CLEARPOINT

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SEPTEMBER 2022

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WHAT SHOULD INVESTORS DO WITH THEIR PRIVATE CAPITAL PORTFOLIOS TODAY?

BY JOSEPH D. BOUSHELLE, CFA, CAIA*, SENIOR MANAGING DIRECTOR, ALTERNATIVES

The last 10 years have been a boom time for private markets. Leveraged buyout, growth equity funds, and venture capital have all benefited from low interest rates and a bull market. As a result, private equity funds have seen annualized returns of 18.9%,[1] outperforming public markets (the S&P 500 returned 16.5%[2] during the same period if you assume dividends were reinvested), although not the 400 to 600 bps of outperformance we have seen historically.[2] Venture capital has returned 18.3%[3] although we expect those valuations to come down a bit. These strong results have caused robust asset flows into private investments as more institutions and individuals increase their allocations to private alternatives. According to *Pitchbook*, private equity funds have raised over $4 trillion globally since the beginning of 2012 and venture capital funds have raised another $1.6 trillion.[4] Increasing public equity valuations and the flow of capital into private markets have pushed private market valuations to high levels.

As of the end of 2021, median private equity multiples in North America were almost 13x[5] and remained strong through the first half of 2022, although pricing pressure is starting to materialize.

CLEARSTEAD ACQUIRES SCOTT SNOW (FINANCIAL ADVISORS) LLC

On June 30, Clearstead acquired Scott Snow (financial advisors) LLC, a local high performing private wealth management firm, as part of its continued strategy to grow through acquisitions. This was the sixth acquisition Clearstead has made in the past seven years.

The firm, founded by Scott Snow in 2005, advised high-net-worth families and provided holistic financial and tax planning services. This acquisition will add about $530 million to Clearstead's current $31 billion under advisement.

Clearstead Chairman and CEO Dave Fulton said, "Scott Snow has done a fabulous job building his firm and has provided his clients with his expertise in investments, taxes, and financial planning."

Mr. Snow said, "Clearstead is a nationally recognized and well-respected wealth management firm, and I look forward to joining such a talented group of people and enhancing our overall client success."

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

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However, the investment environment is beginning to shift. Interest rates are rising as the Federal Reserve attempts to put a damper on inflation. Public equities have been pressured by rising rates and the potential of a recession, as well as a resetting from hyperbolic growth over the past couple of years. This could pressure private market valuations as well as lead funds to hold on to assets longer, as returns will need to be driven more by operational improvements rather than multiple expansion. The decline in the public markets has already led some institutions to reduce their private market allocations as they are impacted by the denominator effect (described later) and allocations to private markets move out of investment policy ranges. A slowdown in private market commitments, combined with a decline in dry powder might mean that there are fewer private market capital chasing opportunities.

All of this means that now might be shaping up to be a great time to invest in private equity. We would rather buy low and sell high, and the reset in valuations might make this an opportune time to invest capital (even with higher interest rates). In general, some private equity vintages that overlap with or immediately follow a recession have historically performed better than those that immediately preceded a recession. If the Federal Reserve also manages to tamper inflation, we would expect rates to moderate over time, which may benefit existing portfolios.

THE DENOMINATOR EFFECT

Private market valuations are set by the fund manager's valuation policy and funds are often slow to adjust valuations in falling markets. As a result, private market valuations tend to decline slower than public market valuations and do not tend to overshoot. This means that an investor can end up with a private market allocation that is higher than his targeted range.

For example, let's say a $100 million institution has a 60% allocation to public equities, 20% allocation to fixed income, and 20% allocation to private equity and has an investment policy that targets a private equity allocation of 17-23%. In this example, a 25% decline in the public market portfolio and a 10% decline in the fixed income portfolio would mean that the institution has a 24% allocation to private equity (assuming no change in valuation). This is highlighted in the table below:

Asset Class	Target Allocation	Original Allocation	Change in Value	New Allocation	% of Assets
Public Equities	60%	$60,000,000	-25%	$45,000,000	54.2%
Fixed Income	20%	$20,000,000	-10%	$18,000,000	21.7%
Private Capital	20%	$20,000,000	0%	$20,000,000	24.1%
Total Assets		**$100,000,000**		**$83,000,000**	

