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CIO MONTHLY / JUNE 2019

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Considering private equity in *volatile times*

Renewed market volatility has been unleashed again. This time in the wake of a single Sunday night tweet in early May. Trade talks between the US and China have broken down. Once again, we are confronted with an escalation in the trade dispute and the rising risk of an all-out trade war between the US and China. Heightening the market's reaction, expectations were high as April drew to a close that a critical US-China trade deal was virtually complete. Together with mounting evidence of a pick-up in global growth into mid-year, equity markets and other risk assets had been recovering solidly.

Such volatility for traditional asset classes in the later stages of this macro and market cycle, together with heightened volatility due to geo-political risks (not only between the US and China), strongly supports significant portfolio allocations to alternative assets. Last month we highlighted the rising importance of alternative assets in our client portfolios, where allocations have risen by more than 50% over the past year or so.

"We invest across all asset classes—listed equities, private equity, property, infrastructure, timberland, debt, alternatives, cash and overlays."

THE FUTURE FUND,
AUSTRALIA'S SOVEREIGN WEALTH FUND

This month we take the opportunity to dive deeply into one of the key sub-sectors of alternative assets, namely private equity. We discuss the benefits of private equity in a diversified portfolio, some of the key private equity strategies, as well as some of our recommended private equity opportunities.

Volatility is likely to persist

We continue to anticipate a US-China trade deal. Both players have a strong incentive to finalise a deal. US President Trump faces an election next year and the negative impact on equity markets, business confidence and US exports (especially agriculture) is not without risk. For China, a deal is key to achieving its targeted 6% growth near term. Recent comments by President Trump and President Xi suggest talks have not completely broken down, also providing some hope for a trade deal over coming months.

The current skirmish should not materially damage the growth outlook. In contrast to September 2018 when the trade war last escalated, both inflation and central bank policy tightening now looks certain to be in retreat this year, calming the historic catalyst that typically ends a macro cycle. This, together with rising wages and supportive fiscal policy, suggests the global economy has a greater prospect of absorbing much of the negative growth impact of the current trade skirmish. Moreover, global research house, the Bank Credit Analyst, notes that "in a worst-case scenario where the trade talks break down completely, the combination of aggressive Chinese stimulus and a still-dovish Fed will likely preclude a major global economic downturn."

UBS notes that for the US economy, while "the next stage of tariffs, 25% on $200bn, will have large effects...the most susceptible firms have [already] failed, and others are diversifying supply chains." Credit Suisse agrees that "the economic impact [of higher tariffs] is less now than last year".

We continue to anticipate a US-China trade deal…

…but we choose to tactically hedge that position this month given recent developments.

Still, the risk of a political misstep and further escalation has risen. The US president's decision to collapse the previous trade deal and seek a better outcome for the US has challenged many geo-political strategists' confidence in the likelihood of an eventual deal. Subsequent decisions to prepare compensatory support for US farmers, as well as progressing down a path to widening US 25% tariffs to a further USD 300 billion of China's exports to the US has also narrowed the odds of a broader more destructive trade war. The risk remains that the gap between the US and China simply can't be bridged.

We remain neutral risk but are tactically hedging our position. This reflects the significance of the trade war escalation, and our current positioning that favours emerging market equities while underweighting Australia. A total breakdown in trade negotiations, consistent with historic periods of global stress, likely favours US equities (and the US dollar), not emerging markets—while also supporting domestic equities as a defensive regional market. Alternative assets remain an important portfolio diversifier.

We have made a modest tactical shift this month

We remain overweight emerging market equities but are trimming our position (from +2 to +1) to reflect the rising risk of a damaging trade war escalation and capital flight from emerging markets. A likely stronger US dollar would also weigh on emerging market returns.

We remain underweight domestic equities but are trimming our position (from -2 to -1). Australia would likely benefit from defensive flows in a further trade war escalation, while recent developments also ease some of our concerns about Australia's outlook. The latter include the positive impact on business and housing sentiment post the re-election of the Liberal-National Coalition (Coalition) in mid-May, the now near-certain Reserve Bank of Australia (RBA) rate cut in early June and the Australian Prudential Regulation Authority's (APRA) recent decision to ease some lending criteria.

