Hamilton Lane
Research

CHOOSE YOUR OWN DOWNTURN

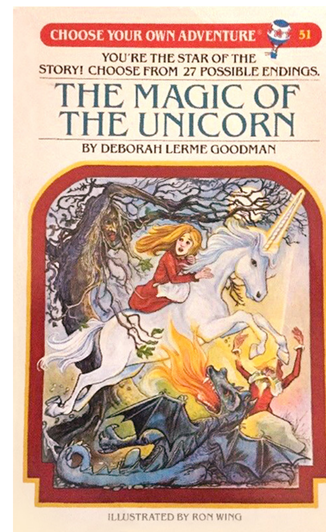
By Jeff Meeker, Chief Client Officer

At Hamilton Lane, we spend a lot of time listening. It's how we stay in tune with the mood in the market and a big part of how we ensure we're offering our clients and investors the service and support they're looking for in this asset class. Lately, what we're hearing as the first, second and third question on the minds of LPs is some version of the following: Volatility is on the rise and a downturn is inevitable, so how do I best position my private markets portfolio?

Whether an investor in the private markets or not, everyone thinks a downturn is coming. Strike that. Everyone *knows* a downturn is coming. Pick your favorite indicator – jobs reports, central bank policy, the yield curve, the cosmetic surgery index – panic is spreading, and that isn't necessarily a recipe for making good decisions.

First, let's address the obvious: Of course a downturn is coming. It has to eventually; after all, market cycles are a fact of life. The word downturn predictably strikes fear in the minds of investors all over the world, and yet it could manifest itself in a variety of different ways. Given that, we'd argue the more relevant questions to be asking today are: when is the downturn likely to happen, and how severe is it likely to be.

But, nevertheless, let's get back to the bigger dilemma keeping LPs up at night – how best to position their portfolios in advance of the impending downturn. There is nothing simple about this question, other than the answer (gauntlet thrown). Every limited partner has underlying beliefs or motives driving its own actions, so we need to keep those in mind as we explore this topic further, which we thought we'd do by employing a cultural phenomenon that started back in the 1970s: Choose Your Own Adventure.



For those unfamiliar, we'll first provide some background. Choose Your Own Adventure was a series of children's books in which the reader made choices that determined how the story played out. For example, a small village is in danger and you're trying to save everyone in it. You are riding a horse and being chased by the mythical monster. You come to a stream; you aren't sure how deep the stream is and there's a small, rickety raft on the shore. Do you: a) leave your horse and get on the raft and start paddling (if so, turn to page X), or b) stay on your horse and try to cross the stream (if so, turn to page Y)?

If you made the right choice, your adventure continued. If not, you died. (Children's literature was a lot harsher back in the day.)

So, why choose this analogy? Because it's entertaining! Also, because of the numerous similarities to today's market environment. There was more than one right answer. There was more than one wrong answer. And the potential paths to your eventual outcome were everything from treacherous to choppy to peaceful.

With that, let's begin… "Choose Your Own Adventure: The Market Downturn." Our story opens in the first quarter of 2019; markets have rallied from the steep declines of Q4 2018, but investors are rattled and the financial news media seems to be covering nothing but the looming market downturn. Everyone is convinced the downturn is coming; they're not sure when or what

the impetus will be, but it's definitely coming.

As an investor in the private markets, and the star of this story, you are faced with several paths to consider:

A. I have an existing private markets portfolio, and I'm going to stop making new commitments now. I'll wait for the inevitable downturn to pass then start committing again once the market recovers.

B. I have an existing private markets portfolio, and I'm going to slow my commitment pacing until the inevitable downturn passes, at which point I'll resume my prior commitment pacing.

