INVESTING IN PRIVATE MARKETS – HISTORY AND RATIONALE

White Paper

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Union Bancaire Privée

Key points

- *Amidst growing heads to more traditional return drivers – term premia, credit risk premia, equity risk premia, and earnings growth – investors need to pivot towards alternatives to achieve return objectives looking ahead.*

- *We expect private market assets to offer a credible alternative which can serve to not only diversify but as importantly augment portfolio returns.*

- *Infrastructure-related, private credit and income-oriented real estate market investments provide income streams at a premium to high-yield credit which is more exposed to the expected on-going normalisation of long-dated bond yields and credit spreads.*

- *Private equity earnings streams are more driven by proactive operational management that constitutes a non-cyclical earnings driver amidst a more challenging cyclical backdrop ahead for public equity.*

Global deflationary tailwinds begin to abate

With the peak in inflation in the early 1980s, investors as a whole have benefitted from a secular fall in inflation, driven by structural factors including supportive demographics, globalisation, and productivity-enhancing technology investments.

Undoubtedly, the technology revolution will continue with innovations moving from the consumer and services segments of the global economy to the industrial sector (for more details, please see *UBP Investment Outlook 2022: Embracing Change*, "Embedded Technology in Global Industrials").

However, the maturing of the 'Baby Boom' generation, an aging Chinese population, and a peak in female labour force participation in many developed nations are combining to leave more limited sources of new labour. Concurrently, according to OECD data, a slowing decline in union membership in the US, the UK, and the EU, along with demographic trends, are contributing to, among many other effects, an easing in the downward pressure on wages that has been in place since the 1980s.

Just as importantly, globalisation, which has compressed manufacturing costs as supply chains moved to lower-wage countries, is evolving in the wake of the series of shocks including the US–China trade war of 2018–19, the global Covid pandemic, and most recently, the sanctioning of Russia following its invasion of Ukraine.

The trade dispute between the world's two largest economies forced companies, which had centralised their offshore supply chains in China, to diversify them to other, still comparatively cheap emerging economies.

The pandemic, however, highlighted the fragilities of this strategy, leaving many supply chains exposed to transportation bottlenecks and, periodically, production interruptions.

Thus, strategies to diversify supply chains further and bring production back onshore have emerged, as we are witnessing most visibly across the technology supply chain.

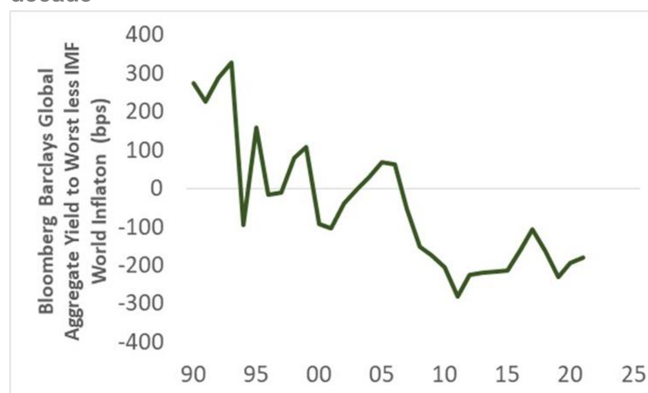
Russia's invasion of Ukraine in February, 2022 inflicted yet another supply shock on the global economy. Whereas the US-China trade war and the pandemic saw most direct impacts upon the finished goods supply chain, sanctions – both formal and self-imposed by corporates – have strained the raw materials end of global supply chains.

As a result, with many western nations seeking to reduce their reliance on the largest exporter of energy, agriculture, and many base metals, higher prices are likely necessary to spur new exploration and investment to identify and extract new sources of supply in the years ahead.

Thus, with inelastic supply chains strained as they look to be reshaped for the remainder of the 21st century, this suggests that the deflationary benefits of globalisation, at a minimum, are likely erode in the years ahead as this reshaping of supply chains is completed.

This should bring an end to the global deflationary tailwinds that have supported investors since the early-1980s and instead present more persistent and elevated inflationary headwinds in the years to come.