In this example the institution might either slow down or put a halt on private equity commitments or sell some of its existing commitments in the secondary market. The sharp decline in public equity valuations early this year has led several institutions to do just that and has resulted in a slower private equity fundraising environment. Established managers, such as Apollo and Carlyle, have had to temper fundraising expectations for their flagship funds. Meanwhile, according to a recent *Pitchbook* report,[6] first time fund managers have raised just $8.6 billion in the first half of 2022, while first time funds have been able to raise an average $26.8 billion per year of the last five years, 2017-2021. The difficulty in conducting diligence on new managers and the faster turn-around in fundraising for established managers (the same reports shows that the average time between fundraising has declined to 3.3 years from 4.2 years in 2017) and declining allocations are certainly taking their toll.

We expect this issue to be compounded by the fact that exit activity tends to slow down during periods of market volatility. This means that investors could get fewer distributions for more mature funds, therefore keeping the allocation to private investments above target allocations. The chart on the following page shows that private equity activity declined during the Great Financial Crisis ("GFC") in 2008 and 2009. There was also a brief slowdown during COVID-19; however, markets quickly bounced back as stimulus was injected into the markets and large pools of dry powder meant there was plenty of capital to chase deals.

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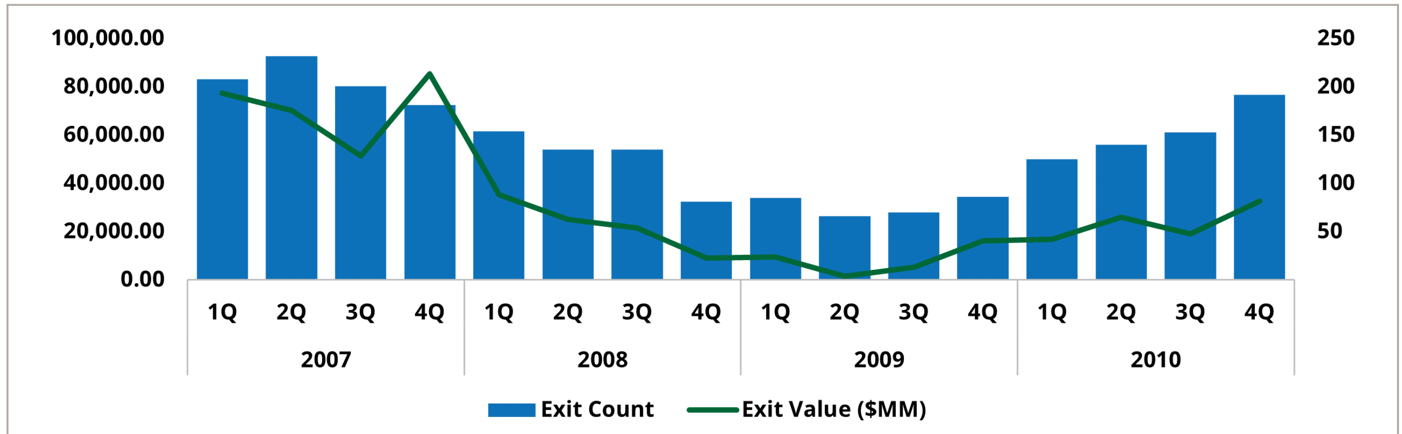
GLOBAL PE EXIT ACTIVITY DURING GFC

