CLEARPOINT

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MICHAEL G. KUEBLER, ANALYST, RESEARCH

DEMYSTIFYING PRIVATE ALTERNATIVES AND DEBUNKING FEARS

BY MICHAEL G. KUEBLER, ANALYST, RESEARCH

Private alternative asset classes can be difficult for many investors to be comfortable with or understand. This may be because of their closed nature and being restricted to eligible investors, and can make them easy targets for raising fear and pointing fingers.

Concerns rise, especially in down markets, as investors keep a watchful eye out for cracks and vulnerabilities in markets. After a volatile and turbulent year for public markets in 2022, fearful narratives about private markets started to appear in 2023. What is catching investors' attention is an apparent disconnect between valuations and returns in public and private investments last year. This disconnect is leading to publicized narratives that highlight potential vulnerabilities in private markets.

Some of these headline-grabbing fears include:

- Looming markdowns in private portfolios spell disaster for public pension funds, private valuations are murky, and private equity manager fees are robbing retirees.[1]

CLEARSTEAD ACQUIRES THE BUSINESS OF CLS CONSULTING, LLC

In March 2023, Clearstead signed an agreement to acquire the business of CLS Consulting, LLC, a consulting firm founded by Ms. Cindy Steeb in 2017. Ms. Steeb advises high-net-worth individuals, private family trust companies, and family-owned businesses on estate planning and fiduciary matters. She is a nationally recognized leader in fiduciary services, having been a pioneer in the development of single-family trust companies in Ohio. Ms. Steeb has served as an advisor and trustee to several family trust companies and is a regular speaker at industry conferences.

Cindy Steeb will join Clearstead as Senior Managing Director, Trust Administration Services in the firm's Private Wealth Management Group.

Additional details can be found in a press release on our website: https://www.clearstead.com/in-the-news/

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- Real estate valuations are unsustainable, and a flood of investor redemptions from nontraded real estate funds will exacerbate the problem.[2]
- Hedge funds have blowup risk and underperform in the long run.[3]

But are these concerns warranted? Hyperbole? Or is the truth somewhere in the between?

PRIVATE EQUITY PERFORMANCE AND FEES IMPACT

Institutional investors such as public pensions, endowments, and foundations make up a large portion of capital invested in private equity. These organizations depend on investment returns to fund obligations, which include retiree benefits, scholarships, and general business operations. Investment losses or unexpected changes to investment portfolios' returns can lead to challenging shortfalls.

Are institutions, including pensions, in trouble? First, we can consider how private funds operate and value portfolios. Private equity funds mark portfolio values quarterly (usually with independent valuation audits annually), so even when private marks perfectly track public marks, there will be a disconnect. However, there is evidence that private valuations tend to understate changes in valuation when using fair value accounting.[4] Any imperfections tend to be self-correcting across quarters and do not affect multi-year returns. To this point, private market valuations were relatively stable through 2022 with modest markdowns appearing in some strategies in Q3 and Q4, such as credit strategies more tied to mark-to-market and venture/growth funds that are more sensitive to public marks in valuations.

Depending on the economic environment in 2023, there may be additional markdowns for private markets. However, markdowns in some of the fearmongering narratives are characterized as if they are realized losses. This is overblown, as it is not the case, just as markups do not equal realized gains. It is incorrect to characterize 2023 markdowns as risking pension plan blowups. However, markdowns can lead to longer holding periods for private investments and delayed distributions to investors, so liquidity and cash flow management is rightly becoming an issue for these institutions to navigate in the short term. In the long run, private equity illiquidity and valuation smoothing can be considered a benefit and not a problem, especially when compared to public market volatility which often leads to emotional, suboptimal investment decisions. Private equity markdowns may be less of an issue for institutions than public markets, whose poor performance in the past year may be a greater concern.

Arguments about manager fees robbing investors and being opaque are equally unwarranted. An investor in a private equity strategy who does minimal due diligence will have the manager's fees and carried interest structure clearly available to them. Additionally, larger investors such as pension funds and endowments can benefit from fee discounts based on commitment size and can negotiate discounts.