Global bond yields persistently below inflation* for a decade



Sources: International Monetary Fund, Bloomberg Finance L.P. and UBP
* 5-yr CAGR

Structural headwinds lie ahead for global bond investors

These deflationary tailwinds have been key to the equity-like returns that bond investors were able to secure through the 1990s: falling inflation allowed for a structural decline in bond yields – from 16% for US corporate bond yields in the 1980s to only 6% at the turn of the century – before stabilising near 3–5% in the 2000s, according to the IMF.

In addition, bond investors received another boost to returns in the 2000s. The 2008–09 Global Financial Crisis, the

eurozone financial crisis, and most recently, the global pandemic have driven central banks to engage in 'financial repression' by driving down bond yields further in an attempt to spur demand in the face of threats to global economic growth.

This left inflation-adjusted government bond yields in key Western nations deeply negative, even despite the rally in yields seen in 2022. Equally as problematic, these financial repression strategies have also shrunk the credit risk premia – credit spreads – paid to investors for taking on corporate credit risk in bond markets. This has turned inflation-adjusted yields on high-quality corporate credit negative too, and weighs on bond investors' returns.

Indeed, since 2008, the yields available to investors on their global bonds – both government and corporate, as reflected by the Bloomberg Global Aggregate Index – sit deeply negative after adjusting for the pattern of troughs and rises in inflation that has begun taking shape over the past five years (Chart 1).

…but headwinds are building in equities as well

To offset the declining returns in bond markets, many investors have turned to equities in the aftermath of the Global Financial Crisis.

Indeed, equity investors benefited repeatedly and in many ways from the policy responses to what was, at the time, the deepest recession since the 1930s Great Depression.

The financial repression strategies of central banks saw global equities' valuations rise from 13–15x in 2005–07 to 15–18x by 2017. Following even more aggressive central bank policies in response to the pandemic, MSCI World equity valuations peaked at nearly 25x in 2020.

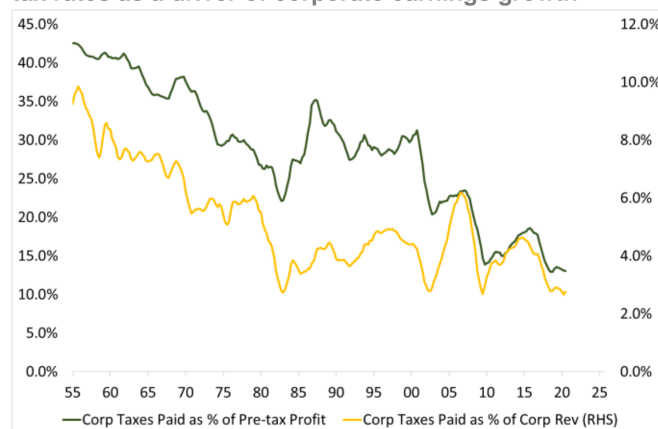
Rising valuations were not the only driver for equity market returns. In the US, for example, the monetary support following the Global Financial Crisis was complemented by fiscal support, which saw effective corporate tax rates falling from an average of 20–25% between 2000 and 2007 to 15% between 2008 and 2019, adding nearly USD 2.5 trillion in net profit to corporate bottom lines over the period.

This added to the deflationary benefits corporates gleaned from below-inflation rates of wage growth (driven by falling unionisation) and the globalisation of supply chains since the 1990s. Looking ahead, however, headwinds are emerging on several fronts.

Equity valuations began retreating in 2021, falling throughout the year. Indeed, the market declines in early 2022 have left global equity prices at 19.5x earnings, although still above even the 15–18x range seen in 2008–17, let alone the 13–15x seen in the early 2000s.

Populist calls in Europe and the United States have likely put an end to the decline in effective corporate tax rates seen in recent decades. Indeed, 136 member nations of the OECD struck an agreement in late 2021 to establish a minimum corporate tax rate of 15% in an attempt to end tax competition from low- or no-tax havens around the world. It is expected that this new agreement will come into force in 2023.

