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Market Outlook & Strategy

Second Quarter of 2024

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Executive Summary

- **Q2 2024.** The US equity market ended up a very respectable 3.2% for the quarter and is now up almost +14% year-to-date. Gains were due in large part to expectations for interest rate cuts by the Federal Reserve, positive inflation news and continued strong financial performance from AI-related technology companies.

- Unlike Q1 2024, market gains this quarter were less distributed across sectors as technology stocks resumed their climb leading growth stocks (+8.3%) to outperform value stocks (-2.2%) by a wide margin.

- International equity showed mixed results. Emerging markets (+5.0%) outperformed the S&P 500 in Q2 thanks to optimism towards a rebound in Chinese economic growth. Foreign developed markets (-0.5%), meanwhile, lagged both emerging markets and the S&P 500.

- As for fixed income, the leading benchmark for bonds (Barclays U.S. Aggregate Bond Index) realized a flat return for the quarter (+0.07%) as rising expectations for a September Fed rate cut and moderating U.S. economic growth boosted bonds broadly.

- In this report, we take a close look at the state of the private equity industry and explore whether we should explore allocating in that direction. The question arises because private equity firms have been keen to tap the wealth of individual investors and many now offer lower investment minimums to facilitate entry.

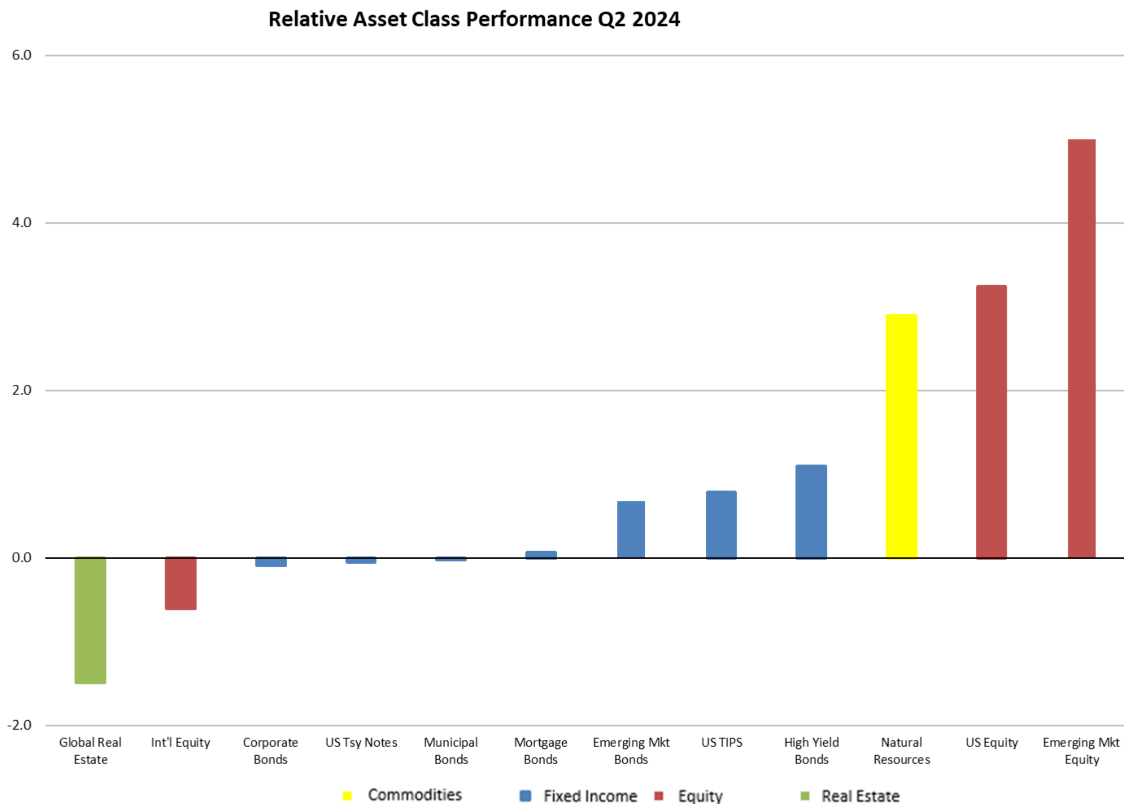
- Our analysis concludes that there are quite a few reasons to believe private equity returns over the next decade are going to be lower than they have been in the past. A number of academic studies show that private equity has not outperformed public equity on a net-of-fee basis since at least the Great Financial Crisis, when appropriately benchmarked. The winners have been the general partners of the private equity fund, not the investors in the funds.

