



Blast Out of Your Mental Sand Trap

By Mario Giannini, CEO | 9 March 2021

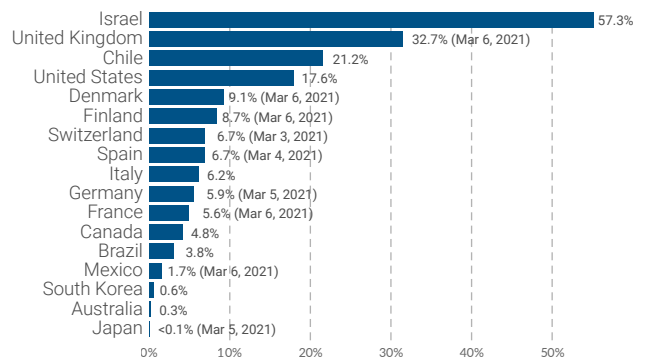
Key Takeaways

- What do we need to worry about? Herd Immunity. The math on herd immunity is tricky. (p. 4)
- Many countries are pushing for a digital vaccine passport that allows free passage if you have proof of vaccination. It sounds ideal, doesn't it? Here's why we may not see one. (p. 4)
- I'll make a prediction. Inflation isn't coming back. Interest rates will stay lower for longer. This inflation scare will continue as economies surge post-vaccination. (p. 5)
- While one can say value investors are also paying much higher prices today than they did a few years ago for slow growing businesses, it may be that, in a world where everything is expensive, you should focus more on the downside than upside potential. (p. 6)
- These updates have dealt, at various times, with the phenomenon in the secondary market known as GP-led deals. I'll be clear: These are here to stay and will be one of the most important trends in private markets over the next few years. (p. 6)
- If there is one market that seems to be edging into the danger zone, it's credit. (p. 7)

COVID-19

This chart provides a visual on the number of people in each country that have received at least one dose of a vaccine (some countries don't provide that information).

Share of People who Received at Least One Dose of COVID-19 Vaccine, March 7, 2021



Share of the total population that received at least one vaccine dose. This may not equal the share that are fully vaccinated if the vaccine requires two doses.

Source: Our World in Data

Quick tidbits you should know

1. The Johnson & Johnson vaccine was granted emergency use authorization in the U.S. and will be given similar treatment in many places globally. It is a single dose vaccine—it is a game-changer.
2. Most European countries have now allowed the AstraZeneca vaccine to be used in older populations. This had previously not been allowed based on suspect reading of the data by the EU. Populations in some countries have refused this vaccine, preferring



Pfizer or Moderna. This is particularly true in Germany, France and Italy, where politicians criticized the vaccine and now wonder why their populations are skeptical.

- 3. CanSino Biologics filed for approval in China, saying its Phase 3 trial showed an overall 65% efficacy rate. It would be the third vaccine approved in the country.

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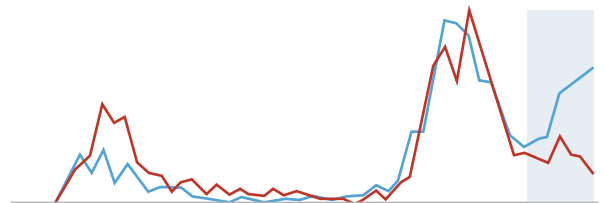
What we don't need to worry about

Vaccine Effectiveness. We need to take a step back and appreciate how awesome the vaccines are working in practical application.

- Israel's largest healthcare provider supplied data on over 600,000 patients treated with both doses of the Pfizer vaccine. They reported a 94% drop in symptomatic COVID-19 infections and said the same group was 92% less likely to develop serious illness from the virus. The vaccine was even more effective two weeks after the second dose. Let's note, as many skeptics already have, that this study was observational. This means it wasn't a random group of patients and those who take the vaccine may be more likely to be careful and that can skew the data. Let's also note that it seems more than coincidental that real world results are virtually identical to Pfizer's clinical trial results.
- Want more? Israel's Ministry of Health provided the following efficacy data for Pfizer's vaccine, 14 days after the second dose:
 - 95.8% preventing illness cases
 - 98.0% preventing fever and/or respiratory symptoms
 - 98.9% preventing hospitalization
 - 99.2% preventing severe illness
 - 98.9% preventing death
- Still more? It's not just Pfizer. Scotland reported this about one dose of the Pfizer and AstraZeneca vaccine: "By the fourth week after receiving the initial dose, the Pfizer vaccine reduced the risk of hospital admission from COVID-19 by up to 85%.

