INSIGHTS:
MARKET UPDATE
MARCH 2020

iCapital NETWORK

PERSPECTIVE ON THE ALTERNATIVES MARKETPLACE

Similar to traditional assets, alternatives such as private equity and hedge funds will no doubt be impacted by the current environment. Because some of the assets utilized in Private Equity and Hedge Fund portfolios price less frequently than mutual funds, it will take longer to gauge the impact. General Partners of our funds report that they are deploying comprehensive risk management strategies to curtail the negative impact and are selectively seeking out investment opportunities following the massive dislocation in global equity and credit markets. The following offers some perspective on the current environment, what may lie ahead, and how advisors should think about their alternative investment allocations today.

WHAT'S HAPPENING?

While market volatility and the evolving response to the COVID-19 pandemic make it virtually impossible to provide a pertinent "real-time" update, here is a quick snapshot:

- Global equity markets are currently down (20%-30%) thus far in March, which would represent one of the worst monthly results in the Post-War era, spanning 75 years.
- Credit markets have been impacted in a material way as well, with spreads widening and certain segments of the securitized credit market (e.g., CLO equities, aviation finance, RegCap bonds, etc.) most impacted.
- The war on oil prices is exacerbating this situation. Energy was already depressed and, given the Saudi Arabia/ Russia war on new supply, we may be left with an enormous build-up of reserves combined with a market shock in the form of reduced demand as China and the world slow down.

While the impact on publicly traded securities is obvious, private capital strategies have a lag effect in terms of performance and long-term portfolio implications, though they have historically outperformed during prior periods of extreme market duress.

IS THIS DIFFERENT THAN 2008?

Many global investment firms have pointed out that this environment is very different than 2008. The Coronavirus is causing a different kind of disruption than we've experienced before, one that requires social distancing and restricts physical interaction, but it is not a crisis of the financial system at this stage. The banking system is well capitalized and securities continue to trade. This is despite markets continuing to decline after the Fed's weekend announcement of (a) effectively zero interest rates and (b) purchasing $700 billion of Treasury and Agency bonds, and coupled with the increased probability of a global recession.

This highlights the fundamental difference between an economic crisis driven by a global pandemic and a financial crisis with systemic issues (we are facing the former and not the latter, at this point). In 2008, the government was concerned about public sentiment toward a perceived bailout of Wall Street. Today, a trillion-dollar stimulus package to help businesses and households get by is not at all controversial – in fact, it has an almost humanitarian quality. The Fed stepped in on a Sunday to reduce interest rates, and the private and public sectors are encouraged to lend to help businesses remain solvent and keep layoffs at bay. The Fed also noted that big financial institutions have $1.3 trillion in common equity and hold $2.9 trillion in high-quality liquid assets on their balance sheets.

However, while the banking system and broader economy in the U.S. are much sturdier than they were in 2008, we should be careful not to assume that things will simply return to normal once the virus subsides. Deeper cracks in our financial system may yet form. Hopefully, we will return to normal before too long, but as major countries focus entirely on stopping the spread of COVID-19, the economic impact caused by quarantines and disruptions to consumer and commercial activities will obviously magnify over time. More businesses will eventually have a harder time staying afloat and families may have trouble paying their bills.[1]

WHAT ARE MANAGERS DOING?

Responses vary based on myriad factors but, generally speaking, hedge fund managers have cut risk; raised cash; sold out of many non-core securities; held onto select positions that may be down substantially (but are not structurally impaired); and are opportunistically purchasing new positions or adding to current holdings that offer compelling risk-reward opportunities.

A majority of general partners ("GPs") expect the impact of the current environment to last for some period of time (one or two quarters, or perhaps much longer) and are proactively increasing liquidity and improving the quality of their respective portfolios.

On the private equity and private credit side, GPs are laser focused on protecting their portfolios by running stress tests to stay ahead of any liquidity or covenant concerns. Where possible, they are reducing expenses, refinancing, drawing down revolvers, and stretching payables. We can expect to see private equity deals that were negotiated over many months, but not yet finalized, unravel, and we're already seeing PE firms shelve sale processes of their portfolio companies, pulling them off the market for now.

