PINEBRIDGE INVESTMENTS

2018
PRIVATE FUNDS OUTLOOK

Uncertain Markets? Look for Relative Value and Shorter Duration

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- As many investors continue to expect lower returns in traditional markets, we expect money to continue to flow into the private markets.
- Given macroeconomic uncertainties and indications that valuations and debt levels are at cyclical highs, we believe having a relatively shorter duration in your investments makes sense.
- Today, and in 2018, we are focused on relative value and finding opportunities in areas including the small and midmarket segments of the private markets.

Investors continue to turn to the private markets for yield and capital appreciation at an increasing rate given the longer term prospects for the traditional markets. Many are anticipating when the next slowdown will hit. Will the unwinding of the unprecedented major central bank interventions be manageable?

For the time being, global growth is turning up in a synchronized manner, so there is a growing chorus that believes the developed market economies may be able to maintain their growth momentum. In the private markets, since our capital is not as fluid as in traditional markets, we cannot wait around for a definitive signal that the bottom (or top) of the market is approaching. We need to find opportunities that properly reward our clients for the risks they take in either scenario.

Money has been flowing into the private markets, and we see no sign of it slowing in 2018. However, if liquidity were to freeze, that trend could be disrupted.

2018 Private Funds Convictions

Relative Value

Shorter Duration

Middle Markets

Where we look for opportunities

Currently, we are focusing on finding opportunities with a relatively shorter duration as well as relative value. When the market is uncertain about intermediate or long-term macroeconomics and there are indications that valuations and debt levels are at cyclical highs, we believe having a relatively shorter duration in your investments makes sense. And while certain strategies look expensive, there are often sub-strategies available that are less so. Yes, these sub-strategies require more work, but if you are capable of doing the proper underwriting, investors can be rewarded for the risks they take.

We look for opportunities in the small and midmarket segments of the private markets. However, these segments require greater expertise and selectivity, and while they're not cheap, they offer relative value compared with the larger end of the market. We see investors continuing to be willing to pay a full price for assets that are easier to evaluate from a due-diligence perspective and from well-known shops. Conversely, prices haven't risen as much for transactions that are harder to assess or from less-well-known sponsors.

Risks to keep in mind

The private markets have unique aspects of risk relative to traditional markets. Proper due diligence is critical to make sure the manager you go with can execute on the type of mandate you've given them.

It's important to remember that private equity portfolios cannot react as quickly to market developments or uncertainty as compared with more traditional asset classes. So investors must always be mindful of liquidity. Since 2009, exits have been quite strong relative to the long-term average for private equity. But we think, over the next three to five years, the private equity industry will experience mean reversion when it comes to liquidity.

Investors should also keep an eye on leverage. Some managers that rely on financial engineering use leverage to drive returns. Looking ahead, this may not be the most optimal strategy. We think the leverage market has a higher likelihood to contract over the next three to five years. On the other hand, managers that are skilled at operating improvements, repositioning, and smaller buy and builds will be better positioned into the next cycle.

While we see some emerging markets as exhibiting a relative value proposition, there are risks to consider there as well. Industries that look expensive in the developed world can be associated with a lower price tag in emerging economies, but investors must consider the macroeconomic and currency risks of the country in a given emerging market. Currency risk is an unknown variable that investors may not be able to quantify. Currency movements have had a huge impact on returns for international investments.

Fees will take center stage

As institutional investors anticipate that markets will generate lower returns in the future than they have in the past, they are focused on fees more than ever before.

This change in attitude has the potential to have a huge impact on managers. The large ones and the small ones are adjusting to the environment. Midsize managers, however, will likely have a harder time because they don't have the scale of the large managers and, unlike the small ones, they have a meaningful overhead fixed structure. This is true outside of the private markets as well.

Why does this matter to investors? They will need to be cognizant of negotiating fees and expenses, and be able to evaluate which managers can operate in an environment of lower fees.

Money should continue to flow to the private markets in 2018

The industry has been converting portfolios into realized gains. We've seen some signs this year that liquidity has slowed, but not enough to signify a permanent shift. Capital is relatively cheap, enabling acquisitions and more asset transfers.

As many investors continue to hold the belief that traditional markets are going to be challenged, we expect money to continue to flow into the private markets as they are seen as less correlated with higher return potential. There doesn't seem to be much that could get in the way of that trend other than increasing defaults in the high yield debt used in private equity acquisitions. If investors perceive there will be a heightened level of defaults from highly leveraged companies, it could slow the movement of capital.

The bigger question is whether the private markets will be able to continue to absorb all the capital that's flowing in. If it becomes harder to put money to work with fewer deals available, the combination of higher purchase price multiples and increased leverage could lead to higher risk profiles.

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