We remain significantly underweight fixed income (at -3) but have **increased our underweight to both domestic and global high-grade bonds** (both from -1 to -2). The recent trade re-escalation has underpinned a fall in global bond yields to expensive levels, accentuated in Australia by expectations the RBA will cut rates below 1%. In contrast, with little prospect that central banks will hike rates and constrain global growth, we have closed our underweight in global corporate credit and moved overweight domestic corporate credit.

Our current positioning would still benefit from a trade resolution. **We remain overweight equities relative to fixed income** (0 versus -3), a position that has now been enhanced via the initiation of the overweight to corporate credit. Our current strong **overweight to alternatives** also provides significant portfolio risk diversification in this period of heightened volatility.

"Alternative investments can provide many benefits to investors, ranging from potentially higher returns to lower risk and better diversification than may be available from a traditional portfolio."

BLACKROCK INC.

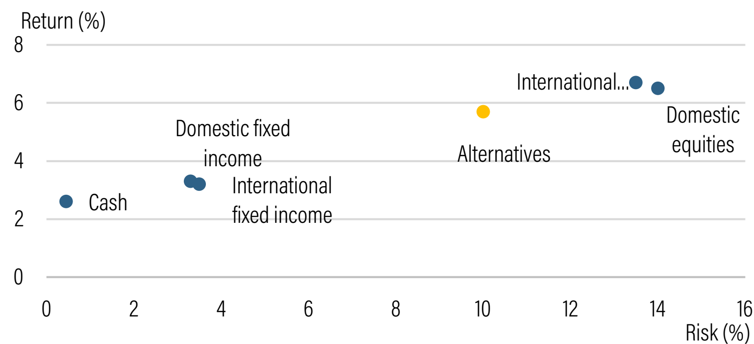
What are alternatives and where do they fit?

Alternatives are best thought of as a diverse range of assets that exists outside traditional investments like publicly traded equities, fixed income securities and cash. Given the differing return characteristics and drivers of risk among alternatives, they can add a variety of features to a portfolio. In particular, they can increase the return potential of a portfolio and also enhance diversification. This is because their return profiles are typically uncorrelated, or have a lower correlation, to broader market swings. They can also be used to facilitate specific outcomes or themes—such as liability matching, cash flow stability or inflation protection.

The main sub-sectors of alternatives are hedge funds, real assets, private equity, private debt and structured products. At Crestone, we currently separate alternative investments into three key categories—hedge funds, private equity and real assets (which includes unlisted real estate equity and debt, as well as infrastructure assets).

As shown in the chart on the following page, while alternatives are considered higher risk than fixed income and cash, they have, historically, generated stronger investment returns over the longer term. Compared to equities, the broad set of alternatives have generated less return but also exhibit less risk.

How alternatives compare to other asset classes



Source: Crestone. Long-term capital market assumptions shown.

Private equity is a close substitute for public equity, but it typically utilises significantly more leverage and is more illiquid than public equity.

Private equity provides a greater opportunity set which is helpful in volatile times

Private equity typically refers to investing in the equity of businesses not traded or listed on a public exchange. These investments generally involve allocating capital to partnerships or private equity firms which, according to Blackrock, "source capital and financing to create change in a business".

Private equity firms often take private a company that was previously publicly listed or purchase a family-owned business that is already private. As noted by alternative investment management firm Hamilton Lane, the ability to create value in private equity often involves "restructuring, refocusing and revitalizing inefficient operating companies". Future areas of focus are likely to be firms leveraged to technological disruption, healthcare and e-commerce—and in infrastructure, growth areas such as renewable power.

Private equity is a close substitute for public equity, but it typically utilises significantly more leverage and is more illiquid than public equity. This, in turn, can lead to a greater level of risk and greater return.

What are the key benefits of investing in private equity? The much higher number of private companies versus publicly listed companies brings a greater opportunity set and is widely seen as an advantage of investing in the asset class. The number of publicly listed companies has also generally been in decline for the past two decades. In addition to providing greater diversity, private equity investments have consistently outperformed listed equities over time and with lower volatility (see chart below). This is because valuations tend to be less impacted by sentiment-driven swings in public markets.