The Oxford-AstraZeneca vaccine reduced the risk of hospitalization by up to 94%." Oh, and those EU leaders worried about AstraZeneca's effectiveness for older patients? Scotland reported that those over 80 had an 81% reduction in hospitalizations. It's always uncomfortable when data trumps politics.

- Not enough for you? This is data from Asturias, a region in Spain. The red line is weekly deaths in nursing home residences. The blue line is weekly deaths outside residences. The shaded area is when vaccinations started in nursing homes. That can't be a coincidence.



How much good news can those of you peeking from behind the face shields actually stand? These vaccines work. They work exceptionally well. We hope that similar, real-world data, is gathered for other vaccines, including those from Russia and China. (Part of Pfizer's agreement with Israel to supply doses so quickly was in return for data on vaccination.)

Vaccine Supply. We are bombarded daily with stories of inadequate vaccine supply throughout the world. Everyone everywhere is blasting manufacturers, governments, health systems, anyone they can find to blame. There are eight billion people in the world. That means, with most vaccines requiring two doses, we need 16 billion doses. When was the last time 16 billion of anything, other than opinions on social media, were instantly produced? Everyone take a deep breath.

- By July, which I know seems like a very long time away, but is really only a few months, almost everyone that wants a vaccine will be able to get one in places like the U.S., Canada, Europe and parts of Asia. Supply will continue to increase through 2021.
- I suspect some countries will go to a one-dose regimen on the Pfizer and Moderna vaccines. A letter published in the New England Journal of Medicine recently looked at FDA data provided by Pfizer and Moderna, and concluded that one dose provided 92.6% and 92.1%, respectively, efficacy. Israeli data shows a 47% reduction in symptomatic infections



two weeks after the first dose and an 85% reduction over the following two weeks. Both studies note that one shot may not provide as long an immunity as two, and Pfizer and Moderna have been clear that their trials were conducted for two-dose regimens. Going to a one-dose regimen, even delaying the second shot by a few weeks, will significantly increase the number of vaccinations and give supply time to catch up with demand. The UK undertook that policy with the AstraZeneca vaccine and it is cited as a major reason why the UK is far ahead in vaccination.

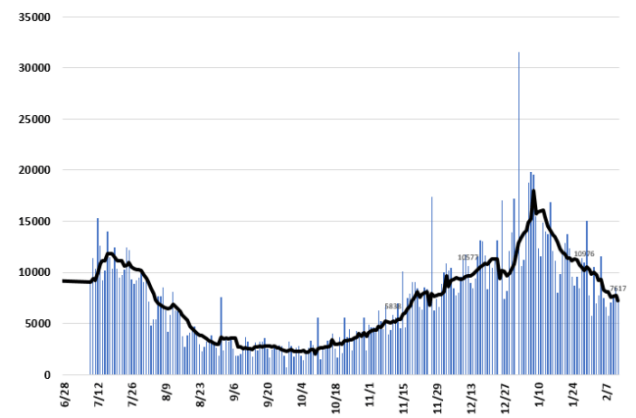
Vaccine Effectiveness Against Variants. There was quite a bit of publicity around a study that found that Pfizer’s vaccine was 66% less effective against the South African variant. OK, some facts please.

- This was a lab test, not a real-life trial. Beware of sweeping conclusions based on lab results.
- The lab test looked at how many antibodies were produced against the variant and found two-thirds less. Sounds concerning. You’ll have to answer these questions to know how concerning: (a) How many antibodies does it take to provide immunity? (b) What other parts of the body’s immune system are involved in developing immunity? (c) Do the antibodies increase over time? What, you can’t answer them? Neither can any of the researchers. We have one data point, fewer antibodies, that may be indicative if you make certain assumptions, but tells you very little about real-world application.
- As we have seen with trial data, less effectiveness likely means that you have stronger symptoms of COVID-19 but prevents death or morbidity. That’s a good outcome.