- **Artemis Strategy.** We didn't change much this quarter. We are, however, currently taking a close look at our fixed income (i.e. bond) exposure as we are firmly in the camp that inflation is moderating for good and that the Federal Reserve will start reducing interest rates soon. Bonds should appreciate nicely in such an environment.

Markets in Review – Q2 2024

Despite some volatility early in the quarter, the U.S. equity market ended up a very respectable 3.2% for the quarter and is now up almost +14% year-to-date. Gains were due in large part to expectations for interest rate cuts by the Federal Reserve, positive inflation news and continued strong financial performance from AI-related technology companies. Growth stocks (+8.3%), propelled by AI enthusiasm, outperformed value stocks (-2.2%), particularly energy, materials and industrials, as the latter were more affected by growing concerns about future economic growth. Small company stocks also underperformed (-3.25%) for the same reason (see Figure 1).

Figure 1. Asset Class Returns in USD for Q2 2024(%)



The news on inflation was positive. While the March Consumer Price Index (CPI), released in mid April, actually came in a tad higher than expected at +3.5% year over year, the April CPI report came in slightly lower at +3.4% and May at +3.3%. (Spoiler alert – the June CPI

released in mid July came in at +3.0% and showed the first month-over-month decline in prices of -0.1%.) This trajectory led Fed Chair Jerome Powell to state at the June FOMC meeting that two interest rate cuts are possible in 2024, rather than a previously stated possible single reduction.

Internationally, emerging markets (+5.0%) outperformed the U.S. in Q2 thanks to optimism towards a rebound in Chinese economic growth. Falling global bond yields late in the quarter also boosted the attractiveness of emerging market investments. Meanwhile, foreign developed markets (-0.5%) lagged both emerging markets and the U.S. market. Concerns about the timing and number of Bank of England and European Central Bank rate cuts, along with French and German political concerns later in the quarter, acted as headwinds for foreign developed equities.

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) realized a very slight positive return (+0.07%) for the second quarter, as rising expectations for a September Fed rate cut and moderating U.S. economic growth boosted bonds broadly.

Is Private Equity Past Its Prime?

In recent years, private equity firms have been aggressively trying to attract capital from small, private investors by pitching the merits of private equity to advisors in private wealth firms. I have listened to many of these pitches but have remained skeptical of the utility of holding private equity in client portfolios. As such, except in a single case when a client specifically requested an allocation, Artemis does not allocate client assets to private equity. Should we start doing so now?

Have Artemis Clients Missed Out?

The most common pitch from private equity purveyors is that returns have been higher in private equity than in public equity, much higher according to the most ardent believers. Why not then allocate to private equity? After all, a big part of our job is to provide good risk-adjusted returns to our clients. I recently had a look at the academic research on this topic and learned that most studies conclude that private equity has not outperformed public equity *on a net-of-fee basis* since at least 2006, when appropriately benchmarked.

Here's the issue. Many private equity funds benchmark their performance against either the S&P 500 or the MSCI All-Country World Index (which measures the size-weighted returns of 99% of the global market public equity universe). The problem with these benchmarks is that the average private equity portfolio is very different than the portfolio represented by these two ubiquitous benchmarks. Companies are much smaller and less profitable in the

typical private equity portfolio, and industry and geographical concentration is much greater. And very importantly, the returns of public equity are much less leveraged compared to those of private equity. (Leverage is the use of debt to increase the return on equity.) Here's one study's conclusion:

> *Using a bottom-up approach, we identify the systematic risks of underlying companies in buyout funds to inform an appropriate risk-adjusted benchmark, which we determine to be a levered size and sector-adjusted public index. After making these risk adjustments,* ***we find no significant outperformance of buyout fund investments versus the public market equivalents on a dollar-weighted basis.***[1]

