



INFINITE MONEY

NEW PARADIGMS AND CHALLENGES FOR INVESTORS A CASE FOR PRIVATE MARKETS

By Nicolo' Miscioscia

SECULAR DISRUPTIONS IN THE ECONOMY - pg. 2

- Central banks and technology have created a new economic paradigm
- Cash oversupply & inequality in wealth distribution has become the *new normal*
- Misallocation of assets and lower future expected returns for investors

THE COMEBACK OF PRIVATE MARKETS - pg. 3

- After a century of public markets “monopoly”, private markets are back
- Investors are more inclined to give up liquidity for long term returns
- Information inefficiency in private markets warrants a premium over public ones

DECALIA PERSPECTIVES - pg. 4

- Level of cash in private markets at an all-time high
- Disruptions hit the financial sectors
- Investors must integrate new skills to identify resilient investment strategies

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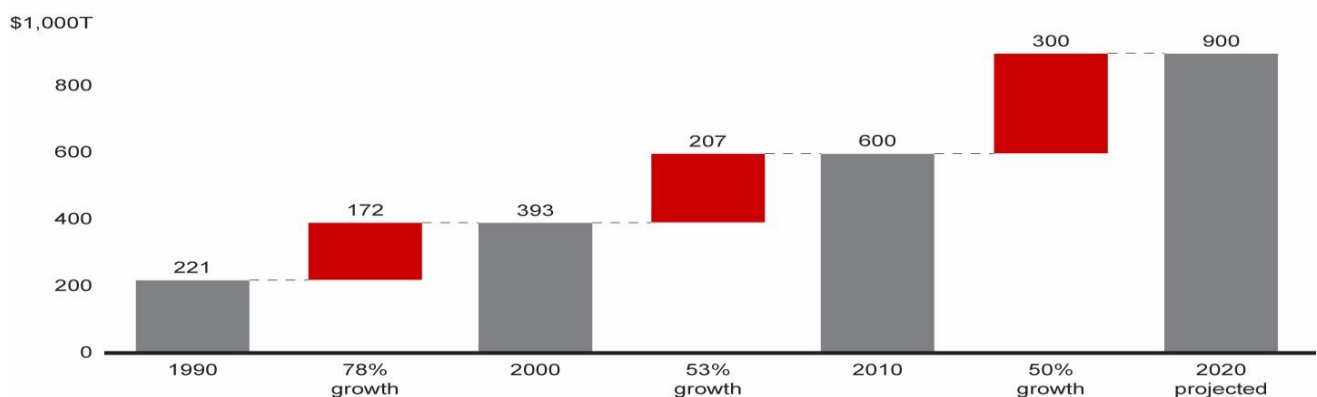
A case for private markets

Secular Disruptions in the Economy

More than a decade has now past since the global financial crisis and the start of major central banks' unprecedented monetary policy measures. While this sizeable stimulus has largely contributed to a period of (seemingly) uninterrupted economic growth across the globe, it has also drastically reshaped investors' market environment with lastingly low interest rates "artificially" supporting the valuation of most financial assets. Within this new framework, not only did mindsets have to evolve but portfolios' asset allocation needed to adapt too. As a result, we have witnessed a steady but marked rotation into *riskier* asset classes in recent years. Whereas the latter was partially driven by investors' willingness to participate in the economic upcycle, the real reason for much of this gradual shift proved to be the screaming need for alternative solutions to former traditional yield-enhancing fixed income assets as portfolio performance *stabilizers*.