Killer Variants. I dealt with the variant hysteria in my last update. I’d like to say that the noise has diminished, but it hasn’t. The most feared variant remains the UK variant. I am not sure if that’s because it’s the first one identified or because it speaks English and is easier to understand. There’s little data to support many conclusions about the variant, but that hasn’t stopped anyone. Data from the UK is not conclusive because the country remains in lockdown, so it’s hard to know what to make of case levels. As a proxy, let’s look at the U.S. state of Florida. The news media have proclaimed Florida, “ground zero” in the U.S. for the UK variant. (When in doubt, use language that hearkens to nuclear disaster. Whither goes the apocalypse go human eyeballs.) The number of variant cases has quadrupled in the last month. (Before

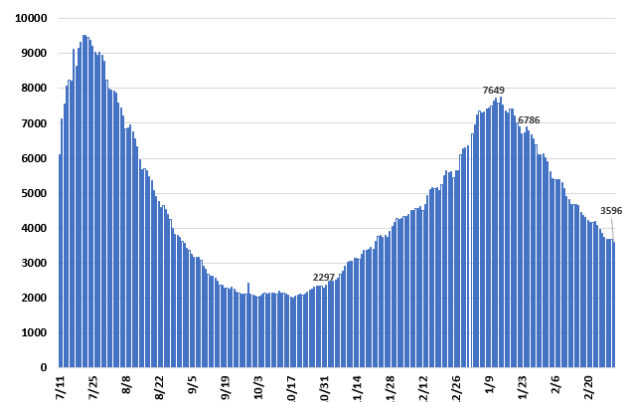
you call your nuclear shelter builder, we are talking about a total of 380. I’m not kidding.) So, with the variant “out of control” in the Sunshine State, what’s happening with cases, hospitalizations and deaths?

Daily New Coronavirus Cases, 7-Day Avg. Trend Line



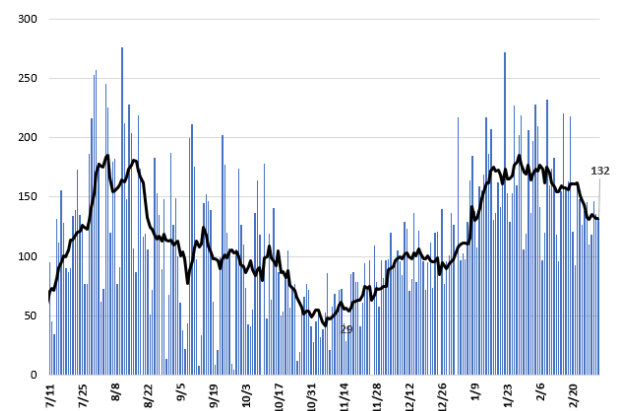
Source: www.tallahasseereports.com

Current COVID Hospitalizations



Source: www.tallahasseereports.com

Daily Fatalities, 7-Day Average Trend Line



Source: www.tallahasseereports.com



You can't argue lockdowns are keeping the variant under control—there are few in Florida. I look at those charts and don't find any evidence that the variant is causing havoc. Here's another tidbit: The Florida Department of Health reports that, in that month during which the variant was "exploding," not one hospitalization or death was attributable to someone with that variant. Maybe we simply don't understand. As a state health official gravely pronounced, "Every new infection allows the virus to mutate and gives it the opportunity to gain some advantage." There really is no hope...

Remember in the good old days of the pandemic, we worried about rising cases creating a burden on the healthcare system and more deaths? Such simple times. Now, we worry about rising cases leading to more mutations that could, might, or have the possibility of starting the pandemic all over again with what I guess we'll have to call COVID-19, version two. (Would the next update in that world be #33 or COVID-19v2 update #1? It's complicated.)

What we do need to worry about

Herd Immunity. The math on herd immunity is tricky.

