Market Timing

- Warren Hibbert, Managing Partner, Asante Capital Group

Warren Buffett has been quoted as saying "my favourite time frame is forever". In the private equity market, however, the relatively standardized duration of funds dictates that there is a limited timeframe within which to invest and to exit all fund investments, and in most cases, the investment and hold periods are aligned more towards short- to medium-term investing than long-term investing. Moreover, many astute investors over time have made reference to the fact that you can't time the market and shouldn't try to – which leaves the private equity industry with an interesting challenge of having to invest and exit consistently within defined time periods, through increasingly volatile swings in global markets.

This dilemma is further exacerbated as the global capital markets appear to be racing towards 2007 levels and beyond, and as the market starts to reach boiling point (yet again), the various private equity constituents start peddling faster and faster. Add to that the fact that fund investors (LPs) review between approximately 400 to 600 funds per annum and it becomes clear that LPs have less and less time to fully diligence each opportunity deemed potentially appealing, while still having to carefully balance the portfolio to take advantage of swings in market cycles.

As the market continues to rise with prices, leverage multiples and generally frenetic levels of activity, the fundraising environment follows suit, albeit with a marginal lag, and as the fundraising environment improves, thanks to a strong exit environment, another wall of capital is built just as it becomes increasingly expensive for fund managers (GPs) to buy into the market.

In a perfect world, the market and fundraising cycles would operate inversely so that as the market peaks, less and less capital is allocated to invest, and as the market dips, a new wall of investable capital is built up. In most instances, this strong correlation between the broader market and private equity fundraising cycle will result in poorer performance through the dip, as GPs raise and invest significant sums at the top of the market and battle to generate returns where they hold typically over-leveraged assets that struggle to deliver on their growth expectations, and end up being sold into a lower priced environment in years to come. Of course that is a generalization and there will be a number of strategies that will fare better than most through a down cycle, assuming they are not forced to put money to work ahead of market swings – such as special situation and turnaround managers, that should be well placed to pounce should the market correct at some point in the future and assuming they've remained disciplined through the headier times where they would have seen fewer attractive opportunities. There are also a number of other strategies that should be well positioned to generate strong returns; for example, energy funds that find themselves in an attractive pricing environment today, yet with a strong long-term demand cycle; and financial services funds that can take advantage of global banks being forced to jettison non-core, yet fundamentally attractive operations across various markets (primarily in Europe).

One of the questions this poses is whether there is merit in recalibrating (to some extent) private equity fund portfolios between cycles to ensure that those managers best positioned to take advantage of the next cycle are those that are most recently funded. Given where the market is today, what should LPs be looking for? Relevant strategies as we approach the top of a market cycle may include: select managers investing in emerging markets that have yet to shine and yet have continued to perform despite their peer group generally underperforming (such as India for example); special situations/opportunistic managers that are able to access relatively unique opportunities/assets given their deep and sophisticated skill set (shipping for example) or special situation credit investors that are able to take advantage of pricing arbitrage due to information mismatch and translate the initial credit risk into an equity return over time ('loan-to-own' strategies, for example) – again having a very specific skill set within the team to execute consistently on strategy.

Another sector that is experiencing a significant downturn and hence exhibiting special situation opportunities, a pricing mismatch and a long-term positive demand trend, is energy, and to an extent, the broader real assets category that has typically provided an inflation hedge. It has been evident from a number of the recently announced, successful energy fundraisings (both credit and equity funds) that the opportunity is clear, and according to some, the pricing arbitrage in the underlying commodity is a potential '50-year storm event'.

Secondary investors should also fare well in the event of a market correction. Pricing on secondary fund interests is close to par, if not above, in many instances and the quantum of attractively priced opportunities should increase significantly through a dip in the market where increasing levels of uncertainty abound.

A number of more generalist strategies in the private equity industry have done well to adapt to more of a buy-and-build approach in cases where they had previously executed a more standardized buyout strategy. This has generally allowed them to find smaller assets at more attractive prices, albeit typically with more operational risk too. One of the concerns, however, given where the market is today, is that even the smaller assets are still trading at relatively expensive levels.