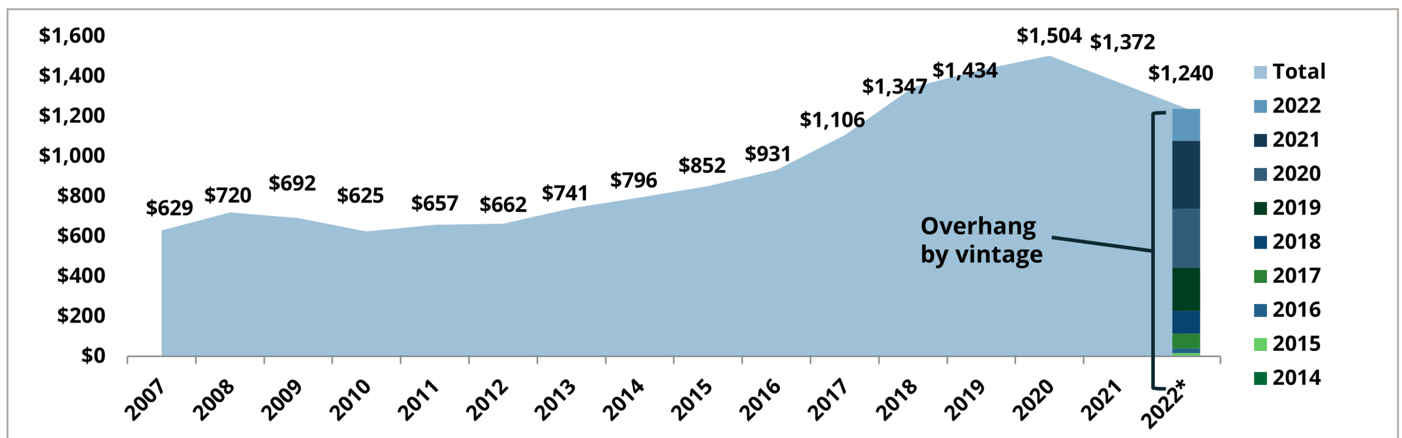


Source: Pitchbook.

We believe that the current market dynamics are putting investors in a bad position if there is an economic slowdown. We believe it may be a better time to commit to private equity (see discussion below) as valuations reset before another economic expansion. Therefore, we believe that investors need to have flexible bands around their private equity allocations that allow them to continue to commit to new strategies while not being forced to sell existing positions at a potential discount to current valuations as secondary buyers often demand a discount. As a firm, we continue to spend time looking for high-quality private market opportunities, whether they are with established or emerging managers and can help our clients find appropriate investment opportunities.

PRIVATE EQUITY DRY POWDER IS STARTING TO COME DOWN

There have been several articles over the past few years discussing the rising pool of dry powder in private equity and whether that means there is too much capital chasing too few opportunities. We have argued in the past that the opportunity set in private markets continues to grow and companies are deciding to remain private rather than float public equity (the Wilshire 5000 no longer has 5000 companies). However, this is starting to change. The slowdown in fundraising activity combined with aggressive deployment by general partners post the COVID-19 reopening, probably helped by fears of future tax law changes and inexpensive and abundant debt, has led to a recent drop in dry powder. According to *Pitchbook*, private equity dry powder was $1.2 trillion as of June 30, 2022. That is down from the peak of almost $1.5 trillion at the end of 2020 and similar to numbers seen in 2018.



Source: Pitchbook Q2 2022 US PE Breakdown Summary (data as of June 30, 2022).

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Rising interest rates, inflation, and the conflict in the Ukraine have led to a slowdown in deal activity and multiples are already starting to come down. According to *Pitchbook*, global multiples for M&A dropped to 8.8x as of June 30, 2022 from 11.4x at the end of 2021, and deal count has plummeted to 181 transactions in the first half of the year, compared to 997 in all of 2021. Deal activity does tend to pick up towards the end of the year, and outside of a major Lehman-type event, we anticipate this year to show a similar pattern, though we still expect the total deal count to be well below 2021 levels. This number is also skewed somewhat by the lower multiples paid for add-ons, but multiples seem to be coming down across the board for most transactions. There are some exceptions. As we discussed with Craig McDonald from HarbourVest in our upcoming podcast, companies in sectors that funds covet, those with strong recurring revenues and a positive model that was resilient during COVID-19, continue to fetch strong multiples, even four turns higher than similar transactions last year.

GLOBAL MULTIPLES FOR ALL M&A'S

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022*
EV/EBITDA	11.6x	10.8x	7.8x	9.3x	9.7x	9.0x	9.1x	10.3x	9.8x	10.3x	10.1x	10.5x	10.5x	10.2x	11.4x	8.8x
Count	1006	801	380	671	815	785	686	849	1116	1219	1187	1088	935	748	997	181

Source: Pitchbook Q2 2022 Global M&A Report (data as of June 30, 2022).

COULD NOW BE A GOOD TIME TO COMMIT TO PRIVATE EQUITY?