Other studies I reviewed that use differing methodologies come up with similar results, with one specifically testing the relationship between pension fund allocations to various alternatives (defined at private equity, hedge funds, real estate and commodities) and their overall performance during three different periods: 2001-2009 (before and during the global financial crisis), 2010-2022 (post crisis) and 2001-2022. This study finds that all but hedge funds outperformed public equities in the earlier period. But in the post-2010 period, "**private equity outperformance was not statistically significant suggesting many pension funds could have done just as well investing in public equities."**[2]

A final study worth mentioning reviews a whole bevy of academic studies on the topic and concludes that "**private equity funds have returned about the same as public equity indices since *at least* 2006."** This report is an interesting read as it tabulates that during the period analyzed (2006-2015), the fund operators (called general partners) did manage to earn $230 billion in performance-related fees. So in essence, all outperformance went to the operators and not the investors.

Ok, but investors today are buying the industry's future returns, not its historical record. Thus, the question becomes are conditions better or worse today for private equity and will prospective returns be more attractive?

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[1] L'Her, Jean-Francois, Rossitsa Stoyanove, et. al. "A Bottom-Up Approach to the Risk-Adjusted Performance of the Buyout Fund Market. Financial Analysts Journal. Volume 72, Issue 4. 2016.

[2] Aubry, Jean-Pierre. "Public Pension Investment Update: Have Alternatives Helped or Hurt?" Center for Retirement Research, Boston College. Number 20-22, November 2022.

Condition 1: Excess Supply of Unsold Firms

To answer this question, it's helpful to remember how the private equity industry works. Private equity funds are run by general partners (GPs). GPs are tasked and paid to buy companies, grow them, improve them and sell them for a price higher than what they paid. This excess is returned to the fund's investors, called limited partners (LPs), net of the so-called "carry" earned by the GPs of a fund (i.e., the 15-20% of the amount earned over a certain hurdle rate) and a variety of fees charged by the GPs. For GPs to continue to make money, they need to regularly raise new funds as the companies in earlier funds are sold. Investors typically need to receive the proceeds of any fund they have invested in to be able to invest in a next fund. It all works swimmingly until it doesn't.

We seem to be in a "it's not working" period. After record fundraising over recent years, buyout groups face a challenge in exiting from trillions of dollars worth of unsold companies. Many of these deals were agreed to during the 2021 to 2022 window of low interest rates and buoyant markets. According to the management consulting firm Bain and Co., funds currently face a challenge of exiting more than $3.2 trillion worth of companies (representing 28,000 unsold companies). "The backlog is massive by historical standards," according to Bain's 2024 report, representing ~25% of the total size of the private equity industry. If the firms can't sell these companies, then investors won't have the liquidity to invest in the next fund, GPs won't make their money, and some (perhaps many) GPs won't make it to the next fund.

Why the backlog? What has emerged is a big difference between what sellers believe their portfolio companies to be worth and what buyers think is a fair price. A lot has to do with the market reset in 2022 and the massive increase in interest rates in 2022-'23. Would-be buyers are holding out in the expectation the ultimate valuations of many of these companies will eventually be lower than private equity holders are hoping. Yet, as Bain and Co. points out in its most recent report on the industry, valuations, which tend to move inversely to interest rates, have tipped downward over the last year but only slightly so far. Bain argues that it's because sellers are bringing to market only the highest-quality assets, those they are confident will move at a reasonable return. (By the way, Bain and Co. has the world's largest private equity practice so it has a fair bit of data on the industry.)

