MarketDesk Research
Friday Strategist

Bi-Weekly Report

November 13, 2020

This Week's Market Action Makes Private Assets More Attractive

Private Equity Managers Offer Indirect Exposure to the Private Markets

Bottom Line

The next decade of public market investing will be challenging. U.S. equities trade at expensive P/E multiples, while treasuries trade with historically low yields. The last decade of U.S. market returns were robust due to quantitative easing and tech sector growth. The next decade's annualized returns are projected to shrink for U.S. large and small caps, as well as U.S. treasuries. More frequent volatility spikes increase the risk of permanent capital loss if investors face a surprise liquidity need.

Alternative assets offer differentiated return streams compared to public market equities and bonds. With the combination of expensive valuations, low interest rates, and volatility spikes, private markets and alternative assets are set to play a bigger portfolio construction role. Owning private equity managers gives investors exposure to the private markets and alternative assets via management and incentive fee and PE firm co-investments in their own funds. This tactical position aims to invest in the trend of rising alternative asset demand.

Main Points

► **Public Market Investing Will Be Challenging Over the Next Decade**

- Equities and bonds are both expensive. The Shiller CAPE P/E ratio sits at 30.6x vs a 20yr avg of 25.7x. The 10yr treasury rate sits below 1%.

- High valuations, low interest rates, and smaller projected returns increase the attractiveness of private markets and alternative assets.

► **Private Equity Managers Forecasted to Continue Growing Assets**

- Blackstone, Apollo, Carlyle, Brookfield, KKR, & Ares grew their combined fee generating AUM by 97% from 12/31/2015 through 3Q20.

- The fundraising environment is expected to remain favorable, with total fee generating AUM at the six PE managers forecasted to grow +29% from 3Q20 through the end of 2022.

- Growth in perpetual capital is an additional catalyst as PE managers purchase insurance firms to increase their mix of permanent AUM.

► **Rising Interest Rates & a Stock Market Selloff Represent Significant Risks**

- Rising interest rates make debt service more costly and reduce asset valuations. Market selloffs lead to lower incentive fees and investment gains.

- We believe stock market selloffs represent the biggest risk to PE managers. The Federal Reserve saved the economy from a severe recession earlier in 2020, but the risk is the Fed just pushed the economic pain down the road.

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Audio Link
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Trade Details

Trade Type
U.S. Equity / Sector / Industry

Trade ID
USEQ.2020-17

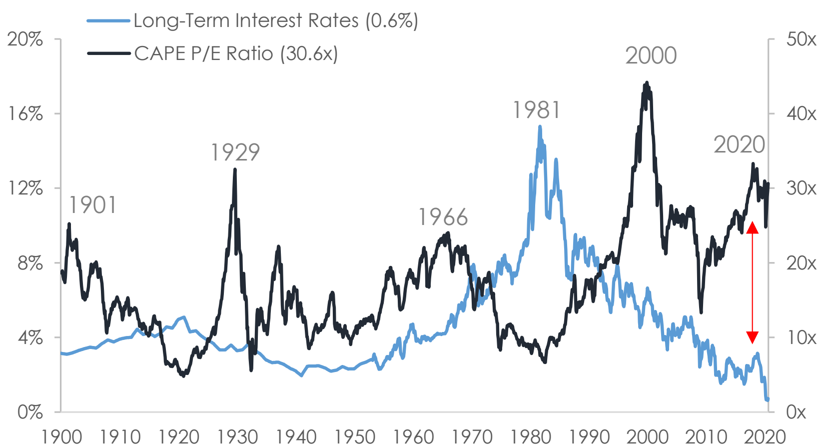
Ticker(s)
Stocks: APO, ARES, BAM, BX, CG, KKR

Benchmark
Vanguard Financials ETF (VFH)

