CLEARPOINT

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FEBRUARY 2023

MIKE MCLELLAND, CFA, CAIA, ANALYST, RESEARCH

PRIVATE STRATEGY CONSIDERA-TIONS IN DISLOCATED MARKETS

BY MIKE MCLELLAND, CFA, CAIA, ANALYST, RESEARCH

Global markets reached an inflection point in 2022 as economic headwinds, geopolitical instability, and reactive central bank policies flipped the script from economic exuberance to a period of ambiguity. Public equity and bond markets sharply corrected, the fourth time since the 1929 Great Depression that stocks and bonds ended a year in negative territory. Further, deteriorating conditions and aggressive actions from central banks have unveiled potential liquidity issues for public and private markets.

Declines in public markets also have led to many investors to reduce their exposure to private investments, and pausing their commitments to private strategies as allocations move out of policy target ranges. Investors are assessing whether they overcommitted to private investments and the potential impact on portfolio liquidity. A frenetic and crowded fundraising environment, paired with increased accessibility to private strategies by retail investors, has contributed to an investor base without the capacity to make future commitments. For private fund managers, realizations have declined, and valuations are beginning to reflect economic reality and trend lower. Private equity ("PE") managers are focusing efforts on driving returns from operational improvements (versus multiple expansion) and holding onto assets longer. While liquidity constraints are prevalent throughout the investment landscape, for both investors and private fund managers, dislocated markets have historically presented lucrative opportunities to generate strong returns in the long run.

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client and Administration teams with Samantha Sutton, Kaila Unger, and Kim Kozak.

Samantha Sutton joined Clearstead as a Client Planning Associate, Tax. She has a Bachelors degree from John Carroll University, majoring in Finance. Samantha joins us from MAI Capital Management where she was a Senior Tax Associate.

Kaila Unger joined Clearstead as a Client Planning Associate, Tax. Kaila has a Bachelors degree from Kent State University, majoring in Accounting. She was most recently employed as a supervisor at Rea & Associates, Inc.

Kim Kozak joined Clearstead as an Accounts Receivable/Accounts Payable Specialist. Prior to joining Clearstead, Kim served as an Accounting Specialist for Skyline Trisource Exhibits of Cleveland.

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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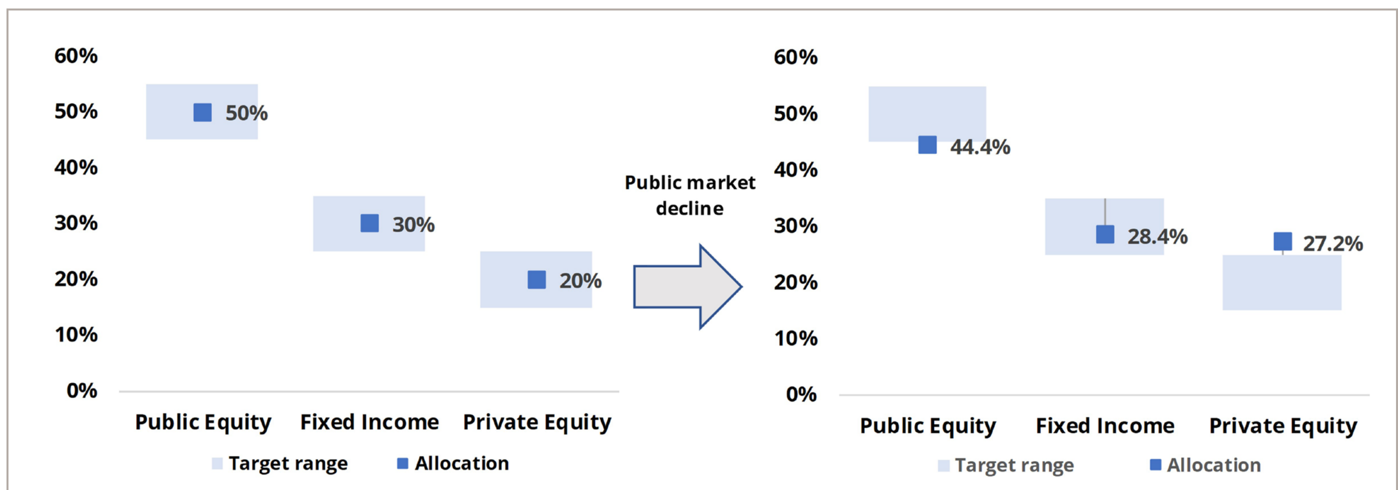
DENOMINATOR EFFECT CREATING CHALLENGES FOR INVESTORS AND PRIVATE FUND MANAGERS

