt managers poised to turn these weakened assets around.

The public market dislocation has clearly impacted the fundraising abilities of private equity managers. However, with rates so low to start the year, valuations were admittedly stretched, and the pullback has been a

Chart 2



necessary correction. Recession fears are real. And private equity will continue to add a necessary component in investor portfolios as both a return driver and a volatility mitigator compared to public equity positions. Conversely, the timing is ideal for more private credit strategies. The inherent interest rate protection that direct-lending strategies can provide are sensible in this time of seemingly-out-of-control inflation and corresponding draconian Federal Reserve reactions.

The public market dislocation has pushed the percentages of private investment allocations in institutional portfolios upward. This has provided an opportunity for investors that can increase their allocations into more alternative investment strategies—such as private credit—to be rewarded.

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