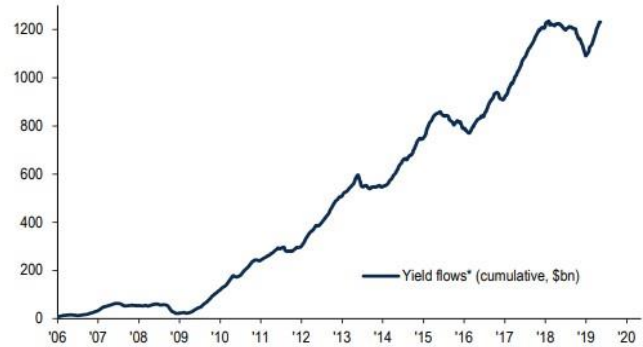
But beware: the aforementioned cyclical forces at play can be misleading when it comes to gaining a true understanding of the underlying trends and whole story. Indeed, whereas major central banks have been indeed adjusting economic levers to accommodate investors' needs, technology has in fact played an even more powerful disruptive role in defining a new economic paradigm: oversupply of financial capital.

Total world financial assets



Note: All figures are in real 2010 US dollars at 2010 exchange rates
Sources: International Monetary Fund, *World Economic Outlook: Slowing Growth, Rising Risks*, September 2011; Organisation for Economic Co-operation and Development; national statistics; Bain Macro Trends Group analysis

\$1.2tn cumulated inflows into riskier "yield assets" (IG debt, High-Yield, EM debt, REITs) over the past 10 years



Source: BofAML Global Investment Strategy, EPFR Global

The numbers are simply impressive: global financial aggregate capital (debt, equity) has increased by +53% between 2000 and 2010, reaching \$600 trillion, or 10 times real global GDP. Analysts currently anticipate another +50% surge by 2020, eyeing the \$900 trillion mark... (Bain & Co.)

And this trend seems irreversible driven by sharper financial engineering, the advent of high-speed computing, and the overall contribution of technology to flourishing capex-light business models. Unlike many "old economy" companies, much of today's corporates are able generate sufficient cash organically in order to cover their capital expenses. Indeed, with 80% of their value linked to intangible assets, up from just 20% forty years ago, technology has provided them with unprecedented "scalability", allowing for virtually *infinite* revenue growth without much, if not any,

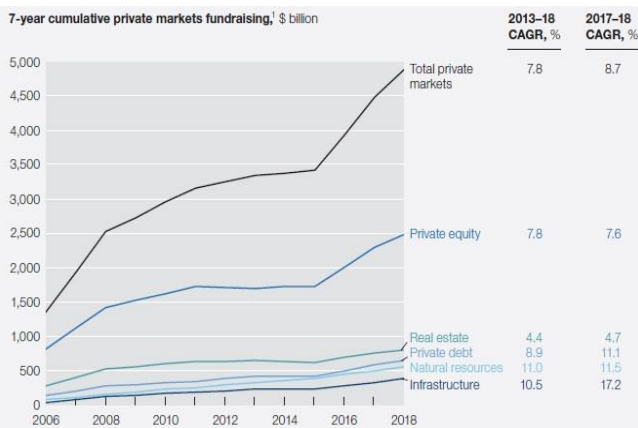
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incremental investments. The proliferation of such new cash war chests in recent years has triggered a wave of shares buy-backs, steady dividend hikes and in some instances, even been used to start lending activities to other businesses. (Carlyle)

Of course, from an investor’s perspective, the flip side of the coin is that in a world where capital is no longer a scarce resource, it will be harder to find returns...

The Comeback of Private Markets



¹ Private markets refers to private equity, real estate private equity (i.e., closed-end funds), private debt closed-end funds, natural resources closed-end funds, and infrastructure closed-end funds. All fund types are included, except for secondaries and funds of funds, which are excluded to avoid double counting of capital fundraised.
Data source: Preqin