From the investor's perspective, public market volatility has directly affected the flow of institutional capital into private strategies. Allocations to privates on a relative basis have increased as public markets declined, resulting in a "denominator effect" where investors halt future commitments to private funds as allocations deviate outside of investment policy guidelines. While public markets have transparent pricing and liquidity, private investments are valued infrequently and do not trade regularly. This can create a valuation gap during sharp public market drawdowns as investor portfolios end up having more exposure to private alternatives than allowed per policy guidelines. For example, let's assume a client has an account with the following allocation: 50% to public equities, 30% to public fixed income, 20% to PE, and a PE policy target of 18-22%. If public equities and bonds decline by 25% and 20% while private equity is marked up by 15%, the portfolio would hold over 5% more private equity than acceptable per investment policy.

Denominator Effect Example



Asset Class	Before Value	Allocation	IPS Target (%)	Projected Decline (%)	After Value	After Allocation
Public Equities	$50.0	50%	48-52%	-25%	$37.5	44.4%
Fixed Income	$30.0	30%	28-32%	-20%	$24.0	28.4%
Private Capital	$20.0	20%	18-22%	15%	$23.0	27.2%
Total (denominator)	**$100.0**				**$84.5**	

The denominator effect is difficult to eradicate. Private strategies, especially newer vintages with substantial dry powder, will look to deploy capital at cheaper valuations during periods of market turbulence. Assuming no change in valuation, increased deployment only elevates private market allocations and leads to institutional investors scaling back new commitments to mitigate a potential liquidity crunch. Investors could look to secondary markets for liquidity, but buyers have the negotiating power during periods of economic stress. Any acquirer of secondary interests would require a sizable discount to current marks. Liquidity is front and center as investors assess the possibility of a public market rebound and how that affects annual spending requirements and private fund contributions.

FUNDRAISING AND THE DEMOCRATIZATION OF PRIVATE ALTERNATIVES

Private market fundraising has ballooned to historic levels in recent years. Total fundraising eclipsed $6.6 trillion over the past five years combined, representing a 50% increase from the prior five-year period (2013-2017). While fundraising slowed

