Another Lap Around the Inflation Merry-Go-Round

What the continued burden of inflation means for private investments

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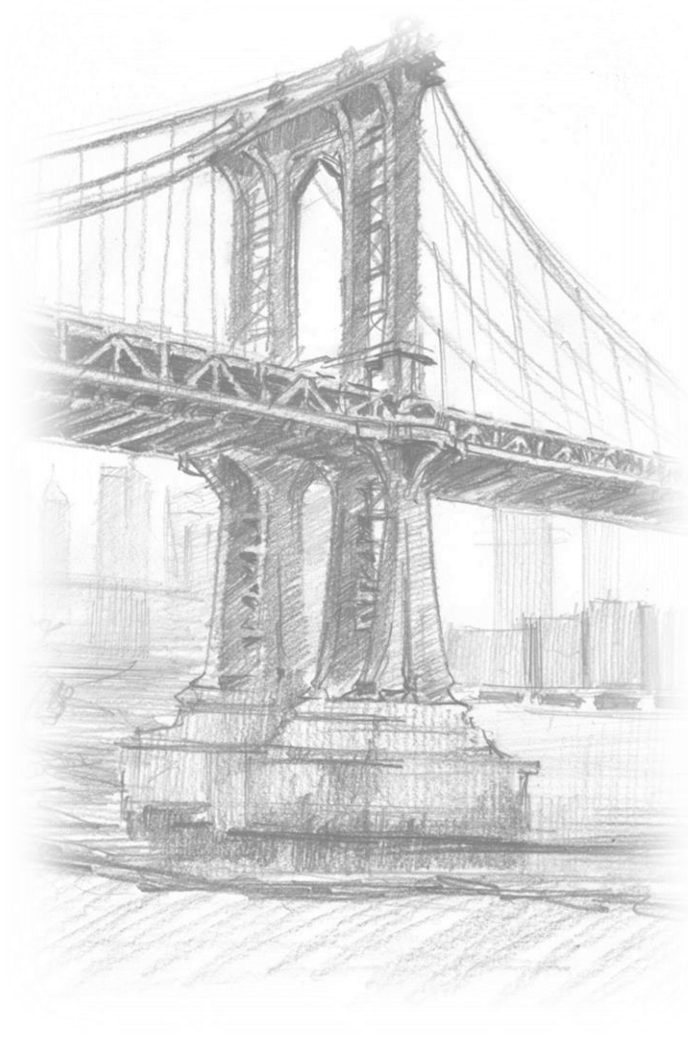

After August saw the Consumer Price Index remain high (8.3%), the Federal Reserve may be feeling dizzy after another lap on what seems like the world's worst merry-go-round. To its credit, the Fed has shown a true dedication to its pledge to stabilize inflation, pulling the trigger on more strategies to fight it as recently as last week. As valiant as it is, the Fed's all-in commitment to the battle continues to weigh heavily on public markets.

So, what does this mean for private markets?

When public markets are under pressure in such an uncertain investment environment, there are indeed ramifications on private markets. Preqin's 2022 Capital Fund Terms Advisor provides meaningful information to gauge the current landscape in new fund launches.

Many private equity strategies are being pressured by the rising rate environment—especially the ones that are more leverage dependent. Conversely, as the absolute dollar value of spreads tends to increase with rising rates, rising rates can benefit more hedge fund and active trading strategies. Regardless of the environment, when risk assets are drawing down to the extent they have in 2022, nearly all asset raises will be impacted to some degree. It's a simple equation that shows investors are drawing from a smaller allocation pool.

As fund sponsors deal with a less optimal fundraising environment compared to last year, it is not surprising to see fund terms trending to be more favorable to LPs with recent raises. Institutional investors have been pushing back on private investment fees for years now, especially as historically low rates drove near linear upward performance in the public markets, raising questions around the necessity of locking up capital.