Research Portal →

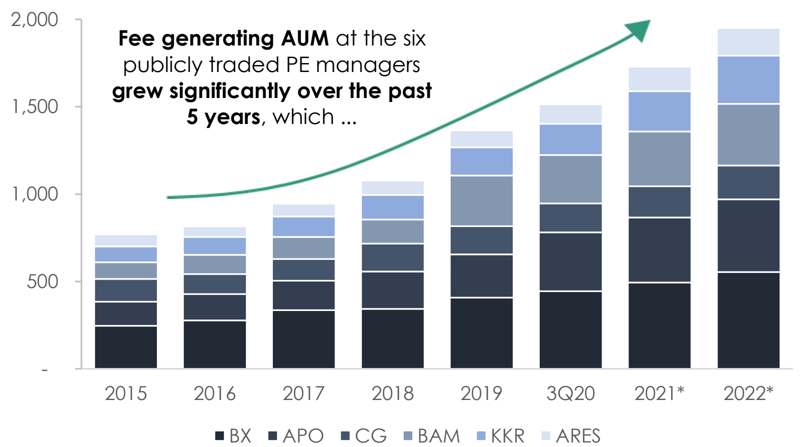
A Search for Alternatives & Increased Fee Generating AUM

Figure 1: Shiller CAPE P/E Ratio vs 10Yr U.S. Treasury Rate (1900-Present)



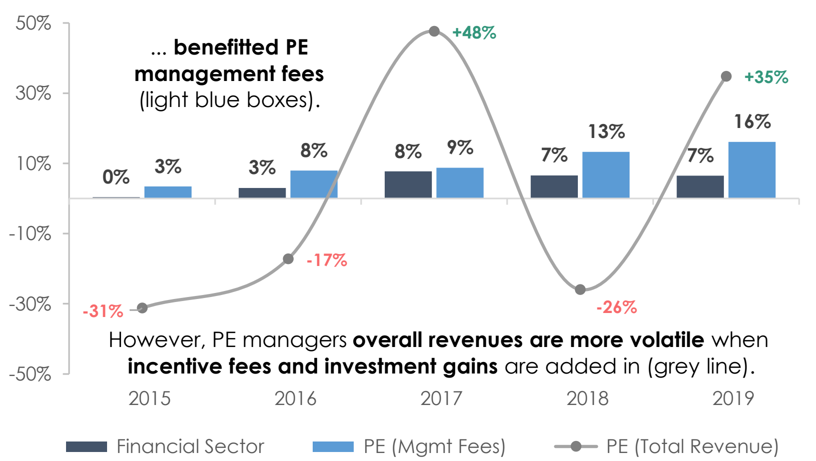
Source: MarketDesk Research, Robert Shiller / Yale

Figure 2: Publicly Traded PE Managers' Total Fee Generating AUM



Source: MarketDesk Research, Various company filings

Figure 3: Y/Y Revenue Growth — PE Managers vs the Financials Sector



Source: MarketDesk Research, Various company filings

Expensive Bonds & Equities Leave Investors Searching for Alternative Future Returns ...

- Figure 1 succinctly sums up today's financial markets -- both equities and bonds are expensive. The Shiller CAPE P/E ratio currently sits at 30.6x vs a 10 year average of 26.1x and 20 year average of 25.7x. The 10-year treasury rate sits at historic lows under 1%.

- Valuation levels impact future return potential, so investing at today's elevated valuations leaves less room for price appreciation. From a macro perspective, we anticipate a low-growth environment with low interest rates defining at least the first quarter of the 2020s, if not longer. The next decade of public market investing will be challenging.

A Search for Alternatives is Pushing PE Managers' Fee Generating AUM Higher ...

- Figure 2 graphs total fee generating AUM across six publicly traded PE managers --Blackstone, Apollo Global, Carlyle Group, Brookfield Asset Management, KKR, and Ares Management. The six firms' combined fee generating AUM grew +97% from 12/31/2015 through 3Q20.

- PE managers benefitted from an equity market rally and low interest rates coming out of the 2015-2016 downturn. Asset values increased, and demand for alternatives and fundraising were robust. The fundraising environment is expected to remain favorable, with total fee generating AUM at the six PE managers forecasted to grow +29% from 3Q20 through the end of 2022.