- **Within a country.** No one quite knows when herd immunity is reached, but let's go towards the low end of the range, which is around 65% of a population. Let's start with a country like the U.S. Right now, no one under 16 is being vaccinated because none of the vaccines have been tested in that cohort. That's roughly 20% of the U.S. population. That means that the highest percentage you can vaccinate in the U.S. is 80%, at least until early in 2022 when, perhaps, vaccination can begin for younger people. To reach herd immunity, you need to vaccinate over 80% of those eligible to be vaccinated. Is that realistically going to happen? Some number are very hard to reach, whether because of location, logistics or belief. A recent poll showed that 41% of Republicans, 31% of Blacks and 30% of Hispanics will not take a vaccine if it's available. The math doesn't work. I'll make a prediction. Right now, the world is in a state of hysteria over the lack of vaccines. It's a supply frustration. In two or three months, much of the world will be in a state of hysteria over the lack of people willing to take vaccines. It will be a demand frustration.

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- **Globally.** I discussed this in the prior update. The world needs to reach herd immunity and that means vaccinating countries that cannot afford to buy the vaccine. Russia and China are supplying some vaccines to the rest of the world, but we will not reach global herd immunity until countries like the U.S., Canada and the EU start releasing the large surplus of vaccines they ordered. In a few months, we will see the demand problem in places like the U.S. and the EU mirrored with a supply problem in much of the rest of the world.

International Travel. How will this happen as more people are vaccinated? There are a few options, but how will they play out?

- a. **Vaccine passport.** Many countries are pushing for a digital passport that allows free passage if you have proof of vaccination. It sounds ideal, doesn't it? Here's why we may not see one.
 - Challenging health privacy laws in many jurisdictions
 - Issues of fairness have been raised. What if I can't get vaccinated for religious reasons? Or because I have a medical issue? Are we creating two classes of citizens? Is it discriminatory?
 - The WHO has expressed their opposition based on fairness and enforcement
 - What will be a valid vaccine? If you think this sounds easy, consider the politics around vaccination. Suppose the U.S. or EU do not accept the Russian or Chinese vaccines because their test results have not been put through those regulatory systems. First, that disqualifies travel to and from a large number of countries. Second, those countries will just as easily not allow U.S. or EU vaccinations for the same reason. If the initial vaccine war was over time to market, this one is over a more existential threat: Technological prowess. The



Pfizer and Moderna vaccines are breakthrough technologies from the U.S. and Germany. That is not an achievement the Russians or Chinese are keen to promote.

- The EU has said they are working on a passport that will work with vaccination and COVID tests. They have said it will take three months to develop the rules. You read that correctly. They urged member countries to act swiftly after that to implement the proposals. Hopefully sooner than three months. It will be hard, however, as the EU has provided little indication of what their measures will contain. These measures will only apply to travel within the EU. They are unsure if any proposals would be developed for international travelers.
- b. *Vaccine countries.* I believe we will see countries, particularly tourist destinations, allow free entry to visitors who provide proof of vaccination and a negative COVID-19 test. However, there will be notable countries that will not permit that, whether because of concern over some vaccines' efficacy or worry that any introduction of the virus will lead to outbreaks in a population that may not have reached herd immunity in that host country.
- c. *Vaccine mandate.* We have seen the cruise industry move to mandated vaccines for any crew member or passenger over the age of 16. Increasingly, I believe events and destinations will gravitate to this requirement. It will be for safety reasons and to ease potential customers' concerns. I wonder whether the volume of people who want to travel will overwhelm those who have issues with vaccine mandates and make those mandates the de facto standard. If you refuse, who cares? There are plenty of waiting customers to take your place.

Vaccine Aversion. It started with the EU and their foolishness around the AstraZeneca vaccine. I mentioned that, now, some people refuse to take the vaccine, claiming it is not effective enough. But it extends beyond that vaccine. Some people have proactively indicated they will not take the J&J vaccine because its efficacy is slightly lower than Pfizer's or Moderna's. There is some concern that, because the J&J vaccine is easier and faster to administer to patients that are harder to reach, it will become viewed as the "poor person's vaccine," inferior to the other two. In addition, the U.S. Conference of Catholic Bishops, in a stand contrary to the Vatican, has expressed "moral

concerns" with the vaccine because it uses lab-grown cells derived from cells taken 40 years ago from aborted fetuses (separated by thousands of generations of cells). Moderna and Pfizer used similar cells in their testing but not in the vaccines' production. At this point in the pandemic, anything that slows down the pace of vaccination, for whatever reason, is concerning.