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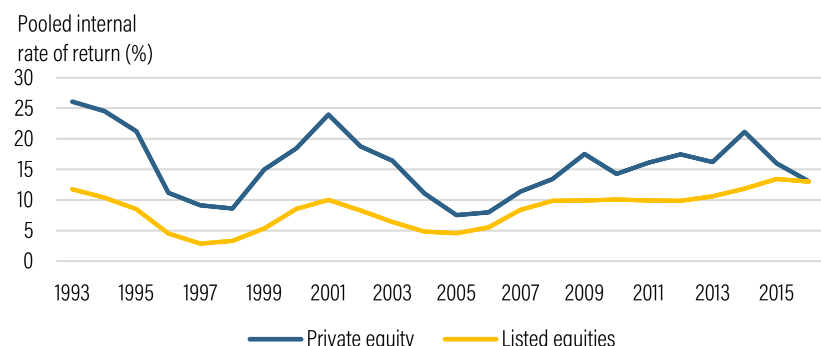
Private equity has consistently outperformed listed equities



Source: Cambridge Associates LLC, Frank Russell Company, MSCI Inc., and Thomson Reuters Datastream. Data as at 30 September 2018. Private equity is the Cambridge Associated Benchmark index. Listed equities are the MSCI All Country World index (gross) modified public market equivalent internal rate of return. Based on data compiled from 1,990 buyout and growth equity funds, including fully liquidated partnerships, formed between 1993 and 2016. Internal rates of returns are net of fees, expenses and carried interest.

Where does private equity source its return? Private equity investments derive their return in much the same way as listed equities. However, private equity managers have an expanded toolkit to drive outperformance. This can include better access to information, improved governance (through control and alignment of interests), an operational, long-term focus, and favourable exit timing. Such tools are often not available in listed equities. Manager return dispersion can also be quite wide, which means manager selection is often a key source of return within fund-of-fund vehicles. Although private equity has a high correlation to listed equities (it can be as high as 0.8), volatility is typically much lower.

How liquid is it? Private equity is usually a highly illiquid investment. Once invested, capital often cannot be redeemed for the full term of the investment (often six to 10 years), and returns are often irregular as the fund's investments are realised. Investments can sometimes be sold on secondary markets, but this can be at a discounted value. However, according to Blackrock, "the cashflows from a successful fund should be positive after a few years, as the fund begins to exit portfolio companies".

Private equity strategies are less regulated than publicly offered investments and may exhibit higher operational risk.

What are the key risks? There is a range of risks specific to private equity, though utilising fund-of-fund vehicles rather than a single alternative investment partnership can lower these risks. Private equity strategies are less regulated than publicly offered investments and may exhibit higher operational risk; manager selection is also key. Acquired companies can also be more exposed to specific economic themes and sector events, and failure risk in venture capital is high. Investments can also be vulnerable to 'vintage year' risk where private equity managers can at times face acquisitions in an expensive public market environment.

Some common private equity strategies

Primaries—these strategies make up the core of most private equity strategies. They include 'buy-outs' where companies are acquired to create an uplift in value, often using significant leverage. Primaries also include venture strategies where start-up or early-stage companies are acquired to access their significant operating leverage. This more speculative equity is usually acquired at attractive prices and rarely with debt.

Secondaries—these strategies involve a manager investing in existing portfolios of primary investments, which are often offered at a discount due to either a shorter remaining fund life or poorer quality of assets. Managers often allocate part of their capital to secondaries as they can be an effective diversification tool. They can also be used to reduce some of the risk associated with manager selection uncertainty, known as blind pool risk.

Co-investments—these strategies involve investing alongside another core manager who has a specific area of expertise, and often involve taking direct minority ownership of the investment. As these strategies often have lower fees, they can be used to target a specific industry in a cost-effective manner.

We believe that the core, or bulk, of an investor's private equity exposure should be managed by a team of experienced professionals.

How can an investor gain exposure to private equity?

We believe that the core, or bulk, of an investor's private equity exposure should be managed by a team of experienced professionals who are solely dedicated to understanding private equity investments and constructing multi-manager private equity portfolios. This type of vehicle is called a fund-of-funds and provides diversified exposure to a range of managers and strategies across geographies within a single fund.

These diversified strategies can help mitigate many risks associated with investing in individual private equity funds. While all private equity investments should be considered as long-term illiquid investments, some managers will structure their vehicles to offer a defined level of liquidity, which can assist in managing broader portfolio allocations over time.

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