Also, investors must evaluate returns being achieved for higher fees. According to PitchBook which measures North American Private Equity returns by vintage year, the median IRR for all but two vintages from 2000 to 2020 outperformed the S&P 500 (see table on following page). It is important to note that the private equity fund returns are net of investment manager fees and carry but gross of client advisory fees.

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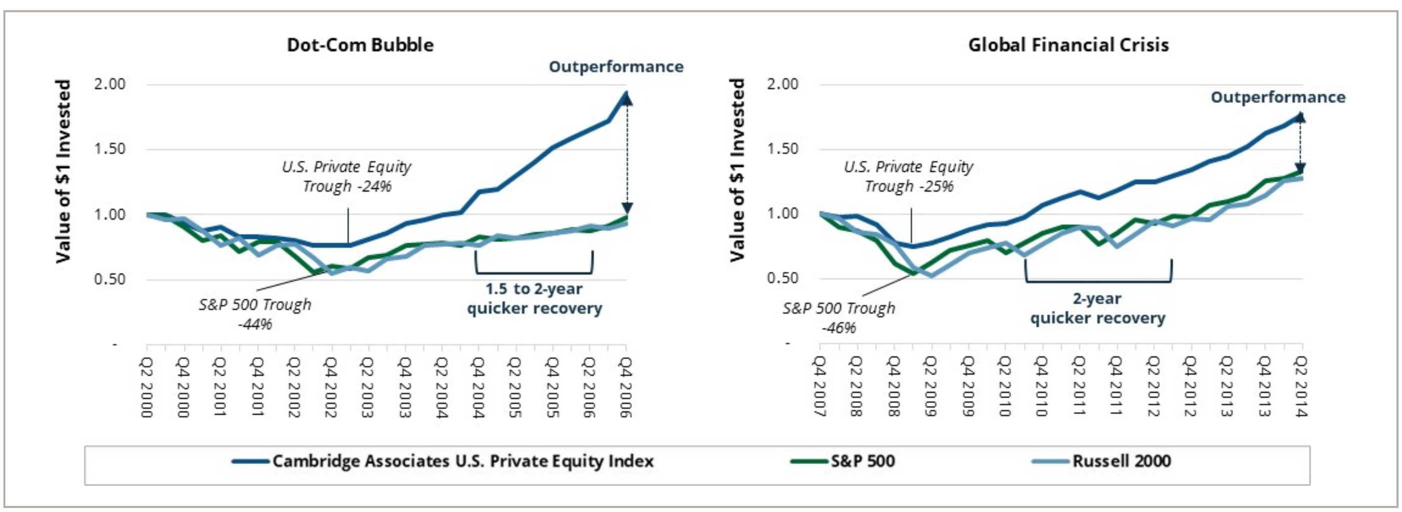
Vintage Year	Top Quartile US PE IRR	Median US PE IRR	S&P 500 Return (PME)	Top Quartile US PE MOIC	Median US PE MOIC
2020	39.00%	24.05%	15.85%	1.36x	1.24x
2019	37.79%	25.95%	15.43%	1.57x	1.31x
2018	39.45%	28.09%	12.00%	1.76x	1.58x
2017	33.64%	23.37%	13.46%	2.07x	1.62x
2016	27.61%	23.39%	14.75%	2.11x	1.88x
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

Source: PitchBook as of 6/30/2022; Peer group – North American Private Equity Managers.

In addition, a study by Cambridge Associates shows that the U.S. Private Equity Index after the Dot-Com Bubble and the Global Financial Crisis declined less (speaking to the current debate about valuations), recovered quicker, and then continued to outperform in the long run compared to both the S&P 500 and Russell 2000.



Source: Cambridge Associates as of 12/31/2022, Bloomberg.