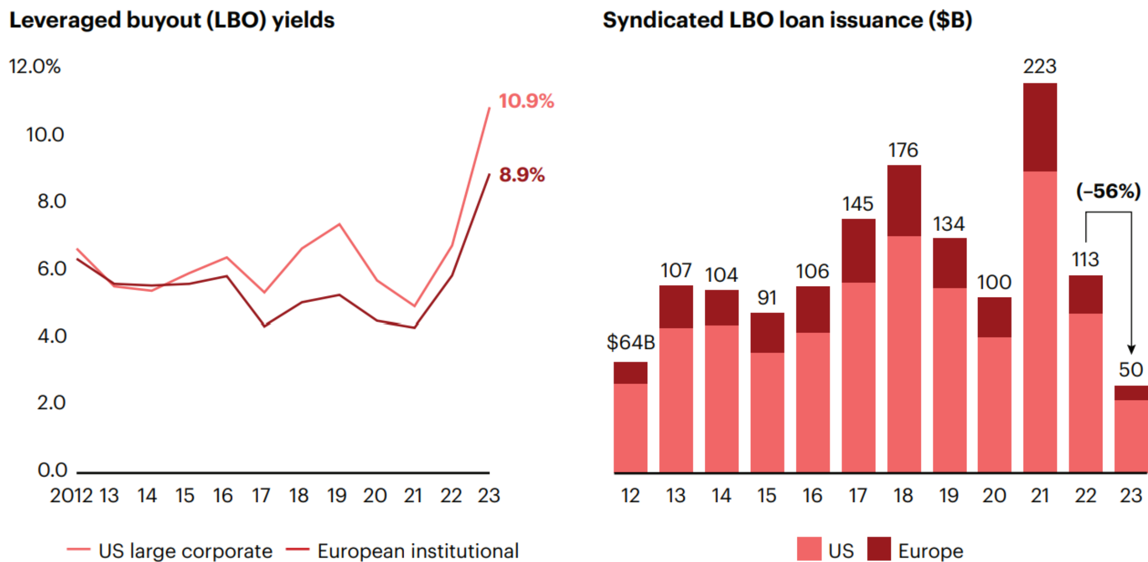
How long is this going to last? In a separate section of the report, Bain tabulates that exit value (i.e., the total value of firms sold) is on track to finish 2024 at $361 billion. If true and if the sales rate doesn't speed up, it will take almost 10 years to clear out the backlog, not counting for the increase in inventory to sell along the way. All of this suggests that valuations will likely need to come down to clear the backlog.

Condition 2: Higher Interest Rates

A standard way private equity firms make money is to use borrowed capital to increase the return on the equity invested. Leveraged investing can be quite attractive – say you buy a home for $1.0M with 10% down and then sell the home for $1.2M a year later (net of all costs and interest paid). You only invested $100k of capital, yet received $200k, effectively doubling your investment when the home only appreciated by 20%. More leverage and lower interest rates only magnify the return on the original capital invested.

This party seems to be over, at least for now. As shown in Figure 2, The cost of financing for buyout firms today is almost double what investors had in their pre-2020 valuation models and debt issuance has collapsed. High interest rates make it much harder for a leveraged company to service its existing debt and take on new debt to grow. All of this puts downward pressure on asset prices (although as stated earlier, we are not yet seeing actual marks come down because so many companies remain unsold, for now at least).