C. I'm new to the asset class, and I will wait until after the downturn to start building my private markets portfolio.

D. I have an existing private markets portfolio and will stay the course; no changes will be made.

E. I have an existing private markets portfolio and will generally stay the course, but will make some tactical changes.

F. I don't invest in the private markets. I'm not sure how I even made it into this story.

Let's see how you did:

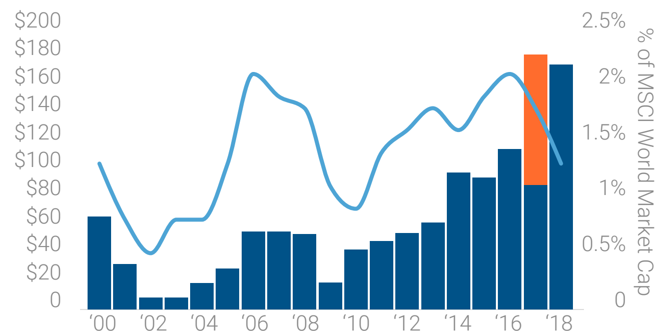
CHOICE A) *I have an existing private markets portfolio, and I'm going to stop making new commitments now. I'll wait for the inevitable downturn to pass then start committing again once the market recovers.*

You chose poorly. And you died. The cardinal rule of private markets investing is that you cannot time the markets. No one can! Look at the fundraising numbers leading up to 2008: We reached an all-time high that coincided almost exactly with the beginning of the Global Financial Crisis. Getting the timing wrong means missing out on good vintages or overcommitting to so-so ones. No matter the asset class, as investors, we tend to be awful market timers. Pulling back when a crisis hits (assuming your guess on timing was even right) hurts returns since the crisis-era vintages tend to have strong performance. It also means your portfolio is now (relatively) overweight vintages from a few years prior to a crisis, which tend to be poor vintage years. The time to cut back would have been a couple of years before a correction.

Moreover, this approach ignores one hugely important point about our asset class: The day you commit to a new fund, you've handed over the responsibility of "timing the market" to the general partner. You no longer control that capital, since it's the GP that decides how rapidly or slowly to deploy. This isn't the strategy to follow.

Global Private Market Fundraising

USD in Billions



● All PM Fundraising ● % MSCI World Market Cap
● SoftBank Vision Fund

Source: Bison data via Cobalt, Preqin (March 2019)

CHOICE B) *I have an existing private markets portfolio, and I'm going to slow my commitment pacing until the inevitable downturn passes, at which point I'll resume my prior commitment pacing.*

Ouch, you've been seriously maimed. Your decision isn't as poor as choice A, because at least you continued committing, but you still attempted to time the markets (see: Choice A analysis). It's as simple as the old adage: Buy low, sell high. By cutting back commitments as the market approaches its low point, you are hindering your opportunities to buy low.

CHOICE C) *I'm new to the asset class, and I will wait until after the downturn to start building my private markets portfolio.*

You died! Though, to be fair, you never really lived. Read choice A. Also keep in mind some of the interesting nuances we've historically seen in our asset class. LPs almost always commit because they want outperformance versus the public markets. The data shows that the private markets outperform by roughly the same amount in volatile and sanguine markets.

So, why wait? Where else are you planning to put your money during a downturn? While the private markets are more highly correlated with the public markets than they were 20 years ago, non-traditional private markets strategies, such as distressed debt, secondaries or real assets, could potentially introduce some interesting diversification benefits. What about the GPs who are resilient through the crises? Think you will get allocation to them later? Good luck with that. Oh, and you can't time the markets, so you could easily be waiting for, well, who knows how long.

CHOICE D) *I have an existing private markets portfolio and will stay the course; no changes will be made.*