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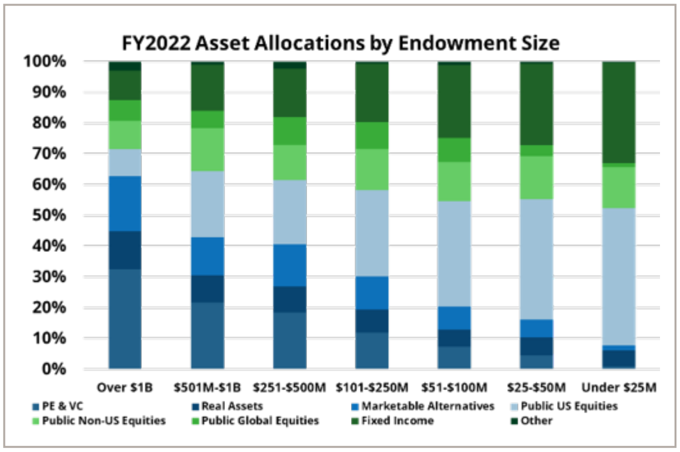
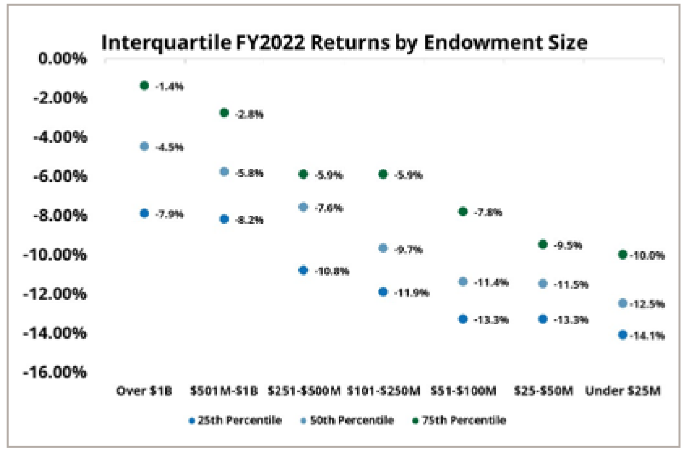
Data from one set of institutional investors—university endowments—also hints at a potential relation between higher allocations to private assets and higher returns. The 2022 NACUBO-TIAA Study of Endowments shows that endowments with higher allocations to private equity, venture capital, and real asset strategies also experienced higher FY2022 returns (the 2021 study showed similar results). While causation cannot necessarily be proven, the correlation indicates there may be something there.



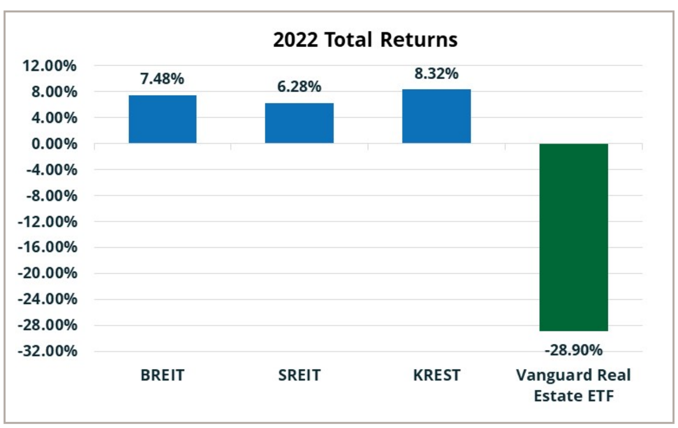
Source: 2022 NACUBO-TIAA Study of Endowments. NACUBO: National Association of College and University Business Officers.



Source: 2022 NACUBO-TIAA Study of Endowments. NACUBO: National Association of College and University Business Officers.

REAL ESTATE VALUATIONS AND LIQUIDITY

Private real estate funds became the poster child late last year for criticism of disconnects between private and public valuations. This came to the forefront with a surge in investor redemption requests from nontraded REIT strategies of firms like Blackstone (BREIT), Starwood (SREIT), and KKR (KREST). As opposed to publicly traded REITs that have daily liquidity, the nontraded REIT structure is semi-liquid including general quarterly redemption limits of 5% of net asset value. The rush of redemptions was largely blamed on investors realizing gains in these products to rebalance based on losses elsewhere in their portfolios in 2022. While publicly traded REITs posted negative 2022 returns, the nontraded REIT products of Blackstone, Starwood, and KKR were all up for the year.