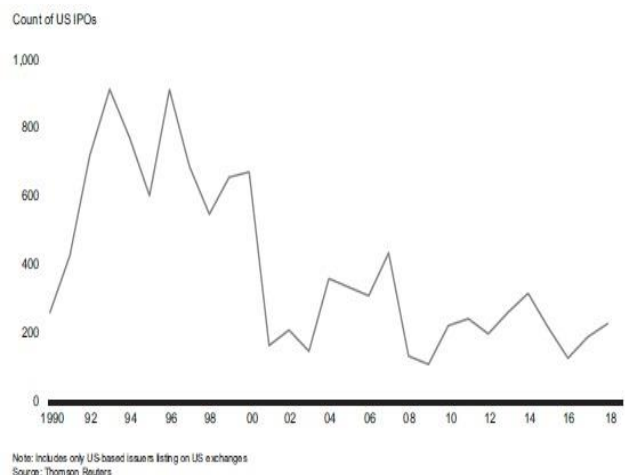
Historically speaking, one could rightly argue that investments were all about private markets, and that it has been just in the past century that institutional investors deployed most of their assets across public financial markets. Today, the greater availability of capital and associated quest for (decent) returns has set the stage for a comeback of private markets investing.

Indeed, when compared to their public counterparts, we believe that private markets now provide investors with some compelling features:

i. Private markets remain largely inefficient: information asymmetry and therefore active management still allow for a return premium over public asset classes;

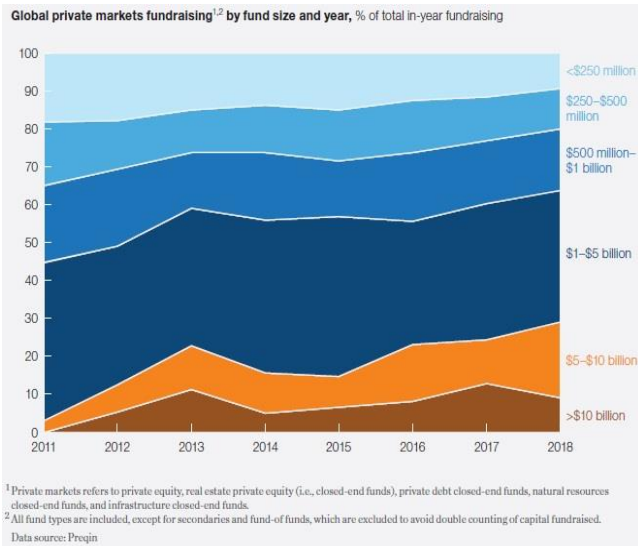
- ii. Returns tend to be linked to company fundamentals rather than financial markets volatility, hence forcing managers to focus on real growth: evidence shows that the longer assets are held for, the more their return can be explained by cash flows rather than external factors, offering some decorrelation from the large picture;
- iii. Illiquidity (1): it may sound like a paradox, as investors typically prize the value of immediate availability of cash (“liquidity”) over illiquid assets. However, given the scarcity of consistent “public” assets returns, an increasing number of investors are attracted by the value of “locking” capital in long term strategies in exchange for a premium;
- iv. Illiquidity (2): locked-in capital can prevent poor investment timing decisions often dictated by short-term market volatility and forces to be consistent with the investment case.

All of these characteristics have made private markets popular with investors. Since the start of this economic cycle in 2009, they have allocated to global private markets no less than \$5.8tn (Bain & Company). Moreover, between 2000 and 2018, the number of private equity-backed companies in the US rose from less than



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from close to zero twenty years ago. Most of the capital has flown into mega funds such as Apollo, Hellmann & Friedman and Carlyle, which raised \$24.7bn, \$16bn and \$18.5bn in their latest vintages, respectively. Preqin (data provider) estimates that about 75% of capital raised globally in 2018 went to funds above

Along with institutional investors, retail actors are now increasingly looking at ways to participate in this run too. Although fundraising within this segment remains largely limited by regulation aimed at investors' protection (reinforced following the 2008 crisis), it is just a matter of time before we see significant flows of private wealth capital to privately owned assets. This in turn will probably further increase the size of aforementioned mega funds as retail investors opt for *safer* blue chip names to begin with.