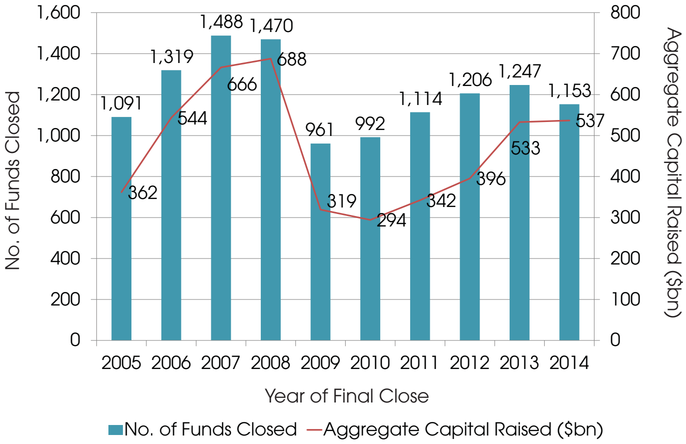
A number of LPs (endowments in particular) continue to recalibrate their portfolios fairly aggressively to focus on a smaller number of managers pursuing 'high alpha' strategies with the potential to deliver strong returns consistently. What does not seem to be evident, however, is whether LPs are recalibrating their portfolios for market cycles. We know of a number of LPs that do calibrate their portfolios relative to where they want to be liquid depending on where in the market cycle they are and they do so by balancing their public equity exposure with that of their private equity positions on a sector-by-sector basis. However, they remain the exception to the rule, and as long as portfolios are not continually calibrated towards future market movements, we will continue to observe an unhealthy number of non-differentiated managers being funded where they've been able to evidence strong exits primarily due to a strong market cycle leading to marked swings in performance across vintages and market cycles further down the line, leading to the situation today where there are ultimately too many managers in the market.

Another big question is whether this conundrum might not exist at all if LPs had more discretion over when a GP put money to work and where they invested. Of course the overriding issue here goes to the fundamental principal behind a blind-pool of capital – that being that the specialist fund managers are best placed, with the strongest teams, to execute their strategy, and by removing their ability to invest in businesses and time the market, the concept behind a blind-pool starts to become redundant. While there are a very small number of highly sophisticated LPs with very large pools of capital (typically sovereign wealth funds or large pensions) that are able to take controlling interests in businesses around the world, this sub-set of LPs is very small and most still rely on the expertise of the GPs they back to provide them with a premium to the public markets and co-investment opportunities that, for the most part, work to reduce the overall cost of the investment to the LPs.

As markets continue to climb ever higher, it will be interesting to watch how the LP community adjust and augment their portfolios and which of the GPs in the market today continue to get funded. There are many GPs that have been very successful, in large part because they are able to generate strong returns on a very consistent basis regardless of market cycle, and they will continue to stand out. With them, there will be a number of new innovative strategies that will emerge as the private equity market continues to evolve, and both should provide the LP community with a strong balanced portfolio of consistent performers able to take advantage of specific points in each market cycle. However, what is clear is that we will continue to see further bifurcation of the market as there remain too many funds unable to successfully deliver performance across cycles via differentiated strategies, and so it becomes increasingly difficult for LPs to gain sufficient allocation to the best managers.

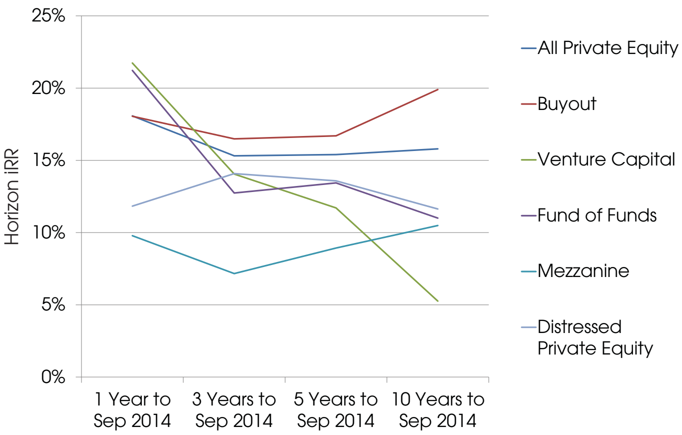
It is clear that trying to time the market is futile, but developing a select portfolio of private equity managers that can take advantage of different points in each market cycle, and that are optimally funded as and when the opportunities are most evident, is the holy grail for any LP in the market today, but it is also clear that the search for this holy grail will continue to ensure that there is funding for a far broader set of managers to come.

Fig. 1: Global Annual Private Equity Fundraising, 2005 - 2014



Source: Preqin Funds in Market

Fig. 2: Private Equity Horizon IRRs as of 30 September 2014



Source: Preqin Performance Analyst