GPs also recognize that, during times of extended dislocations, highly attractive deals can be made as the pendulum swings hard and valuations reset to much lower levels, although it is still early days. With $2.3 trillion in dry powder across the private capital markets ($700+ billion in buyout capital alone), GPs are quickly shifting into opportunistic mode, looking to take advantage of falling asset prices. However, there is a natural lag between public and private market valuations. As in 2008 during the Great Financial Crisis, the first wave of opportunities will likely come in the form of distressed assets, while transactions involving healthy assets will decline sharply as stable companies hunker down.

In addition, providers of high-yield debt and syndicated loans will start applying the brakes in this market, potentially constraining financing. So, not surprisingly, look for PE firms, particularly distressed fund managers, to take advantage of sharp dislocations in the most impacted sectors such as tourism, aviation, hospitality, restaurants, oil, and industrials with severe supply-chain issues.

Private equity firms will also be scouring the public markets for opportunities, particularly given the large number of mega funds that have been raised in recent years. One challenge that will be hard to quantify, but that is likely to factor into this crisis, is the difficulty in conducting on-site due diligence and negotiating deals via video conferences. The shift to remote work is likely to affect the pace of activity and the length of time required to complete a transaction.

HOW SHOULD ADVISORS THINK ABOUT CLIENTS' ALTERNATIVES ALLOCATIONS?

For all members of the "capital markets ecosystem" (GPs, LPs, Advisors, etc.) long-term success requires transparency, discipline and communication: knowing what you own, sticking to an investment process / risk framework, and speaking with clients to help navigate the storm.

The worst investments in any meaningful downturn are usually those that are over leveraged, highly concentrated, inadequately diversified, facing asset/liability imbalances, and/or operating in opaque markets. Advisors must feel confident that their underlying investments are protected against structural challenges and that they can ride out this storm.

Market volatility creates opportunities over the long term and this is an opportune time to focus on quality companies with quality assets and earnings. As with any market panic, we will see instances where investors will overreact and try to run for the exits. If you have committed capital to an experienced, proven alternatives fund manager who has lived through deep recessions, that GP should be better prepared to react and capture value by identifying mispriced assets and attractive opportunities during this market dislocation.

As such, having a new commitment with a high-quality private capital firm right now, assuming you can tolerate the illiquidity, is likely to be a good thing. You can take comfort in letting them figure out how and when to buy and sell the right assets.

POTENTIAL BENEFIT TO INVESTORS IN ALTERNATIVES

Performance results will vary dramatically as the current environment persists, but there are at least two critical benefits for investors in traditional alternatives. First, for those in private markets, the lack of emotion and forced selling, which always exacerbates the downside, is relatively minimal.

Additionally, market selloffs offer attractive entry points in the private markets, whenever price and value get temporarily disconnected. This is why the historic outperformance of private equity has increased during prior recessions (see our recent white paper, Private Equity Offers Resilience in a Downturn). A survey conducted in the past two weeks by the placement agent Eaton Partners showed that more than half of the 69 institutional investors who responded view private equity as the most attractive asset class during these volatile and severe market conditions.[2] And for investors in hedge funds, the combination of investing in long-term "winners" while opportunistically hedging their portfolios may offer substantial benefits in a diversified portfolio. As always, the value of patient capital is felt most at times like this.

Nick Veronis
Co-Founder & Managing Partner, Head of Research & Due Diligence

Joseph Burns
Managing Director, Head of Hedge Fund Solutions

END NOTES

[1] From Bloomberg: "The problem, as Larry Summers eloquently put it, is that 'economic time has been stopped, but financial time has not been stopped.' In other words, if we all cocoon for two months, we might physically survive, and the infrastructure of the modern world would be waiting for us upon our re-emergence, but in the meantime the bills pile up. The rent's due. The mortgage is due. … What we need is cash to keep people from going bankrupt or evicted. Cash to keep the lights on. Cash to keep people employed; to keep their healthcare. Cash to buy basic necessities, like food or medicine. So let's not think in terms of reviving growth for now. Let's think in terms of cash, so that for as long as we're in deep freeze, people can stay alive and continue to meet their financial obligations.

[2] Eaton Partners, LP Pulse Survey, March 2020.

iCapital NETWORK