Source: Bloomberg, Blackstone, Starwood, KKR.

Criticisms of gravity-defying valuations of private real estate in 2022 have validity but also are often overblown for the asset class. With the steady rise of interest rates in 2022, there should be increases in the cap rates used to value real estate which will pressure valuations to the downside. While this did not occur widely in 2022, private real estate valuation changes will lag in a similar fashion as discussed for private equity. Private real estate funds (both nontraded REITs and closed-end funds) began to show some negative returns at the end of 2022, and investors can expect more resetting downward in 2023.

The problem with calls for larger resets to private real estate valuations and rushing for the exits in more liquid strategies is that a long-term investment mindset should be used when investing in real estate. The underlying assets are generally extremely illiquid and investing in them should be considered as such. One can argue that this applies to the publicly traded REITs as well and their extended drawdown that have more

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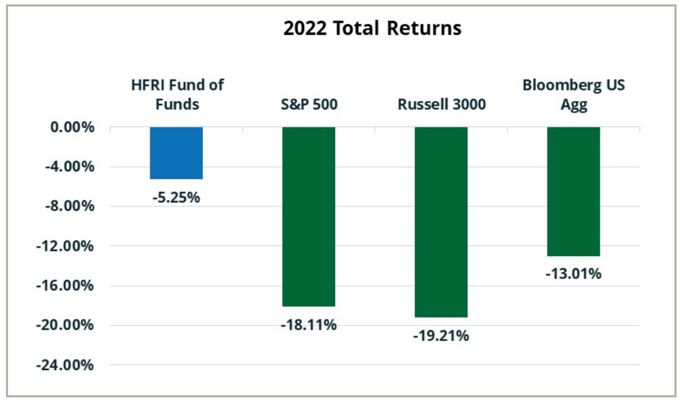
to do with market and investor rationality and sentiment than with underlying fundamentals and valuations. Interest rates and cap rates are only one side of the valuation equation for real estate. Fundamentals including supply, demand, and rent growth all play a role as well, and they still have strong outlooks broadly speaking. So, while there are factors to watch out for such as cap rates, the health of the office sector, and excessive use of leverage, real estate could remain attractive for long-term allocations to the sector.

HEDGE FUND RISKINESS AND ACTIVE MANAGEMENT

Hedge funds may be the epitome of obscurity in financial markets in the eyes of the general population. While the term "hedge fund" encompasses a wide variety of entities and strategies, it is often used colloquially in a manner that considers it a dark, evil corner of the financial world. This can be seen in real-world examples of hedge fund malfeasance and blowups, as well as fictional and non-fictional movies and shows that entertain and captivate audiences.

Hedge funds also receive many arguments against them, comparing them to low fee, passive investing strategies. An often-cited example of this is Warren Buffett's $1 million bet on Vanguard's S&P 500 index fund against a portfolio of hedge funds.[5] The previously cited CNBC article dismisses active managers' outperformance in 2022 in light of longer- term underperformance to the S&P 500.[6] What this view misses however are two purposes that hedge funds serve in a portfolio: diversification and protection (including outperformance) during volatile markets as seen in 2022. In this example, hedge funds in aggregate outperformed broad equity and fixed income indexes last year providing investors with diversification and protection.



Source: Bloomberg, HFRI.