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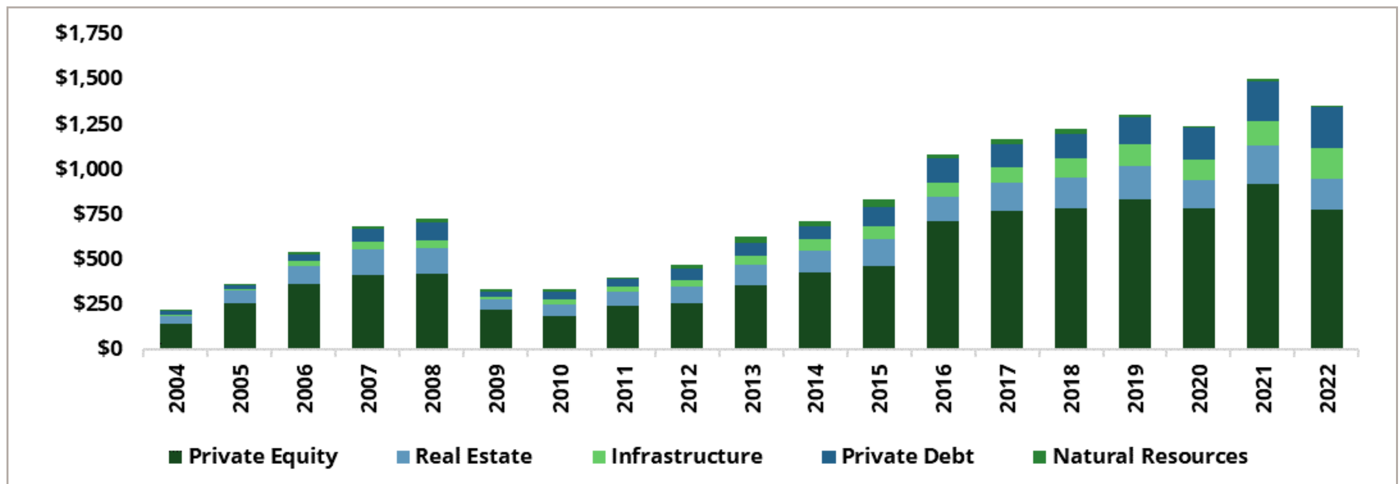
last year versus the historic $1.5 trillion raised in 2021, 2022 levels eclipsed both 2019 and 2020 as fund managers deployed a significant amount of capital post-COVID and came back to market at a rapid pace.[1] In 2022, the average time between new and prior vintages was three years for U.S. private equity funds, nearly two years less than the 2011 average of 4.8 years.[2] Amidst a crowded fundraising environment and investor-specific issues, funds should stay open longer and raise less commitment dollars than originally targeted.

PRIVATE MARKET FUNDRAISING FROM 2004 TO 2022
($B)



Source: Preqin as of December 31, 2022.

Many alternative investment managers have shifted their focus to a traditional asset management model with a full suite of products and strategies geared towards a diversified client base, including nontraditional alternative investors such as retail. Publicly traded alternative asset managers—which are largely measured on AUM growth and fee revenue—have ramped up offerings for nontraditional investors who tend to have more discretion than traditional institutional investors on allocation decisions. This proliferation has notably increased retail exposure through open-ended fund structures and interval funds (among others), especially with income-oriented strategies in private credit and real estate. These funds have stated terms with greater liquidity than traditional drawdown vehicles, while also providing core exposure for institutional and retail investors seeking broad, immediate access to private markets without worrying about capital call pacing and cash flow management.

Investors, as noted earlier, are struggling with the denominator effect and potential liquidity issues after making a significant number of commitments to private strategies in recent years. Retail-oriented strategies, with stated redemption schedules, are being sold or trimmed by many investors for rebalancing purposes and liquidity. Unfortunately, most retail products have limited withdrawal features where redemptions are honored up to a maximum percentage every month or quarter (depending on the fund terms). For example, Starwood's hit its 5% redemption cap in each of the last two months of 2022 and honored 63% of redemptions in November and 20% in December.[4] Retail-oriented alternative strategies are investing in illiquid investments, so it should not surprise investors when it takes some time to receive proceeds, especially as redemption notices compile.

Meanwhile, fund managers of retail-oriented strategies (who are tasked with managing a perpetual capital vehicle with potential investor redemptions) are attempting to capture the buildup of unrealized gains across their portfolios as selling pressure increases. Unfortunately, for a market to exist, there needs to be a buyer and a seller. Savvy buyers are waiting for valuations to trickle down from extreme levels, and many sellers do not have the luxury of time to wait for lucrative exit points. Retail-oriented strategies often lack the negotiating power and discipline in acquiring assets versus traditional drawdown vehicles. Generally, drawdown fund structures provide a greater alignment of interests between investors and