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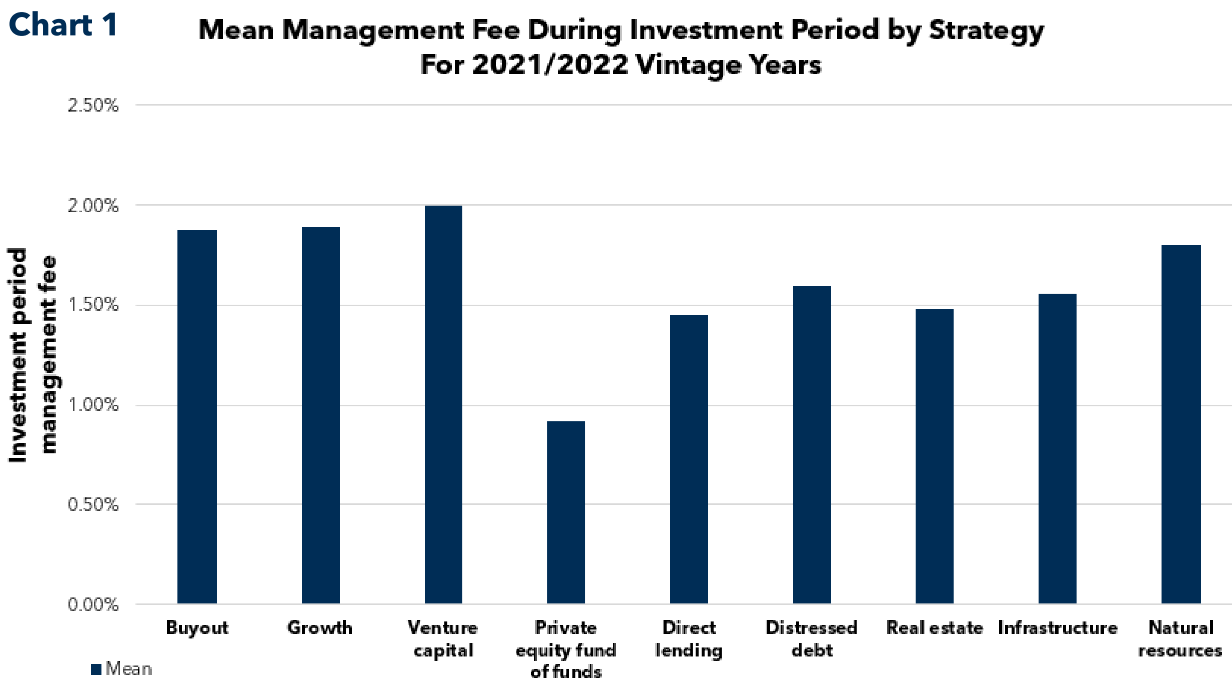
As the Federal Reserve backstop is removed and with the corresponding rapid return of volatility, investors are again reminded of the value of private investments as a stabilizer. Nevertheless, fee compression in the alternative investment space remains a consistent trend, and the amount of side-letter deals demonstrates how much less the larger institutions are actually paying compared to the stated terms.

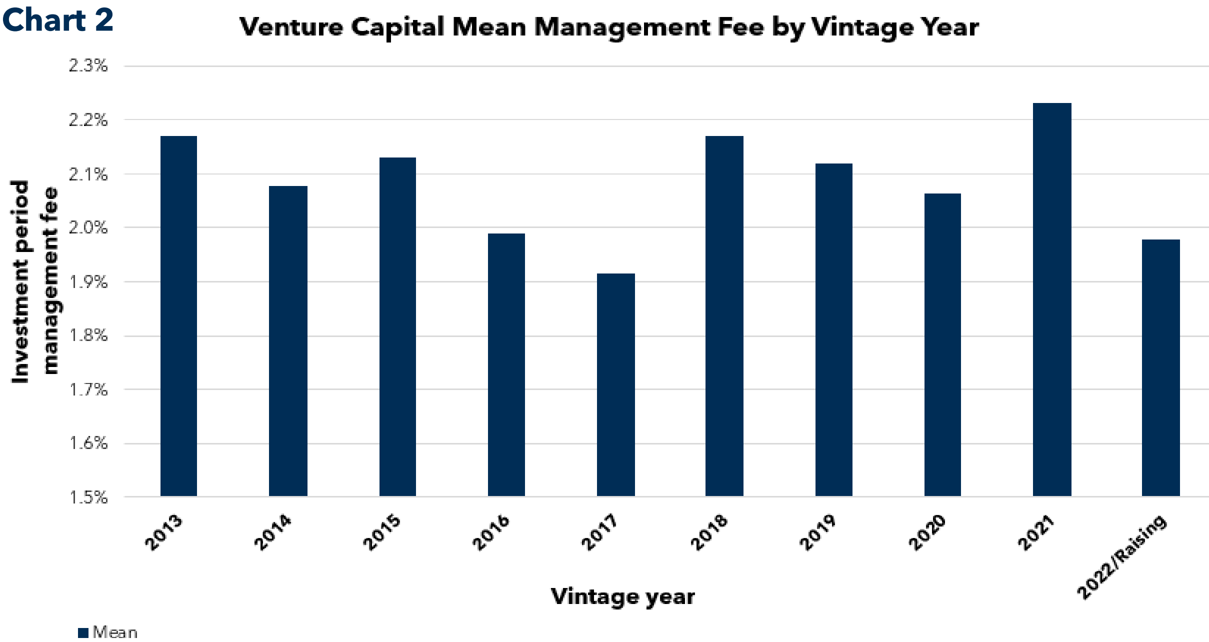
When studying individual management fees, be sure to distinguish fees by strategy since they will vary. Strategies with a higher-returning IRR typically command higher management fees, as Chart 1 demonstrates.

Chart 1



Source: Preqin Pro

Chart 2



Source: Preqin Pro

Historically, venture capital managers have charged the highest management fees compared to other funds. With so much market disruption in 2022—especially in growth and technology names—it's not surprising the decline in venture capital management fees from 2021-2022 is the largest decrease in the last 10 years (see Chart 2). Additionally, many current venture capital funds are sitting on a significant amount of dry powder. Considering the valuation declines across the space, investors would like to see it put to work.

The wrestling match with inflation pressures remain. Throughout this struggle, the Federal Reserve has indicated in both words and actions that it will continue to aggressively raise rates to curb demand and the corresponding inflation pressures in any way possible. In its attempt to limit consumer spending, the Fed is likely imposing additional pain on Main Street USA.

As we have seen with these aggressive rate raises, all risk assets will likely be impacted. Once again, this thrusts the risk mitigation properties and inflation hedges of alternative investments directly into the spotlight. Returns may still be under pressure, but the corresponding fee compression can help increase the return multiples and strategy IRRs for investors.

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