NAVIGATING PRIVATE ASSET ALLOCATIONS AND MANAGER SELECTION

Private markets do not need to be viewed as a black box riddled with hidden risks. Their illiquidity, reduced volatility, return smoothing, and diversification characteristics should be viewed as benefits to investors. They can protect us from succumbing to emotions and negative behavioral finance tendencies at the wrong moment during market volatility.[7] In any investment portfolio, asset allocation is a key driver of return outcomes. With private markets, this generally comes down to manager selection. According to Pitchbook data, there are over 100,000 private fund managers across strategies and asset classes to sift through globally. A daunting figure for any prospective investor to consider. Clearstead has an alternative investment research team dedicated to private market manager due diligence and selection. This coverage includes private equity, growth/venture capital, private credit, real assets, and hedge funds. The team has relationships and access to many top private market managers as well as a track record of selecting above average performing managers. At the end of 2020 and 2021 respectively, a total of 73% and 68% of Clearstead approved alternative fund managers were above median performers with a significant portion of them falling into the top quartile based on Pitchbook Global Benchmarks.* So, if private markets have always seemed scary, out of reach, or even a lingering curiosity, our advisors and research team can extend an open hand in demystifying and navigating these opportunities within a diversified portfolio.

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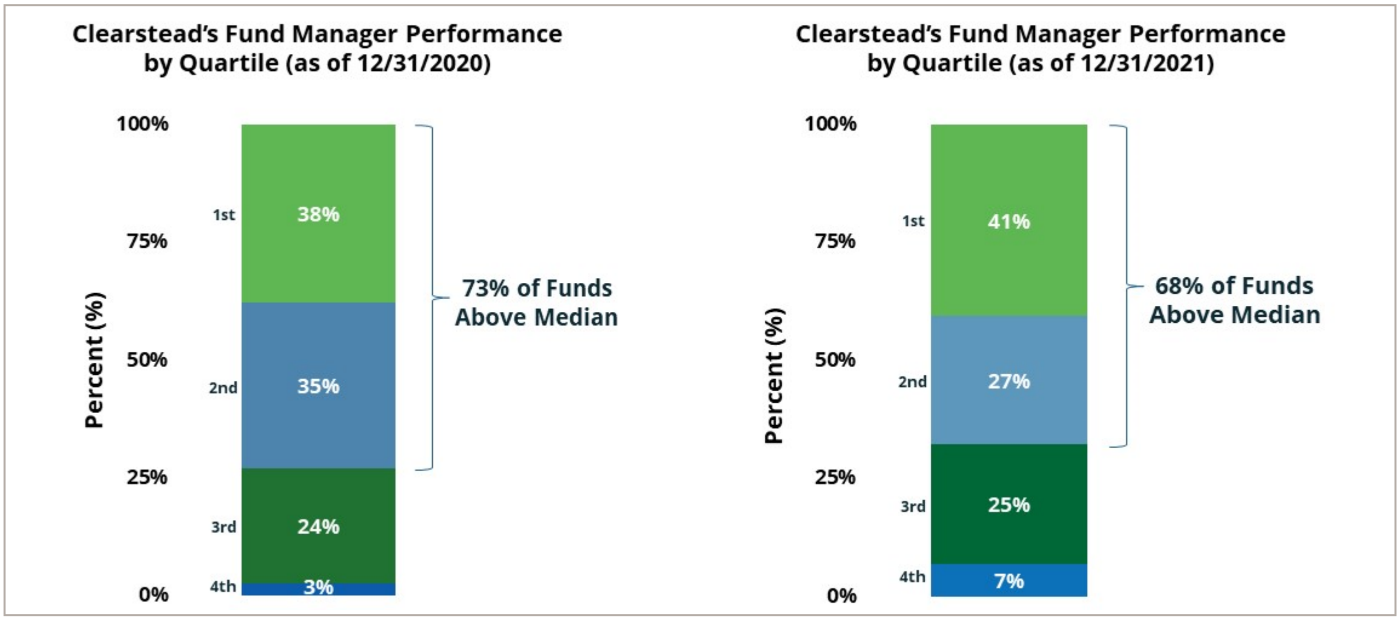

Source: Pitchbook Global Benchmarks as of Q3 2020 (with preliminary Q4 2020 data) for as of 12/31/2020 performance and Pitchbook Global Benchmarks as of Q3 2021 (with preliminary Q4 2021 data) for as of 12/31/2021 data, Clearstead approved alternative fund managers from 2010-2018.