Figure 2. Leveraged Buyout Loan Yields and Issuance Trends

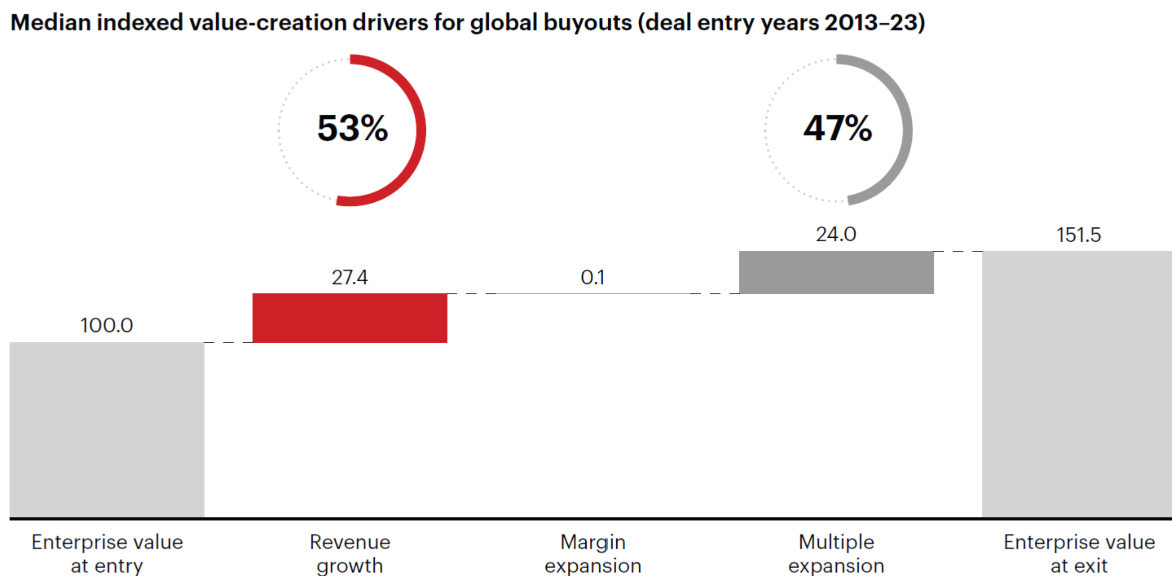


Condition 3: Value Creation Harder to Access

The conventional wisdom is that private equity returns are high because GPs are great at finding companies that have not realized their economies of scale or that are poorly run in some way. The investment thesis is to step in for a period of time, improve the firm in one or more ways and then sell it for a justifiably higher price.

Remarkably, the evidence suggests that buyout funds have not created value by improving operating margins at all (see Figure 3). Rather, value has been created largely via revenue growth and multiple expansion. The latter refers to paying more for a bigger company that is generating the same margin than a smaller one simply because it's bigger or perceived to be less risky. There may be some value in a company having greater scope, but even this benefit has its limits if profitability is not increasing.

Figure 3. Sources of Value Creation in Private Equity



In an era of higher interest rates, it would appear that the industry is going to need to place much more emphasis on margin expansion as a source of value creation. This is hard to do as it means buyout firms will need true expertise in finding companies that due to underinvestment, poor management, or for other reasons have true operating leverage. It also means buyout firms will need effective and experienced in-house operating teams that can work with company management teams to drive performance improvements.

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The Bottom Line

As the above discussion indicates, there are quite a few reasons to believe that private equity returns over the next decade are going to be lower than they have been in the past. And, as discussed earlier, private equity has not outperformed since the Great Financial Crisis, when benchmarked appropriately. At the end of the day this might well be due to the simple fact that the industry has grown so large over the last decade that it's become nearly impossible to identify and acquire companies where robust value can be created.

So is private equity past its prime? Yes. I don't see any reason to pay high fees, put up with a lot of administrative hassle, deal with multiple capital calls and give up access to the investment dollars for up to 10 years, all with the same returns that can be realized in the public markets at a fraction of the cost. Moreover, unlike large pension funds, individual small investors lack the size and leverage to negotiate discounts and gain access to the best private equity managers, or to set up internal investment teams that do co-investments alongside the private equity fund without paying fees. There may well be some diversification benefit of owning some private equity, but honestly, there are so many other ways to diversify a portfolio that are far less costly.

Artemis Strategy

Not surprisingly, Artemis is not chasing private equity returns. We are also not making any big bets currently as the market is being driven by prospective interest rate changes and AI euphoria. All Artemis clients have plenty of exposure to the AI theme already as exposure is hard to avoid given the large weight of the top technology stocks in the S&P 500.

The growing expectation of an interest rate cut by the Fed in September is actually helping parts of the equity complex that have been left behind of late due to the AI stampede and reminds us of the importance of remaining diversified. AI stocks are selling off at the moment (June-July), and money is rotating into small companies (e.g., the small company fund we use is up almost 11% in the last month) and into value stocks, serving as a reminder of the importance of not putting all one's eggs in the same basket.

And by the way, this market rotation should help the relative performance of the ESG funds we use because they tend to include more smaller and medium-sized companies in their mix (despite being called large company funds).

We are, however, taking a good look at all clients' fixed income portfolios. Interest rates move inversely to prices, so as rates come down we should see some decent bond price appreciation, and longer maturity bonds will appreciate more than shorter-term bonds. As

such, we are looking to ensure we don’t have too much money in short-term bonds and we are encouraging those who have a lot of cash on the sidelines to consider converting to bonds.