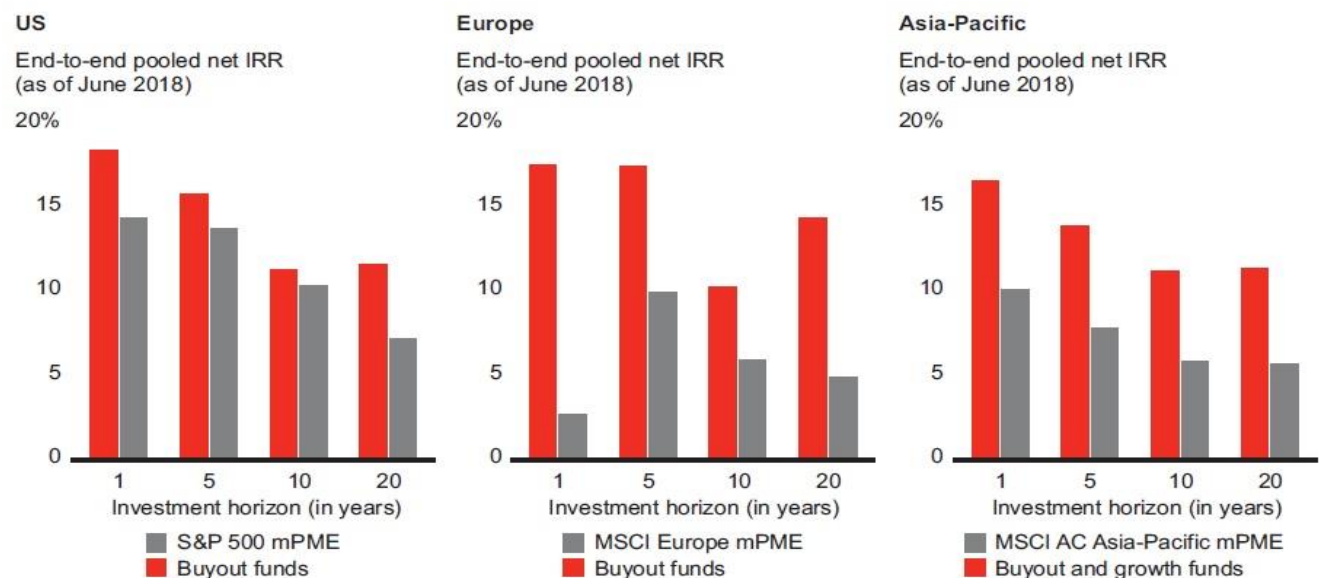
2'000 to nearly 8'000. Meanwhile, publicly listed companies dropped to 4'000 (from 7'000) as corporates increasingly found sufficient financing in private markets and public-to-private deals reached their highest levels since previous boom years (2006-2007). (FT, Bain & Co.)

Decalia Perspectives

Advisor Willis Towers Watson calculated that global asset owners currently invest about 14% of assets in private markets, up

Private asset classes have distinguished themselves for their positive performances