OK, you've decided you aren't going to get vaccinated. I don't know why, perhaps there are religious reasons, or medical reasons, or you don't want Mr. Gates's chip implanted in you. But you don't want to get COVID-19. What to do? I have some good news for you. New research from India suggests that people who wear glasses could be three times less likely to contract COVID-19 than their 20-20 counterparts. Finally, those of us who can't see our fingers in front of our eyes have realized the Darwinian advantage of our bad eyesight. The research looked at people who wore glasses at least eight hours a day. The reason may surprise you. It is not that the glasses protect you from contracting the virus through your eyes. The study found that infection through the eyes is extremely rare. No, the reason is that people who wear glasses don't touch their eyes as much and so passing the droplets from the eyes to the nose or mouth happens less frequently than it does for people without glasses.

My advice here is that if you aren't going to get vaccinated, throw out those contact lenses, reverse your Lasik eye surgery, and go get a good, sturdy pair of spectacles.

The Public Markets

1. We warned you this would happen. Sometime in 2021, as economies continue to grow and as governments pile on fiscal and monetary stimulus, out would come the inflation hawks, their perennial pilgrimage through the markets like the swallows returning to Capistrano. Prepare! Money as we know it will end! This is what you will need to buy a cup of coffee:



It has happened before; it has happened again. Why the U.S. 10-year Treasury has broken through critical price levels! Mamma Mia, il mondo finira!

I expected this hysteria would wait until April or May, but markets have far more foresight than I do. However, I



thought some perspective would help. Here's a chart of 10-year U.S. Treasuries going back to the 1960s. (I use this chart fully understanding that historical perspective now means going back to last week, but bear with me.) I have festooned the chart with arrows at points where the 10-year had similar, or even more dramatic, increases in yield. Go back to your favorite financial news source at those times. As you've heard so many times, history doesn't repeat, but it sure does rhyme.



Source: Board of Governors of the Federal Reserve System (U.S.), fred.stlouisfed.org

As you look at those arrows, note that a large publication termed the recent rise as "seismic." Seismic seems to happen pretty regularly. I'll make a prediction. Inflation isn't coming back. Interest rates will stay lower for longer. This inflation scare will continue as economies surge post-vaccination. On March 1, 2022, we will wonder why we were so worried about inflation and we will wonder why we took our eye off the deflationary trends.

2. Carlyle's latest economic report, which I've referenced often in these updates, provides an economic backdrop to the inflation worries.

- Revenues in non-pandemic industries (travel, tourism, live events) have exceeded pre-pandemic levels.
- U.S. business spending finished February up 7% from year-ago levels.
- U.S. household spending was up 4%.
- Carlyle notes that inflation remains in check, with prices paid up 1.8%, below the Fed's 2% target, although items like lumber prices and shipping rates are up double digits, and they expect comparable increases in flight costs as capacity isn't there to meet post-pandemic demand.

- They expect European GDP to exceed expectations, tied to strength in industrial and business orders.
- Industrial orders in Japan increased by 6% in February from year-ago levels.

3. I am not sure if this belongs in the public or private markets section of this update, but thank you to my colleague Christian Kallen for this chart and commentary. If you have seen Hamilton Lane's Market Overview, you know we spent some time on the growth versus value discussion that has been much debated in the public markets. (If you haven't seen that Market Overview, well, what are you waiting for? Put down Buffett's letter and get to it.)

Attractive Relative Valuations

Having been beaten down for much of the COVID crisis, small cap, cyclical and value stocks still offer comparatively attractive valuations to higher growth and more virus resilient industries and business models.