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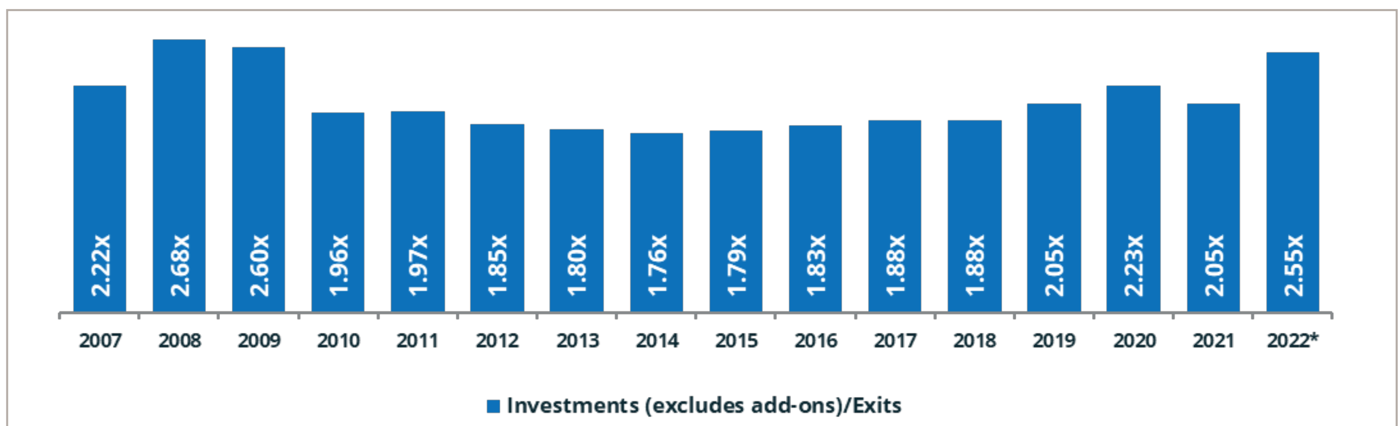
fund managers and can opportunistically deploy capital throughout a business cycle instead of investing a lump sum at once. This is a structural issue that highlights a potential issue of risk transfer and a lack of investment discipline fostered by the fund structure of retail strategies.

SLOWDOWN IN M&A ACTIVITY

As public markets trended lower, there has been a slowdown in the size and volume of private equity investment realizations. Investment activity, on the other hand, declined on a year-over-year basis but eclipsed 2019 and 2020 levels in deal value and volume. Through Q4 2022, there were 2.55 times more acquisitions by U.S.-based private equity firms than exits—levels not seen since the Global Financial Crisis ("GFC") in 2008 and 2009.[2] Sellers are less inclined to accept lower prices, while many PE firms have large amounts of dry powder that they need to deploy. This means that firms will continue to make investments, even as exits decline, leading to a higher ratio going forward.

U.S. PE INVESTMENT/EXIT RATIO



Source: PitchBook as of December 31, 2022.

The decline in exit activity is not exclusive to sponsor-backed exits. Public listings were virtually non-existent due to market volatility and decreasing valuations. Exits to other private equity firms ("sponsors") declined but remained the most likely acquirer of sponsor-backed exits. As a percentage of PE-backed exit activity, sponsor-to-sponsor exits have gradually increased and accounted for 61.8% of all PE-backed exits in Q3 2022.[3] The trend could persist as fund managers have a copious amount of dry powder available for investment and are effectively on the clock to allocate within a preset investment period per fund terms. Managers of older vintages want to realize mature portfolio investments to capture gains, as well as generate distributions for investors (also known as "distributions-to-paid-in-capital" or "DPI") before raising a new vintage. Additionally, we have seen an increase in fund managers utilizing continuation vehicles to wind down mature vintages, generate DPI for investors, and maintain control of underlying assets. Continuation funds acquire assets from mature funds nearing the end of the fund's term and often garner some skepticism regarding the quality of underlying investment(s) and fundraising motivations (generating DPI before coming to market), among other factors.

Exits to corporations ("strategics") slowed last year and could continue trending lower as the economy contracts. Corporations will likely exercise greater caution with strategic acquisitions due to recessionary concerns, and instead prioritize preserving their financial stability. We expect balance sheet issues to motivate corporations to divest non-core business units, which could fuel sponsor-backed acquisitions going forward. Carveouts and divestitures increased to over 17% of U.S. private equity-backed buyouts during the GFC and have slowly trended below 8% through 2022.[2] Orphaned assets are often some of the most lucrative sponsor-backed investments, typically presenting several operational value-add levers.