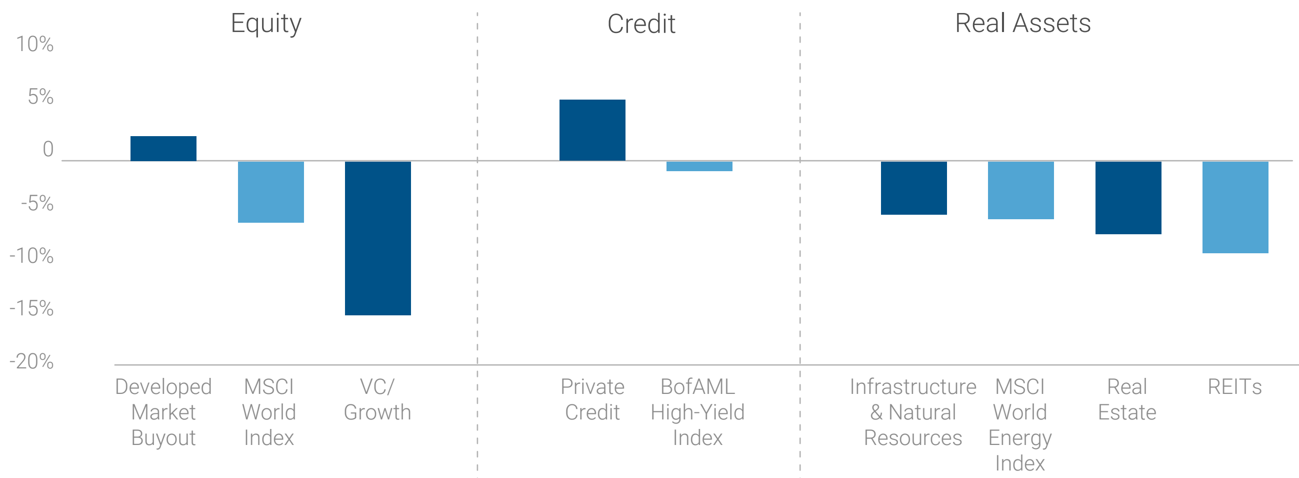
You lived happily ever after! This is a solid choice. After all, it's an asset class with 10+ year fund lives and it is unwise to make short-term decisions. Consistent commitment pacing is key – LPs often underestimate the impact that vintage year pacing can have on their private market portfolio's return. From a strategy perspective, sticking with your long-term plan is not a bad choice.

CHOICE E) *I have an existing private markets portfolio and will generally stay the course, but will make some tactical changes.*

You saved the village, lived happily ever after and future children's stories will be written about you! This is the winning strategy. It's what we are doing at Hamilton Lane and what we've seen done well historically. Keep pacing consistent, but make some tactical decisions that fit the current environment. Each downturn is different, so the tactics we adopt will vary from cycle to cycle. What, specifically, are we doing today? Glad you asked...

- **Lean in on credit.** Simply put, credit has been the safest place to be in the private markets. If you look back over the past 20 years, the segment has never had a five-year period of negative returns. Yes, prices and leverage are high by historical standards. Yes, a lot of capital is flowing into credit. And, yes, we expect it will perform well and will be a better experience than equity when the markets turn.

Lowest 5-Year Annualized Performance



Source: Hamilton Lane Data via Cobalt, Bloomberg, MSCI (February 2019)

- **Lean in on small/mid buyout.** Looking back, small and mid-buyout has been a strong performer on a risk-adjusted basis. The return potential in this segment tends to be higher and has seldom underperformed the private markets averages. Use this chance to build relationships.

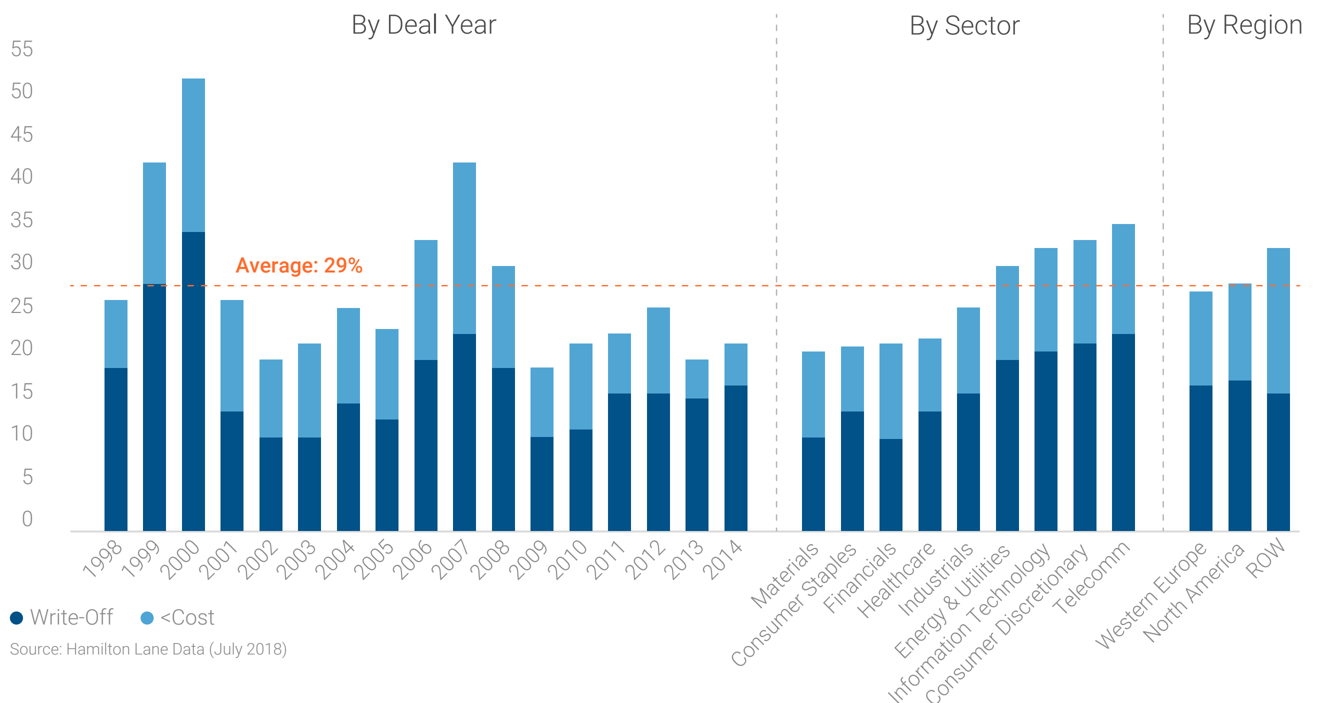
- **Lean out on emerging markets.** You don't need as much as you think in your private markets portfolio. The reward, historically, hasn't been worth the risk. Additionally, tying up too much capital in parts of the world with less regulatory (and, sometimes, currency) stability doesn't seem like a great bet if you think volatility is coming. North America and Europe have been more consistent and a better