Source: Bloomberg

Private markets' value investors say, "Look at this chart to see how growth is overvalued as the spread continues to widen." The value answer is growth has just been mispriced (i.e., was too cheap) in the past and the market has finally realized the value in growth (see how I turned those words around?). It is an important question for investors and, while one can say value investors are also paying much higher prices today than they did a few years ago for slow growing businesses, it may be that, in a world where everything is expensive, you should focus more on the downside than upside potential.

4. It's hard to know whether any SPAC discussion belongs in the public or private market section. But, thanks to my colleague Michael Gahagen for sending me [this](#), I believe we can say SPACs belong everywhere.



The Private Markets

There is a great deal to talk about in the private markets and, in some cases, signs of froth.

- A. I had mentioned in a prior update that being up 10% or 20% seems almost mediocre in this environment. A missing element in these funds are companies that are struggling, yet valuation is neither impaired nor marked down. There are a number of examples where the latest financial figures show double-digit revenue and EBITDA declines over the last two years with valuations generally flat. Projections don't show figures returning to levels from two years ago until the end of this year. My colleague Tom Kerr had the best line for what's going on here. "Adjusted EBITDA: What performance would be if not for underperformance."
- B. These updates have dealt, at various times, with the phenomenon in the secondary market known as GP-led deals. I'll be clear: These are here to stay and will be one of the most important trends in private markets over the next few years. That doesn't mean that stupid stuff won't happen and happen pretty often. It is sometimes happening now as secondary funds with too much money, new secondary platforms that have to make their name, and large limited partners who love to pretend they are deal doers, often decide that they will differentiate their bids by throwing money at GPs with aggressive fee/carry packages. The competition isn't over the price of the asset, but who will pay the most lucrative terms to the GP. This includes low or no hurdles and upside carry tiers at 25-30% with modest IRR hurdles. How do you know this is stupid money? LPs are complaining that the re-invest option is much more costly than the original fund terms. Think of that dynamic for a moment.
- C. Has any space become more mainstream in private equity the last 10 years than software? There have been some clear winners, the early movers, but will that continue? There are two clear paths for the next 10 years: Software-focused firms are one way to invest in this area. However, an emerging trend is not to treat software as a horizontal investment area with a separate deal group but to treat it as a vertical embedded in actual industry teams. Which will prove to be the better path, or will they both be equally successful?
- D. Speaking of clear winners...a few years ago, the Hamilton Lane Market Overview discussed the proliferation of operating partners as part of the GP's

differentiation. How passé. Now, if you want to avoid being described as a private markets dinosaur, you add value with "digital transformation."

A few points to consider:

- It's a tough spot. You aren't differentiated any more, regardless of market segment, without saying you have this skill set, but you're in a penalty box if you don't say you have it.
- Know, however, that many LPs believe this is a real differentiator in the operational toolkit - data analytics, tech enablement across sectors, AI, etc.
- Careful with telling everyone about your AI advantage. The person listening may know you are using a marketing gimmick and what you really mean is you have a web crawler.
- This can, today, increase the multiples on value when you exit. At some point, it will be easier to differentiate truth from fiction but, well, that's for another day.
- As with software, you have two approaches. Build a dedicated function, which has the added bonus of allowing you to raise a product around it at some point if LPs become enamored with this idea. Or, you create a cross-functional capability and leverage it across several investment verticals.
- But, there's more complexity. As a GP, do you buy or build? It's not easy to build and retain these teams and IP's half-life is a whole lot shorter than the classic value creation toolkit GPs trot out. In addition, a digital tool kit can be copied pretty quickly by your competitors, so you may be spending a lot of money and not getting value. Many GPs simply rent the capability.
- Is it really a differentiator? As my colleague Jim Strang asked, can it successfully be weaponized as a marketing advantage? It's unclear. Will LPs be able to fathom what the "optimal"/best model is and link it to superior results explicitly enough to change the answer on decision making? Hmmm.



E. If there is one market that seems to be edging into the danger zone, it's credit.

1. One turnaround GP observed, "Financing markets have gone absolutely crazy. In the last two weeks we've been pitched three holdco, pik toggle notes. That means euphoria has exceeded judgment and the credit markets are manufacturing the next round of opportunities for us tomorrow."