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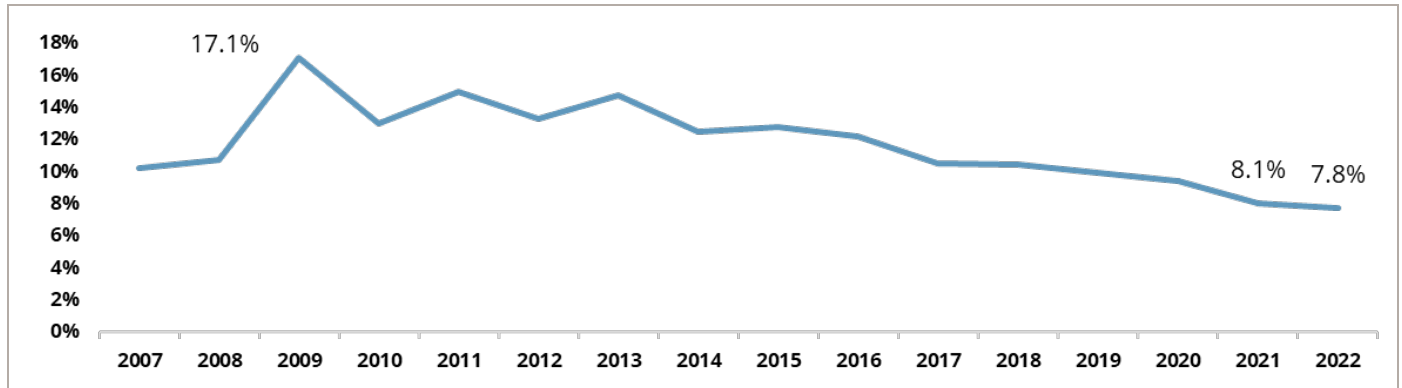
CARVEOUTS/DIVESTITURES AS A PERCENTAGE OF U.S. PE BUYOUTS



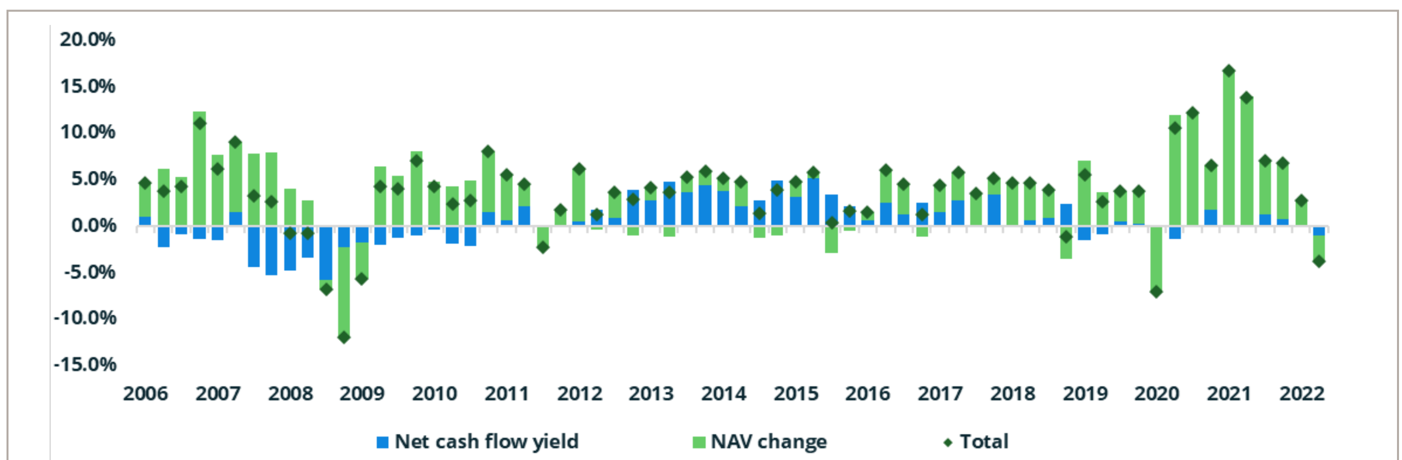
Source: PitchBook as of December 31, 2022.