Private equity performance vs. public market equivalent

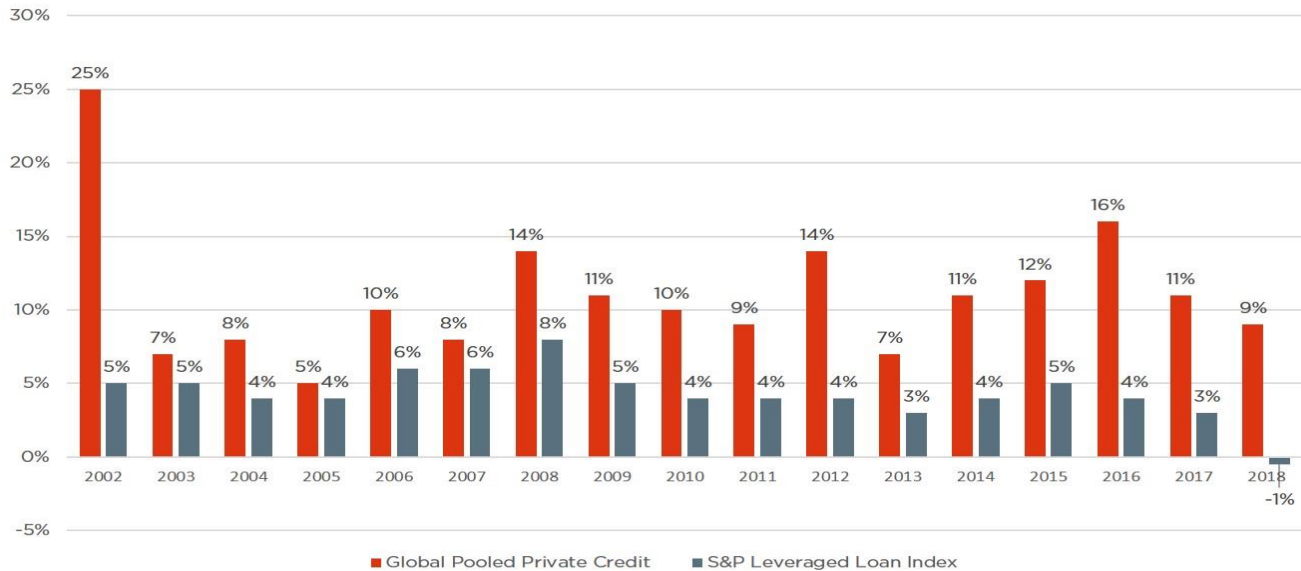


Notes: Data for US and Asia-Pacific calculated in US dollars; data for Europe calculated in euros; Europe includes developed economies only; Cambridge Associates' mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in private equity been invested in public markets instead; the public index's shares are purchased and sold according to the PE fund cash flow schedule
 Source: Cambridge Associates Private Investments Database

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Private credit performance vs. benchmark



Source: ThomsonOne, January 31 2019. Pooled private credit includes Control-Orientated Distressed and Credit Opportunities. S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan Index covers more than 1'100 loan facilities and reflects the market-value-weighted performance of U.S. dollar-denominated institutional leveraged loans

versus public equivalents, however with the increase of available capital the “private” feature of these markets alone will not be sufficient to guarantee compelling returns to investors in the future. The size of the funds forces managers to compete for the largest deals, which are scarce too. Auctions take place between cash-rich giants bidding in an attempt to increase their deployment. Eventually, this highly competitive environment is likely to erode the sought-for “illiquidity premium” over public markets as asset valuations surge.

From an investor perspective, these trends call for a new investment rationale as considerations need to be made around two key elements: i) *time*: long term trends must be met with long term strategies, as investors should think beyond short-term economic cycles; ii) *quality of returns*: only value-adding strategies will prove resilient in the long-term, while capital availability in itself will no longer be a differentiating factor.

Regarding *time*, investors must be ready to give up some liquidity for the same level of

returns enjoyed in the past. Direct private equity deals typically require 5-6 years lock-up periods, which grow to 10-12 years when offered in a diversified fund form.

Real estate requires an even longer investment horizon just as infrastructure. Meanwhile, durations for Private debt can vary significantly depending on strategies. Yet, the existing lock-ups may no longer be sufficient to obtain resilient returns as some large firms are already proposing 20 years term funds to meet demand.

In addition, investors who want to find “*quality* returns” need to employ new origination and analysis skills to identify strategies immune, or at least partly uncorrelated, to the pressurizing impact of capital oversupply. Here, human capital becomes the key differentiating factor: unlike financial capital, there is always scarcity of human intelligence, creativity and adaptability which are at the core of resilient value creation. Teams that will be able to specialize, innovate and/or quickly exploit unusual market conditions, will likely be the ones creating most long-term returns for investors.



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External sources include:

- Carlyle Perspectives “Thinking Beyond the Cycle” published in May 2019
- McKinsey Global Private Markets Review 2019 “Private markets come of age” published on February 2019
- Bain & Company “Global Private Equity Report 2019” published in 2019
- Preqin website and free publications

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