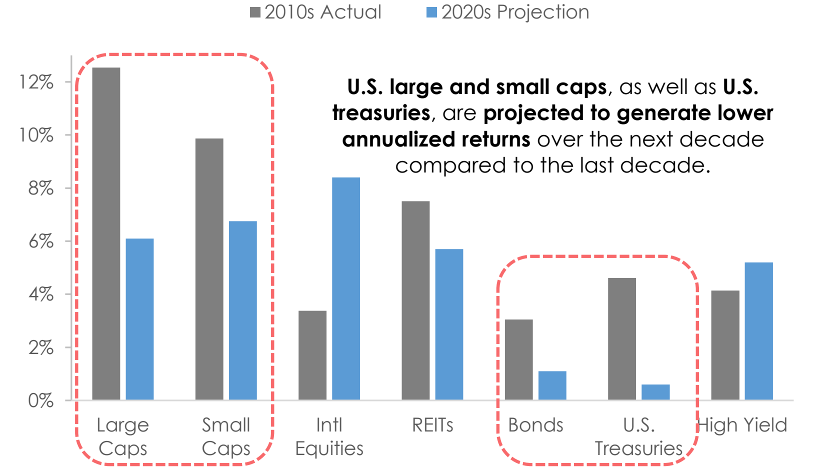
PE Managers' Core Business of Earning Management Fees is Growing ...

- Figure 3 compares PE managers' revenues against the broad Financials sector. The bars compares PE managers' y/y management fee growth against Financials' y/y revenue growth. The line charts PE managers' y/y total revenue growth, which includes incentive fees and income from firms' investments in their own funds.

- The core asset management business is attractive due to its scalability and steady growth in fee generating AUM. However, PE managers' overall revenues, which includes incentive fees based on performance and gains from co-investments in their own funds, is noticeably more volatile. The risk to owning PE managers comes from a market selloff (see page 4).

Projected Investment Returns & Perpetual Capital Growth

Figure 4: Annualized Returns — Realized 2010s vs Projected 2020s



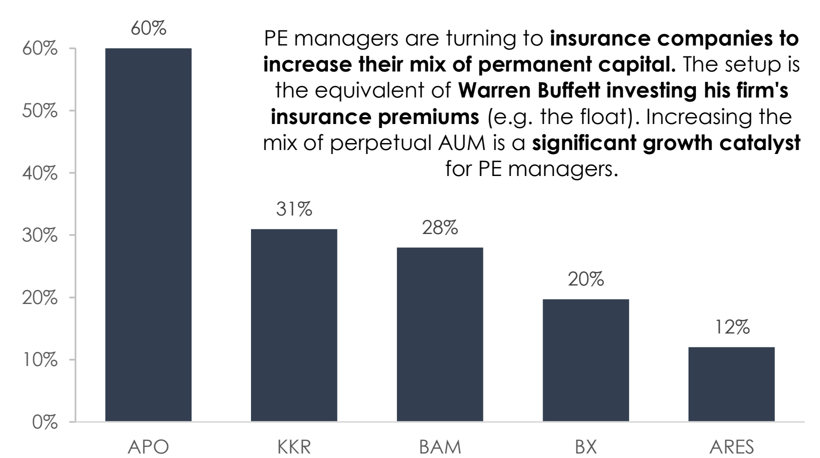
Source: MarketDesk Research. ***Note:*** *Average of Vanguard & BlackRock projections.*

Annualized Returns in the 2020s Projected to Lag Realized Returns in the 2010s …

● Figure 4 compares projected annualized returns for the next ten years against realized returns from the last ten years. After the last decade's robust returns, U.S. large and small caps are projected to return less on an annualized basis over the next decade. The same is true with aggregate bonds and U.S. treasuries due to interest rates already sitting near historic lows.