VALUATION EXPECTATIONS AND OPPORTUNITIES GOING FORWARD

While public markets notably struggled last year, private markets are slowly beginning to reflect economic reality and mark unrealized positions lower. Funds with elevated levels of unrealized gains want to capture these returns at current valuations, but with a sluggish M&A environment and inherent price discovery, expectations are starting to trend lower with marks following suit. Since the COVID-related drawdown in Q1 2020, U.S. private equity funds have returned a cumulative 72.4% through Q2 2022. Nearly 98% of the cumulative return is attributed to unrealized gains, which trended lower in the second quarter of 2022 and could persist in the near term.[3] As a result, firms will likely hold onto investments for longer periods to achieve their previous valuations, even if the volume of purchases decreases. This could prolong the recovery of the market even if the balance between buying and selling activity improves.

This issue is not exclusive to private equity. Venture capital funds have accumulated a lofty amount of unrealized value after capitalizing from historically low interest rates, strong macro tailwinds, and an attractive exit environment (notably via initial public offerings). U.S. venture-backed IPO activity has fallen off a cliff, declining from $638 billion across 303 listings in 2021 to $34.4 billion (76 total listings) last year.[5] The frigid exit environment could extend the holding period across venture-backed companies, which hopefully have enough cash on hand to withstand an economic slowdown or minimize cash burn. That would prevent venture-back firms from raising additional funding at, what is likely to be, lower valuations.

PRIVATE EQUITY RETURN ATTRIBUTION



Source: PitchBook as of June 30, 2022.

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While it may sound like there is plenty to be concerned about, market dislocations have historically presented opportunities to generate strong returns versus historical averages. As pointed out in our *ClearPoint* article from September, *"What Should Investors Do With Their Private Capital Portfolios Today"*, private equity funds have outperformed public markets by 420-650 bps in prior bull markets by 1380-2310 bps during past bear markets.[6] In anticipation of an economic downturn, private fund managers can "batten-down-the-hatches" within each portfolio company to optimize performance during a recessionary environment and drive operational efficiencies. Historical returns show that private equity fund vintages immediately following market crises tend to generate some of the strongest returns on record. Following the market turmoil in 2000 and 2008, new top quartile private equity vintages returned well over two times cost and notably outperformed public markets.[7] These fund managers can allocate capital with less competition (given less deal flow) at lower valuations with potentially greater upside. We expect investment activity to ramp up as managers opportunistically allocate the considerable amount of dry power (estimated at over $1.2 billion)4 ripe for deployment.

Vintage Year	Top Quartile US PE IRR	Median US PE IRR	S&P 500 Return (PME)	Top Quartile US PE MOIC	Median US PE MOIC
2020	39.00%	24.05%	15.85%	1.36x	1.24x
2019	37.79%	25.95%	15.43%	1.57x	1.31x
2018	39.45%	28.09%	12.00%	1.76x	1.58x
2017	33.64%	23.37%	13.46%	2.07x	1.62x
2016	27.61%	23.39%	14.75%	2.11x	1.88x
2015	29.51%	19.80%	12.05%	2.28x	1.93x
2014	26.73%	19.50%	12.38%	2.51x	2.05x
2013	23.71%	15.90%	13.56%	2.14x	1.75x
2012	23.90%	16.26%	13.68%	2.42x	1.78x
2011	24.70%	17.63%	12.95%	2.46x	1.99x
2010	22.60%	15.67%	13.38%	2.29x	1.79x
2009	23.42%	16.20%	15.34%	2.33x	1.83x
2008	19.54%	12.82%	10.34%	2.08x	1.69x
2007	16.83%	10.85%	9.38%	2.13x	1.69x
2006	13.53%	9.55%	9.61%	1.86x	1.55x
2005	13.70%	8.00%	9.61%	2.01x	1.64x
2004	17.63%	10.98%	9.47%	2.02x	1.59x
2003	20.52%	13.00%	10.62%	1.92x	1.71x
2002	30.14%	19.28%	8.69%	2.26x	1.87x
2001	26.37%	15.37%	7.73%	2.38x	1.61x
2000	21.76%	13.05%	6.90%	2.18x	1.69x
1999	16.43%	12.01%	7.20%	2.04x	1.57x