We believe the declining overhang of capital, slower fundraising activity, and falling valuations makes this an attractive time to invest in private equity despite rising interest rates. The chart below shows that historically private equity fund vintages immediately following a market crisis tend to experience higher returns than the funds that were formed prior to the crisis. We can also see from the chart that allocations to private equity tend to come down during these periods (as we are already starting to see today):

Vintage Year	US PE Fund Size (bn)	US PE Median IRR	S&P 500 Index Return (PME)	US PE Median OIC
2020	282.9	56.41%	28.37%	1.24x
2019	341.5	47.68%	23.14%	1.53x
2018	229.3	32.27%	16.98%	1.48x
2017	264.3	33.91%	17.57%	1.90x
2016	230.2	25.99%	18.30%	1.98x
2015	163.4	22.93%	14.80%	1.91x
2014	177.2	22.80%	14.80%	2.17x
2013	164.5	18.10%	15.79%	1.96x
2012	110.2	18.38%	15.69%	2.04x
2011	72.0	17.46%	14.73%	2.11x
2010	57.1	17.64%	15.02%	2.26x
2009	101.2	18.84%	16.96%	2.01x
2008	186.4	14.73%	11.60%	1.78x
2007	222.2	10.98%	10.51%	1.72x
2006	146.3	8.18%	10.67%	1.58x
2005	101.1	10.63%	10.62%	1.75x
2004	62.1	10.84%	10.41%	1.68x
2003	31.8	14.58%	11.55%	1.85x
2002	59.9	20.99%	9.51%	2.05x
2001	45.7	18.49%	8.48%	2.03x
2000	100.2	14.49%	7.59%	1.80x

Source: Pitchbook Q2 Benchmarks as of Q4 2021 North America (data as of December 31, 2021).

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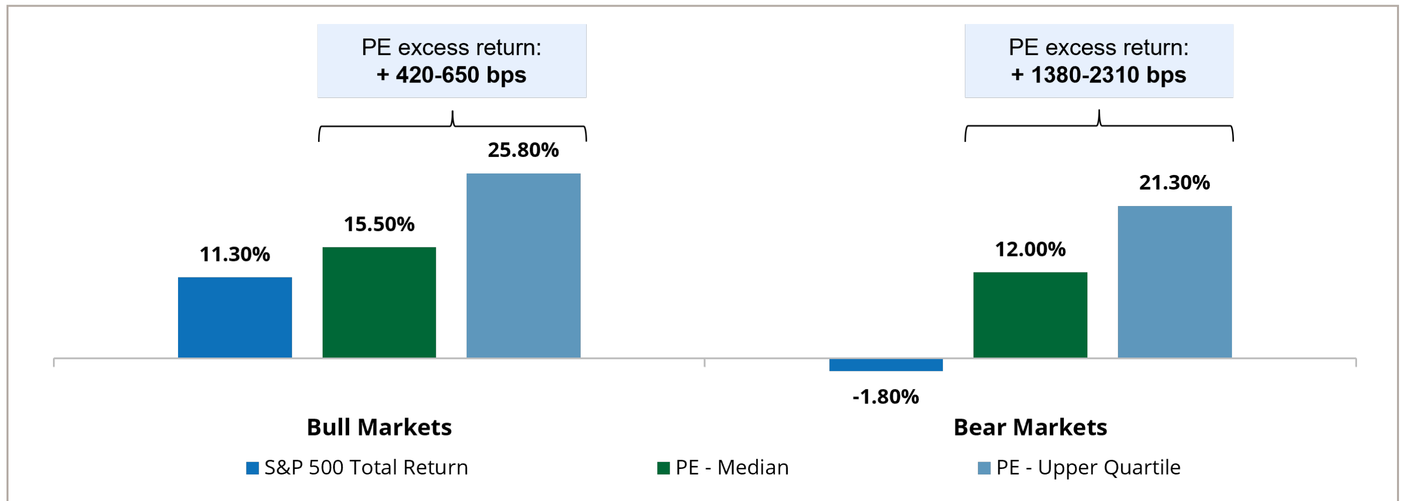
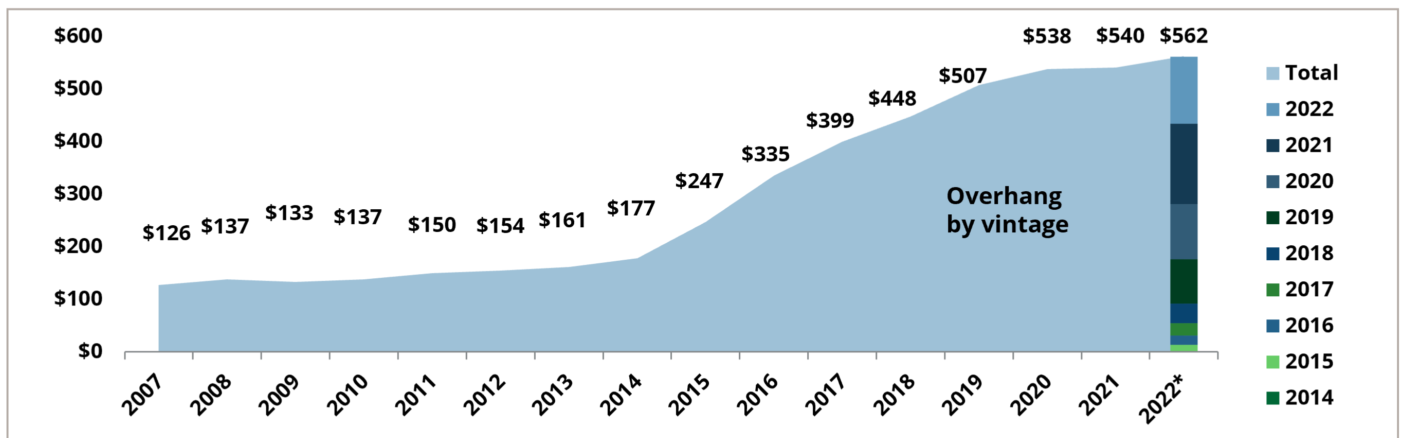
Not only have funds formed during market volatility historically performed better than funds formed before the market volatility, but private equity has also historically outperformed public markets during times of market stress. Much of this was attributed to the delayed mark-to-market valuations of private funds and the fact that their valuations did not swing as widely as public equities. However, private companies also can benefit from having a longer-term focus and can have an easier time making operational changes to help the company better weather a downturn. A recent study that we performed suggested that private equity funds have outperformed public markets by 420-650 bps in past bull markets but 1380-2310 bps during past bear markets.