OECD minimum tax rate = The end of falling corporate tax rates as a driver of corporate earnings growth



Sources: Federal Reserve Bank of St. Louis, US Tax Policy Institute, and UBP

This comes as tight post-pandemic labour markets are putting upward pressure on wage costs for companies around the world, while the reorganisation of global supply chains to enhance their robustness has the potential to bring added costs too. Similarly, the accelerating transition to green energy may likewise require substantial upfront investments until the low marginal costs of climate-friendly power sources reduce expenditure in the decades ahead.

Private markets: a differentiated return driver

Seeing historical return drivers – falling bond yields, tightening credit spreads, and accelerating profit growth – beginning to come under pressure, investors will need to seek alternatives to compensate. Private markets provide such an alternative, we believe.

Undoubtedly, the private market segment will be impacted by the same macro and structural challenges public markets face. However, private market assets comprise additional drivers to augment the total returns available to investors across the risk spectrum. Key amongst these drivers is the illiquidity premium relative to public market assets.

Infrastructure, private credit, and real estate: alternatives to high-yield credit

Infrastructure-related private market investments offer high-visibility long-term income streams at a substantial premium to high-yield credit, which is more exposed to the normalisation of long-dated bond yields and credit spreads ahead.

Indeed, core infrastructure investments can serve as a source of steady income supported by regulated pricing and long-term contracted revenues from governments or high-quality corporates. Moreover, with the pandemic and the increasing incidence of extreme weather around the world highlighting the shortcomings of the 20th-century infrastructure, growing spending in that area should present investment opportunities in the post-pandemic era.

The often inflation-linked pricing structures incorporated into core infrastructure investments shields investors more meaningfully against not only waning global deflationary

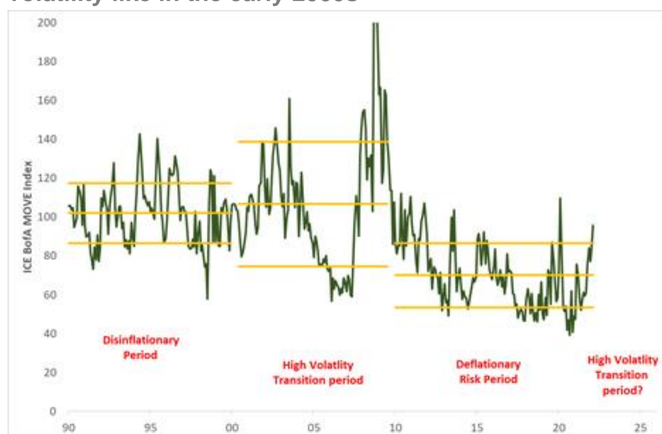
forces, but also the prospect of higher, more persistent inflation.

Returns on private credit and income-oriented real estate are at a premium compared to US high-yield credit, which should help cushion total returns against the impact of even a modest credit cycle in the years ahead.

Substantial illiquidity premia in private market assets

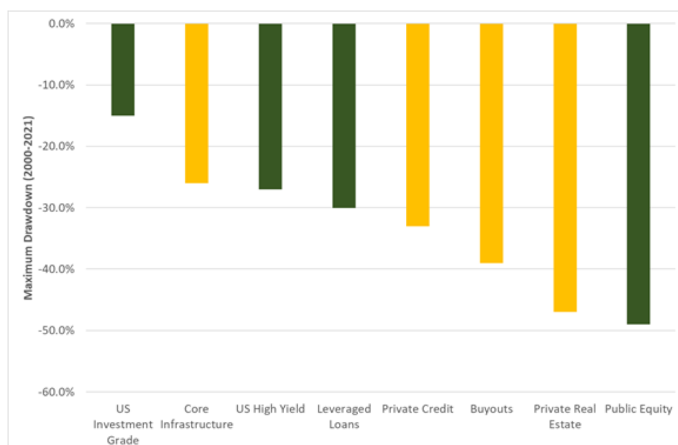
Sources: Carlyle Analysis and UBP
Key: Grey shaded areas represent the illiquidity premium between private market assets (yellow) and comparable public market assets (green)

End of deflation may bring a renewed period of elevated volatility like in the early 2000s



Sources: ICE BofA, Bloomberg Finance L.P. and UBP

Private market assets still susceptible to macro volatility



Sources: Carlyle Analysis, Cambridge Associates, iBoxx, MSCI, Bloomberg Finance L.P. and UBP
Key: Private market assets in yellow; liquid public market assets in green

One consequence of the increased regulatory oversight in the financial system following the Global Financial Crisis has been the growth and maturing of the private credit market.