trade off in almost all environments. We will stick with what we've been saying for years: if you are inclined to overweight your emerging markets exposure, do it in the public markets.

- **Diversify your co-investments.** On average, about one in three buyout deals loses money. Not necessarily a full write off, but some loss of capital. Those numbers go up a lot in bad economic times. 2007/2008 was the worst we've seen since 2000, with huge dispersion on the down side. Don't just pick one or two deals – if you get stuck with a loser, your co-investment portfolio is sunk. Building a larger portfolio of co-investments ensures you're capturing the upside (and lower fees) of going direct, while limiting your risk of loss on the total portfolio. Diversify.

Loss Ratios of Realized Buyout Deals

% of Deal Count



Source: Hamilton Lane Data (July 2018)

- **Watch out for sector funds.** Similar to co-investments, sector-specific funds can increase concentration risk if you're not careful. There is a limited market for high-quality GPs that manage sector-specific funds. If you pick well, you're golden. Pick poorly, and you've seriously damaged your portfolio. In most instances, we prefer quality managers with the flexibility to rotate in and out of different sectors as the market allows. Lighten up on sector-specific funds and do more with generalists.

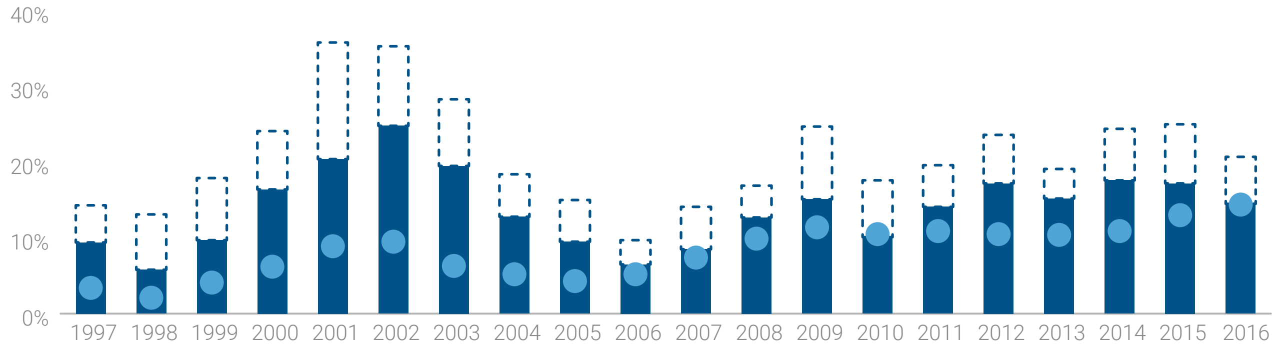
- **Does the ride matter?** Said differently, can you withstand more volatility during the down years if it comes with a bit more upside, or do you want the best chance at the smoothest path? If the former, make some venture and growth equity commitments. They will suffer mightily during a market pull back, but, because they should be diversified over multiple vintage years, will be ready to strike when the opportunities start to reemerge. If the latter, do more secondaries. Similar to the venture scenario, having dry powder available when assets are cheap on the secondary market and other LPs are looking for liquidity is a good place to be. You don't stand to get the same upside, but you should be rewarded from consistently buying at discounts to intrinsic value.