Source: Bloomberg as of 12/31/2021; Pitchbook as of 6/30/2021 (with preliminary 9/30/2021 data).
Bull Markets are defined as 2000-2001, 2004-2006, and 2010-2019. Bear markets are defined as 2002-2003, 2007-2009, and 2020.

WHAT ABOUT VENTURE CAPITAL?

The historical data is not as supportive for venture capital. Although valuations have started to moderate, the strong performance in venture capital pushed by skyrocketing public valuations for growth companies through most of 2021 and an active private fundraising environment where deals were completed in a matter of weeks, usually at significant step-ups from previous rounds, has led investors to ramp up their allocations to the venture capital sector. Almost $160 billion was raised by venture capital funds through June 30, 2022. That is not too far short of the $234 billion raised in 2021, a record year and four times the average amount raised annually between 2007 and 2013. As a result, venture capital dry powder has continued to grow, despite active deployment.



Source: Pitchbook Q2 2022 US PE Breakdown Summary (data as of June 30, 2022).

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Venture capital funds have also not shown the same consistent resilience during past market downturns as private equity funds have. Looking at the bear market years used in the chart on the previous page for private equity, venture capital funds were down 4 bps on average in those years and that is after factoring a 42% increase in 2020 as growth companies rallied in the back half of the year.

Vintage Year	US VC Fund Size (bn)	US PE Median IRR	US VC Median MOIC	US VC Median DPI
2020	84.5	51.57%	1.33x	0.05x
2019	72.0	68.55%	1.98x	0.11x
2018	72.7	36.49%	2.08x	0.13x
2017	48.2	38.95%	2.45x	0.38x
2016	59.7	37.13%	2.86x	0.48x
2015	39.7	27.00%	2.59x	0.67x
2014	40.9	26.76%	3.50x	1.07x
2013	26.0	23.24%	2.83x	1.09x
2012	27.4	21.92%	3.46x	1.45x
2011	28.0	22.73%	3.66x	2.33x
2010	19.4	19.73%	2.58x	1.67x
2009	18.9	13.01%	2.27x	1.51x
2008	33.2	14.82%	2.16x	1.86x
2007	31.0	12.42%	1.97x	1.68x
2006	32.9	5.87%	1.44x	1.27x
2005	22.4	9.07%	1.92x	1.56x
2004	20.5	4.94%	1.41x	1.34x
2003	10.8	6.00%	1.42x	1.38x
2002	12.9	2.85%	1.20x	1.18x
2001	28.8	4.87%	1.38x	1.30x
2000	61.6	-0.42%	0.97x	0.95x