● A prolonged period of zero interest rates and lower projected returns in key U.S. market segments should increase demand for alternative assets. PE managers' fundraising success over the past five years looks likely to continue over the next five years.

Figure 5: Perpetual AUM as a % of Total AUM



Source: MarketDesk Research, Various company filings

Perpetual AUM is a Significant Growth Catalyst for PE Managers …

● Figure 5 graphs the amount of perpetual AUM as a percentage of total AUM. Permanent capital provides multiple advantages: less interruption from redemption requests, less emphasis on fundraising, and a stable management fee base.

● PE managers are increasingly turning to insurance firms to increase their mix of perpetual AUM to total AUM. Apollo is leading the charge and already purchased multiple insurers, including Athene and Venerable. KKR recently acquired Global Atlantic, and Brookfield announced a partnership with American Equity Life. Increasing the mix of permanent capital is a big growth catalyst for PE managers.

Figure 6: Financial Industry Scorecard

Industry	Regulatory Risk	Impacted by Low Rates	Beta
Wall Street Banks	↓	↓	1.3
Regional Banks	↓	↓	1.4
Consumer Finance	↓	↓	1.6
Insurance	→	↓	1.4
Traditional Asset Management	→	→	1.2
Private Equity Managers	→	↑	1.5

Source: MarketDesk Research. Note:

Balancing Regulatory & Interest Rate Risk Against Market Beta …

● Regulation: Depending on Joe Biden's regulatory nominees, banks (e.g. capital requirements) and consumer finance (e.g. interest rate caps) could face headwinds. Asset mgmt and insurance have no clear impact, while PE managers could lose preferential carried interest tax treatment.

● Low Interest Rates: Most financial companies are negatively impacted by low rates because they earn revenue based on interest rate spreads or investments. PE managers use debt to buy assets, so low interest rates make debt service less costly.

● Beta: PE managers have the second highest beta due to their leverage exposure and incentive fee income.

Rising Interest Rates & Stock Market Selloff

Key Risks — Rising Interest Rates & a Potential Stock Market Selloff …

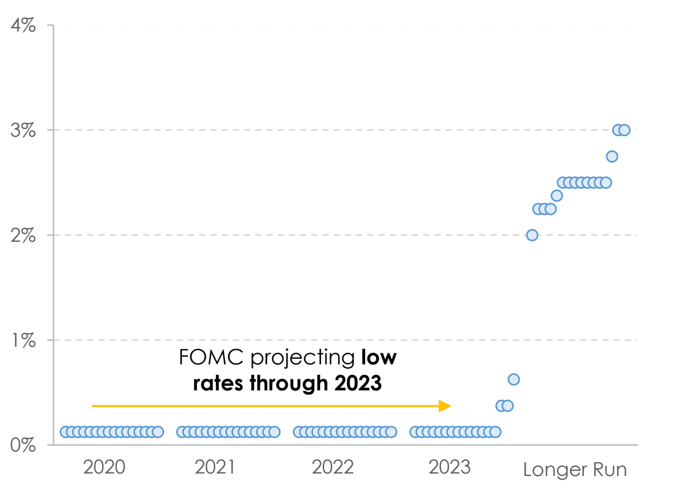
There are two primary risks to a tactical private equity manager position within Financials. Rising interest rates create a double negative effect as debt becomes more costly to service and equity valuations decline. Equity market selloffs also pose a significant risk because PE managers earn incentive fees based on their funds' performance and co-invest in their own funds.

#1 Rising Interest Rates: The private equity business model is stressed when interest rates rise. PE firms use leverage to purchase businesses and other real assets. The leverage provides a boost to their expected returns. However, it also adds a layer of risk. Interest rate increases make it more costly to service the debt used by managers to purchase assets.

Rising interest rates' also hurt equity valuations within the PE firms' investment portfolios. Lower interest rates increase the value of an asset's future cash flows, which in turn supports a higher asset valuation. In contrast, rising interest rates decrease the value of future cash flows and increase the pool of attractive yield generating assets, both of which pressure equity valuations.