Banks, discouraged from lending by growing capital burdens and encouraged to facilitate the 'financial repression' strategy of central banks by buying government bonds, have failed to meet financing needs, especially those of middle-market players, thereby leaving private market opportunities to fill the void.

Though exposed to the macroeconomic, interest rate, and default cycles that also impact traditional bond markets, in many cases the private credit market provides floating-rate exposure that may benefit in rising interest rate environments. Indeed, should disinflationary trends give way to inflation, private debt investors should capture the likely higher short-term rates.

Global real estate investments, long a reliable source of income generation, are seeing a shifting foundation as a result of the pandemic. Office and retail segments in urban centres may face a new demand function as work from home or hybrid working arrangements shift mobility patterns. Conversely, beneficiaries from post-pandemic trends, including logistics and warehousing, and residential property, may benefit from structural demand acceleration as the global economy reshapes itself in the years ahead.

As a result, the historical reliability of global real estate may become more concentrated in select segments which can benefit as the sector adapts to the post-pandemic demand dynamics.

This re-orientation will potentially also bring about dislocation in certain sectors, giving rise to opportunistic investment prospects for skilled private real estate general partners and more risk-oriented investors.

Private equity: An alternative to public equity looking beyond macro and secular drivers

Private equity investors have access to an earnings stream driven not only by the macro and secular global trends seen in listed public equity, but also by proactive operational management that provides non-cyclical earnings drivers for increasingly challenged equity returns.

Indeed, managing partners in private equity schemes take an active ownership interest, allowing investors to influence strategy with the objective of proactively increasing the value of the investment over its lifecycle. This may be done by recruiting talent and entering into partnerships to accelerate business growth and development, identifying operational improvement and synergies, gaining access to new geographies or markets, or even changing the mix of capital deployed in the business.

Put another way, private equity specifically (and private markets generally) opens the door to more direct 'alpha' through managers who not only identify attractive opportunities but also proactively extract value from portfolio companies.

In an era of more modest organic earnings growth prospects, management skill at enhancing shareholder value via

operational improvements, strategic mergers, and capital management can augment shareholder returns.

Macro volatility and manager selection risks

One consequence of the global deflationary risks and the associated monetary policy responses of the 21st century so far has been a structural fall in volatility, especially in bond markets around the world. However, the transition from the disinflationary 1980s and 1990s to this more deflationary period of the past decade came with a period characterised by significant volatility in markets in the 2000s.

Looking ahead, as policy makers cease to fight the deflationary trends of the past decade and instead look ahead to structural inflationary tailwinds building, investors should be prepared for a normalisation of volatility to at least the level seen during the 1990s, if not higher in the transition period.

As regards declines in the private market segment over the past two decades, there have been substantial mark-to-market maximum drawdowns during this transition period of volatility, though in line with and at times smaller than comparable public market assets.

Thus, while private market assets have offered investors premium return profiles, they remain susceptible to global macro volatility and provide only relative shelter versus comparable public markets.

Importance of manager selection

Public market investors in recent years have sought to eliminate the risks of underperformance associated with active management by increasingly allocating to passive strategies such as exchange-traded funds (ETFs).

In private markets, given their structure, such a passive approach is not possible, and this increases the importance of manager selection in identifying opportunities and implementing value-enhancing strategies for the benefit of limited partners.

Indeed, while index measures of private market performance generally demonstrate the illiquidity premia associated with the asset class, as with active public market investments, manager selection has the potential to result in meaningful deviation from such uninvestible index measures.

For example, Carlyle Analysis highlights a 1,000–2,500-bp differential between top-quartile and bottom-quartile buyout funds from 1998 to 2012. Moreover, bottom-quartile funds delivered returns in the period as much as 500–2,000 bps below buyout index level returns.

This compares to the historical 9–10% premium the global buyout index earned relative to global public market equities and the 300-bp premium expected today (Chart 3) by private market specialist Carlyle Group. This dispersion highlights the importance of manager selection for securing illiquidity premia in the private market segment.

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