Source: Pitchbook Q2 Benchmarks as of Q4 2021 North America (data as of December 31, 2021).

The data for venture capital at this stage is mixed. Venture capital raised after the GFC has performed very well, while funds raised following the dotcom bust had difficult performance. We would caution reading too much into the performance number for funds post the GFC since many of those returns have yet to be realized, as exhibited by the median MOIC (multiple of invested capital) to median DPI (distributions to paid in capital), which is wide even for funds raised in 2011. This is not unusual in venture investing since funds tend to invest early in a company's life and can take multiple years before gains are realized. However, it can demonstrate the risk in the current valuations, especially if valuations for growth companies remain challenged. On the flip side, the dry powder overhang might help support private company valuations and provide capital for companies still working towards profitability, even if the public markets remained challenged.

We are not saying that investors should avoid venture capital or growth equity, but we do believe that we still need to keep in mind how the venture markets behaved following previous recessions. Growth companies have not seen the rapid increase in valuations experienced during the late 1990s. According to Cambridge data, venture capital funds achieved a cumulative return of over 2000% from the end of 1994 until the market peak at the end of the third quarter of 2000, but valuations have more than doubled in the last two years (they increased over 3.5x in the two years prior to the venture bubble bursting at the end of Q3 2000). That rapid increase in valuations, along with the surge in fundraising and the lingering dry powder overhang, makes us believe that a little caution would be prudent.

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KEEP INVESTING AND REMAIN FOCUSED ON HIGH-QUALITY MANAGERS

As we have discussed, there is a significant difference in performance between top and bottom quartile managers. This is certainly the case in periods of market volatility.

We have always focused on finding high-quality performing funds for our clients. We look for managers that have unique or proprietary sourcing abilities, a strong operational value add focus, a culture of rigor and alignment with our clients, and do not rely on excessive leverage. We believe these types of funds could perform whether we are in the heart of a bull market, at the end of a bull market (which have been the most difficult years for private equity) or entering a recession. As a result, we hope our private capital portfolios will perform well regardless of where we are in the market cycle. This might just be a good time to allocate to private markets, especially with the guidance of a trusted advisor.

Sources:
(1) Pitchbook Q2 2022 US PE Breakdown Summary. Performance through 12/31/2021.
(2) Bloomberg. Performance is through 12/31/2021 and assumes that dividends are reinvested in the index.
(3) Pitchbook Q2 2022 US VC Breakdown Summary. Performance through 12/31/2021.
(4) Pitchbook Q2 2022 Global Private Markets Fundraising Report Summary. Data as of June 30, 2022.
(5) Pitchbook.
(6) Pitchbook Q2 2022 Global Private Markets Fundraising Report Summary. Data as of June 30, 2022.

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Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

August 31, 2022		1M	3M	12M	YTD
US Large Cap	S&P 500	-4.1%	-3.9%	-11.2%	-16.1%
US Small Cap	Russell 2000	-2.0%	-0.7%	-17.9%	-17.2%
Developed Intl	MSCI EAFE	-4.7%	-9.3%	-19.8%	-19.6%
Emerging Intl	MSCI Em Mkt	0.4%	-6.5%	-21.8%	-17.5%
Real Estate	NAREIT	-5.9%	-5.1%	-10.3%	-17.5%
Core Fixed	BarCap Agg	-2.8%	-2.0%	-11.5%	-10.8%
Short Fixed	BarCap 1-3Yr	-0.8%	-1.0%	-4.0%	-3.4%
Long Fixed	BarCap LT G/C	-4.4%	-3.8%	-22.7%	-22.5%
Corp Debt	BarCap Corp	-2.8%	-2.5%	-14.4%	-13.7%

Source: Bloomberg

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