The obvious risk is interest rates rise off their historic lows. However, the probability of interest rates increasing is low in our view. Global central banks are highly accommodative and remain ready to step in to support financial markets at the smallest sign of any weakness. Market consensus is that interest rates will remain low for years, and the Federal Reserve agrees. The September 2020 dot plot, which tracks each FOMC member's interest rate projections, indicates the majority of members do not expect interest rates to move before 2023. In our view, interest rates do not represent a material near-term risk.

Figure 7: Federal Reserve September 2020 Dot Plot



Source: MarketDesk Research, Federal Reserve

#2 Economic Downturn / Stock Market Selloff: Two revenue streams earned by PE managers are highly correlated to equity markets: (1) incentive fees based on realized performance and (2) principal investment income earned from co-investments into the firms' own funds. Figure 3 shows how incentive fees and investment income can overpower core asset management fees and lead to y/y revenue declines even if total fee generating AUM grows. As a result, PE managers' stock performance is highly correlated to the overall macro environment and financial market sentiment.

The financial market turmoil during 2015 and 2016 highlights PE managers' reliance on equity market valuations. Blackstone's revenue decreased -31.5% y/y in 2015. Apollo experienced a -54.6% y/y revenue decline in 2015, while KKR experienced a -38.5% decline in 2015.

The risk is a delayed economic downturn and/or weak investor sentiment leads to a stock market selloff. PE managers' revenues would suffer as incentive fees and principal investment income fall. Between rising interest rates and a stock market selloff, the stock market selloff is the more significant risk in our view. While the Federal Reserve did prevent a severe recession by stepping into the market earlier this year, the biggest risk is they simply pushed the economic fallout down the road.

Trade Implementation — Focus on Publicly Traded Private Equity Managers

The goal of this tactical position is to gain indirect exposure to the private market and private assets via management and incentive fees earned by PE managers. There are six publicly traded alternatives managers: Apollo Global, Ares Management, Brookfield Asset Management, Blackstone, Carlyle Group, and KKR. The firms manage a variety of alternative strategies, including credit, private equity, real estate, infrastructure, and publicly traded closed end funds and BDCs.

The timeframe for this tactical position is the 6-12 month range. However, the range could be extended past the 12 month mark if conditions remain favorable. Continued growth in fee generating assets, including a push to more perpetual capital, and equity market valuations are the two guideposts we are using to monitor the position.

We are benchmarking this tactical position against the broad Financials sector. We view PE managers as an active tactical tilt within Financials.

Refer to page 5 for additional details on the relevant publicly traded PE managers.

Impacted Companies

Figure 8: Selected Private Equity Managers

Ticker	Company	YTD Return	Price to Book	NTM P/E	AUM Breakout ($Bns)
Publicly Traded PE Managers					
APO	Apollo Global	-10.2%	32.3x	17.4x	$300B Credit; $73B Private Equity; $40B Real Assets
ARES	Ares Management	22.6%	7.6x	21.3x	$131B Credit; $27B Private Equity; $14B Real Estate; $7B Strategic Initiatives
BAM	Brookfield Asset Management	-6.5%	2.0x	17.7x	$114B Credit; $85B Long-term Private Funds; $80B Perpetual Strategies; $11B Public Securities
BX	Blackstone Group	-1.8%	10.6x	19.4x	$189B Private Equity; $174B Real Estate; $144B Credit; $78B Hedge Fund Solutions
CG	Carlyle Group	-14.5%	4.4x	13.2x	$85B Private Equity; $52B Private Equity & Real Estate; $53B Credit; $40B Real Assets
KKR	KKR & Co.	26.0%	2.0x	17.8x	$125B Private Markets; $97B Public Markets; $21B Principal Activites

Source: MarketDesk Research. ***Note:*** *The benchmark for this tactical opportunity is the Vanguard Financials ETF (ticker: VFH).*

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