2. The public credit markets, with inflows showing no signs of abating, have accelerated some trends on the private credit side.

- Creativity (private credit code for lower return with the same amount of risk) is the buzzword. There is increased willingness to move further down the stack and for junior/mezz-focused funds willing to structure what looks and feels like equity-oriented transactions. Public credit markets make it hard to structure anything remotely competitive on pricing in the first and second lien space right now. Without massively leveraging your fund (which no one wants to do in the mezzanine world), hard to hit targeted returns with a more straightforward debt book.

- Lend to names you know.

- Now is the time to rent money. The leveraged loan calendar shows LIBOR floors are largely at 0% for credits above single B, OIDs are in the 0–50bps range, and call protection has fallen to 101 for six months (don't ask where leverage levels are trending). As my colleague Drew Schardt pointed out, "It feels like 2L has adopted Unitranche pricing and preferred equity has adopted 2L pricing."

F. Where have we seen this movie before? Hedge funds are returning to the turnaround deal world. The last time that happened was in the 2003-2006 era, when they bid prices to irrational levels with minimal levels of diligence. Apparently, in most of the world history only rhymes. In the private markets, it washes, rinses and repeats.

G. It is the largest animal migration in the world.



Millions of wildebeest migrate in a clockwise direction across the ecosystems of the Serengeti (Tanzania) and the Masai Mara (Kenya). Are we witnessing a great

migratory echo as, perhaps not millions of general partners, but millions, perhaps billions, of dollars of tax revenue migrate in the counterclockwise direction from the canyons and hills of New York, Connecticut and New Jersey to the plains and beaches of Florida?

Conclusion

"I get in the dumps at times, and don't open my mouth for days on end. You must not think I am sulky when I do that. Just let me alone, and I'll soon be right."

— Arthur Conan Doyle, "A Study in Scarlet"

It should be a positive time, right? The vaccines are beginning to roll out into populations. As fast as we want? No, but getting better almost everywhere. Economies are doing well around the world. Is everyone benefiting? No, but a lot more than a few months ago and prospects are looking better as more segments of economies open

now and in the near future. Offices will begin to re-open, social events are creeping back, the next few months promise more of that happening. Fast enough? No, but better than we thought a short while ago. We even have a pretty good sense of the things we most want to do when we can and a perspective that allows us to appreciate some of the things we might have taken for granted before the pandemic.

Watch the news. Listen to people. Check out social media. What's wrong here? We're worried, we're angry, we're apprehensive, we're wallowing in bad news and shadows we see behind us and around every corner. You almost think we are in March 2020 but fatally armed with all the information we know about the rest of 2020. Think



of this: If I told you, in April of 2020, what the world would like today, you'd be celebrating. Instead, we're glum and certain there's danger everywhere.

Why?

I don't know. I have read articles that say we are addicted to bad news or we've been conditioned over the last year to expect bad news. Can you really become addicted or conditioned to bad news in this short of a period of time? I find that hard to believe. Maybe, for too many of us, that's just who we are. Maybe that's just who the loudest amongst us are and they take up a disproportionate amount of airtime and space. What I do know is that this fixation on bad news is not good for us as investors and not good for us as people. It causes us to make lousy assumptions that lead to equally lousy decisions. It causes us to miss things, many of which are right in front of us but blurred by the barrage of negative feedback. I had a key chain a long time ago that was in the shape of

a golf ball and it said, "Blast out of your mental sand trap!" I have no idea why I had a golf-oriented key chain, what else it said or why that phrase has always stuck with me, but it forms part of my advice for this update. The first is to go listen to some of the bad news or social media rant and then repeat it to yourself in front of a mirror as if you said it or believe it. You will be surprised at how nutty you actually sound and it will put that piece of bad news in perspective. The second is to take five minutes out of your day, sit somewhere quietly, and think of one thing you are looking forward to doing when the pandemic is officially over. No, don't think about when that will be, why it isn't now, how it might not happen. Just think of that moment when you are doing, experiencing or simply enjoying whatever it is you've chosen.

That is the pause that refreshes. Now, either come back more positive or return to your regularly scheduled glumness.