CHOICE F) *I don't invest in the private markets. I'm not sure how I even made it into this story.*

Seriously? How can that be your answer? Have you seen the data?

Buyout IRR vs. PME

By Vintage Year

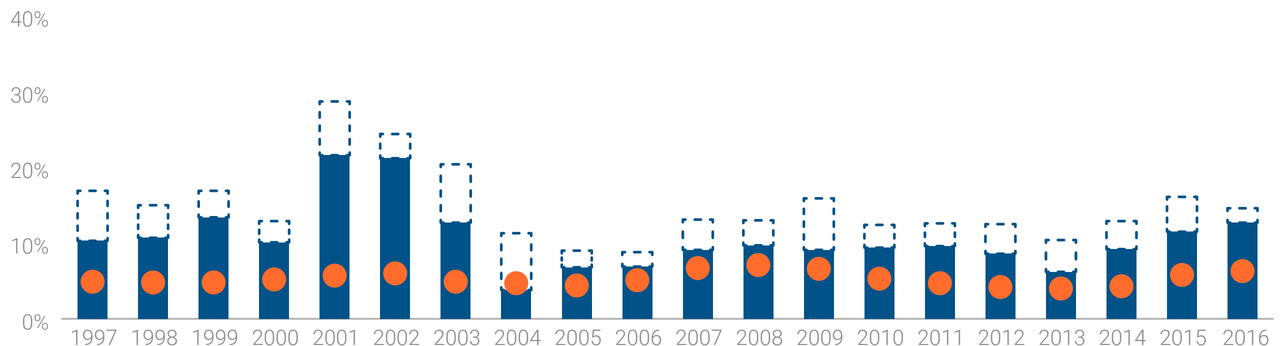


● Buyout Pooled IRR ⁚⁚ Buyout 1st and 2nd Quartile Pooled IRR ● MSCI World PME

Source: Hamilton Lane Data via Cobalt, Bloomberg, MSCI (February 2019)

Credit IRR vs. PME

By Vintage Year



● Buyout Pooled IRR ⁚⁚ Buyout 1st and 2nd Quartile Pooled IRR ● MSCI World PME

Source: Hamilton Lane Data via Cobalt, Bloomberg, MSCI (February 2019)

We know, we know: past performance is not an indicator of future outcomes. But, come on, that's a really good chart.

For those of you who never had the benefit of enjoying the Choose Your Own Adventure series first-hand, we hope this narrative offers a glimpse into the excitement and peril that they inevitably entailed.

Of course, there is one massive difference between the Choose Your Own Adventure books and the decision facing private market investors today: In the books, if you picked the wrong path, you could always just start the story over. The real world tends to be much less forgiving.

Here's hoping you save the village.

Definitions

All Private Markets: Hamilton Lane's definition of "All Private Markets" includes all private commingled funds excluding fund-of-funds, and secondary fund-of-funds.

MSCI World Index: The MSCI World Index tracks large and mid-cap equity performance in developed market countries.

VC/Growth: Includes all funds with a strategy of venture capital or growth equity.

BofAML High-Yield Index: The BofAML High Yield Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

Infrastructure: An investment strategy that invests in physical systems involved in the distribution of people, goods, and resources.

Natural Resources: An investment strategy that invests in companies involved in the extraction, refinement, or distribution of natural resources.

MSCI World Energy Sector Index: The MSCI world Energy Sector Index measures the performance of securities classified in the GICS Energy sector.

Real Estate: Any closed-end fund that primarily invests in non-core real estate, excluding separate accounts and joint ventures.

Corporate Finance/Buyout: Any PE fund that generally takes a control position by buying a company.

Credit: This strategy focuses on providing debt capital.

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