* Information is intended exclusively for the use of the person to whom it has been delivered by Clearstead and is not to be construed as a recommendation or advertisement, reproduced or redistributed to any other person. The data shown compares the manager reported performance of all Clearstead approved private alternative funds from 2010 to 2018 to the Pitchbook Global Benchmarks median performance category. Based on this data Clearstead determined the number of recommended funds that were in each quartile. The alternative manager performance used is actual, net of investment manager fees, but gross of Clearstead advisory fees, third-party administration fees and any other transaction fees, which is considered as GROSS performance and necessary for the purposes of this comparison. The deduction of Clearstead advisory fees, third-party administration fees and any other transaction fees would have the effect of decreasing the investment performance results; however, the fees are NOT DEDUCTED since the "model fee" of 130 basis points or 1.3% result would be deducted from each manager and show the same results. No representation is being made that a client invested in these investment managers will achieve the performance results shown. There is no assurance that the results shown will produce similar results in the future. Past performance is not an indicator of future results. Clearstead disclaims any liability for any direct or incidental loss incurred by applying any of the information listed. All investment decisions must be evaluated as to whether it is consistent with each investor's specific investment objectives, risk tolerance, and financial situation.

Source:

(1) Sirota, David. "US pension funds are on the brink of implosion – and Wall Street is ignoring it." The Guardian, 2 Feb. 2023, www.theguardian.com/business/commentisfree/2023/feb/02/us-pension-funds-implosion-wall-street-private-equity.
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(2) 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.
(3) Sheidlower, Noah. "Despite success this year, underperformance rates are 'abysmal' for large-cap active managers for the long run." CNBC, 1 Oct. 2022. www.cnbc.com/2022/10/01/underperformance-is-abysmal-in-the-long-run-for-active-fund-managers.html.
(4) Cliffwater LLC. "Forecasting Risk for Illiquid Asset Classes." October 2019.
(5) Agarwal, Nikhil. "The man who lost a bet with Warren Buffett is ready for Round 2." The Economic Times, 25 Jun. 2021, economictimes.indiatimes.com/markets/stocks/news/the-man-who-lost-a-bet-with-warren-buffett-is-ready-for-round-2/articleshow/83835366.cms?from=mdr.
(6) Sheidlower, Noah. "Despite success this year, underperformance rates are 'abysmal' for large-cap active managers for the long run." CNBC, 1 Oct. 2022.
(7) ClearPoint: "Behavioral Finance can Create Calm out of Difficult Markets."

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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. The annualized rate of return used in the HSA vs. IRA growth example of 7% is hypothetical and does NOT represent actual or expected returns. The hypothetical rate of return is shown for informational purposes only and Clearstead is making no representation that this rate of return can or will be achieved. The rate of return represents a NET of investment manager and/or advisory fees return which means that the rate of return would have to be higher before these fees were deducted. For example, if the NET of fees rate of return is 7% then the GROSS of fees rate of return would most likely need to be 8% or higher, depending on these fees, which could be 1% or higher.

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MARKET BENCHMARK RETURNS

March 31, 2023		1M	3M	12M	YTD
US Large Cap	S&P 500	3.7%	7.5%	-7.7%	7.5%
US Small Cap	Russell 2000	-4.8%	2.7%	-11.6%	2.7%
Developed Intl	MSCI EAFE	2.5%	8.5%	-1.4%	8.5%
Emerging Intl	MSCI Em Mkt	3.0%	4.0%	-10.7%	4.0%
Real Estate	NAREIT	-2.1%	1.5%	-19.8%	1.5%
Core Fixed	BarCap Agg	2.5%	3.0%	-4.8%	3.0%
Short Fixed	BarCap 1-3Yr	1.5%	1.5%	0.3%	1.5%
Long Fixed	BarCap LT G/C	4.4%	5.8%	-13.4%	5.8%
Corp Debt	BarCap Corp	2.7%	3.5%	-5.3%	3.5%

Source: Bloomberg

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