Source: Source: PitchBook – North American Private Equity Managers – as of June 30, 2022.
*Periods of market stress defined as 2000 and 2008.

Although stressed markets tend to coincide with smaller allocations to private equity funds for these vintage years (i.e., denominator effect), broad dislocation may signal an opportune time for investors to increase their private allocations to capture higher returns following market dislocations. Outside of traditional private equity, we would also expect new vintages of growth equity and venture capital strategies to perform well given the steep discount in public comps and continued innovation. Real assets, such as infrastructure strategies, have historically outperformed during periods of high inflation and could benefit from fiscal stimulus from bipartisan efforts domestically. Value-add and opportunistic real estate

strategies also have historically generated strong returns during periods of elevated inflation while driving returns through property improvements and acquiring at stressed valuations. On the opportunistic side, distressed/special situations and secondary strategies are set to benefit from a looming distressed cycle as defaults are expected to rise and private market investors (both investors and fund managers) seek immediate liquidity at a discount.

The private market is flush with new vintages ready to put dollars to work, but manager selection is key to successful outcomes. There can be a glaring dispersion of returns between top and bottom quartile managers, especially during periods of market stress. Our focus has always been on finding high-quality private strategies that can generate strong performance independent of where we are in a market cycle. We look for managers that have unique or proprietary sourcing capabilities, a strong operational value-add focus, a culture of rigor and alignment with our clients, a strong track record, and do not rely on excessive leverage. While it may be difficult to stay patient and drown out the noise from the talking heads on Wall Street, opportunity presents itself during times of trial. It could be a great time to allocate to private alternatives, especially with the guidance of an experienced, trusted advisor.

Source:

(1) Preqin.
(2) PitchBook 2022 Annual US PE Breakdown Summary.
(3) PitchBook 2023 US Private Equity Outlook.
(4) Bary, Andrew. "Starwood, KKR Retail Real Estate Funds Limit Investor Withdrawals." Barron's, 19 Jan. 2023, www.barrons.com/articles/kkr-reit-starwood-withdrawal-limits-51674142589.
(5) PitchBook Q4 2022 NVCA Venture Monitor Summary.
(6) Bloomberg. PitchBook. ClearPoint: "What Should Investors Do with Their Private Portfolios Today?"
(7) PitchBook Benchmarks – North American Private Equity.

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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

January 31, 2023		1M	3M	12M	YTD
US Large Cap	S&P 500	6.3%	5.8%	-8.2%	-8.2%
US Small Cap	Russell 2000	9.7%	5.0%	-3.4%	-3.4%
Developed Intl	MSCI EAFE	8.1%	20.4%	-2.8%	-2.8%
Emerging Intl	MSCI Em Mkt	7.9%	22.2%	-12.1%	-12.1%
Real Estate	NAREIT	10.3%	11.0%	-10.5%	-10.5%
Core Fixed	BarCap Agg	3.1%	6.4%	-8.4%	-8.4%
Short Fixed	BarCap 1-3Yr	0.8%	1.8%	-2.2%	-2.2%
Long Fixed	BarCap LT G/C	6.6%	13.7%	-18.3%	-18.3%
Corp Debt	BarCap Corp	3.8%	8.5%	-9.1%	-9.1%

Source: Bloomberg

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