

GLOBAL INSIGHT

Overview

- Private equity is now regarded as a well-respected and fully-fledged asset class. Our feature article this quarter gives a brief overview.
- The typical private equity cycle has three phases – pre-investment building relationships, ownership involving strategic management and operational input and exit via private sale or stock market flotation.
- The advantages are potentially higher returns and lower correlations compared with traditional asset classes as well as the ability to access investment opportunities not otherwise available.
- The disadvantages are the difficult decision of manager selection and the illiquidity of direct investment or the discount to NAV of listed investment.
- There are essentially four ways to invest – direct Investment in individual funds, indirect investment via fund of funds, exchange traded funds (ETFs) and listed private equity funds.
- In the Macro View, US growth was slow in the first half but has picked up to around a 2%-3% annual pace; the Euro Area recovery is slow but steady; Japan has had a stop-start economy since the financial crisis.
- Brexit was the political story of the third quarter but the economic impact has been much less than feared ... so far.
- The US Fed is likely to raise rates by 25 bps in December while the Bank of Japan is capping the ten year JGB yield at zero, the ECB will continue to purchase €80bn a month of bonds and the Bank of England cut rates by 25 bps.
- During the quarter ahead, three risks stand out – a No vote in an Italian referendum, a Trump win in the US presidential election and a Fed rate rise.
- In the Investment Outlook, we argue that markets were ruled in the third quarter by the aftermath of the UK's decision to leave the EU.
- After recent weakness in government bonds, investors should consider buying US Treasuries if the 10yr yield approaches 2% and gilts at around 1.25%. We expect index-linked to outperform conventional bonds.
- Corporate earnings in the US are starting to turn upwards but the equity market is expensive while in Europe, Japan and emerging markets valuations are better but prospects are weaker.
- If better than expected economic news continues and UK interest rates and sterling remain low, then UK equities should be able to move higher.



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Economic Highlights

- G7 economy is forecast to grow by just 1.5% next year
- Despite Brexit vote, the UK could grow 0.3% qoq in Q3
- France, Germany and Italy have core inflation below 1%
- Bank of Japan caps 10yr JGB yield at zero but the Fed set to raise rates by 25bps in Dec

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Key Issues in Charts

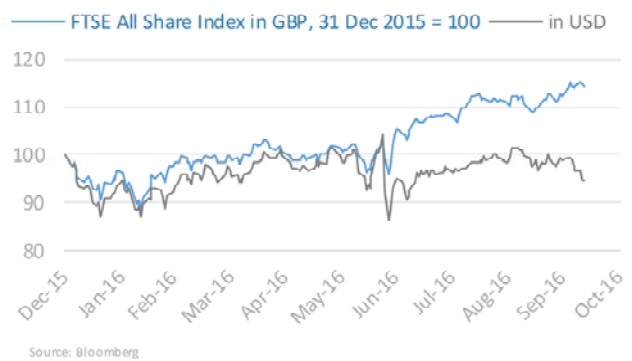
Sterling hits 31-year low versus the US dollar



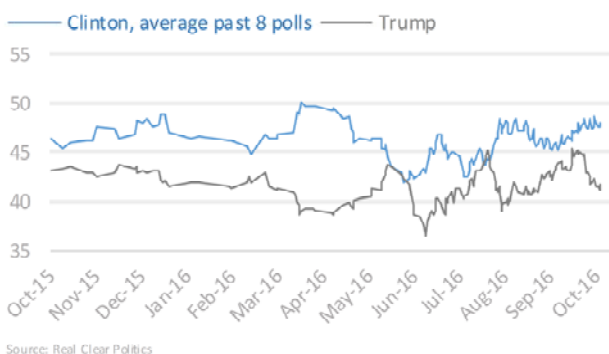
- After a “flash crash” on Friday 7th October, the pound briefly reached a new low of \$1.1491 against the dollar, according to Reuters.
- The pound fell by over 10% after the vote to leave the EU but then traded steadily in a \$1.28-\$1.35 range during the third quarter before fresh jitters set in.
- For the record the previous low was \$1.0520 on 26th February 1985.

UK equity performance less impressive in a neutral currency

- UK equities appear to have had a great year, up over 14% so far this year as at 12th October close
- However, this strong performance is partly illusory. In a neutral currency such as the US dollar, the market was down 5%.
- Compared with other major markets, the FTSE All Share has underperformed the S&P 500, the DAX, the CAC 40, the Nikkei and the Hang Seng.



The US presidential election moves into the final straight



- This year’s election between Hillary Clinton (Democrat) and Donald Trump (Republican) has been perhaps the most ill-tempered in history.
- The voters go to the polls on Tuesday 8th November to elect the 45th President of the United States.
- At the time of writing, after two televised debates and a damaging video leak, Clinton leads Trump by 48.0 to 41.8 in one respected average of polls.

Private Equity as an Alternative Investment

In a low yield, low return world, investor attention has increasingly turned to alternative investments – typically private equity, hedge funds and real estate – in search of high returns and low correlations. Private equity is now regarded as a well-respected and fully-fledged asset class. In this brief review, we look at how private equity works, its attractions and drawbacks and how investors can be involved.

How Private Equity Works. There are different legal structures in different regions but the principles are usually the same. In America, for example, projects often employ a general partner/limited partner model. The general partner is the private equity professional who selects and manages the investments in the interests of third-party investors or limited partners.

Funds are used to acquire equity ownership in private companies (at least a 50% stake, usually much more) or public companies (and delist them). Once acquired, the general partner will seek to add value by taking control of the strategic direction and financial structure of the target.

Thus, general partners usually target businesses with high growth prospects and/or those where performance and value can be significantly improved. Private equity managers commonly look to double the invested capital within three to seven years.

The typical private equity cycle breaks down into three phases. First, the pre-investment phase sees the investment team building relationships with prospects to position themselves better to conduct comprehensive due diligence.

Second, the ownership phase entails extensive strategic management and operational input through board participation and a newly appointed management team. The aim is to expose shortfalls and identify areas needing attention.

The final phase is the exit, which takes various forms including sale to strategic/financial buyers or a stock market flotation.

*“Private equity is now re-garded as a **well-respected and fully-fledged asset class.**”*

Private Equity Cycle



Stage 1: Building Relationships

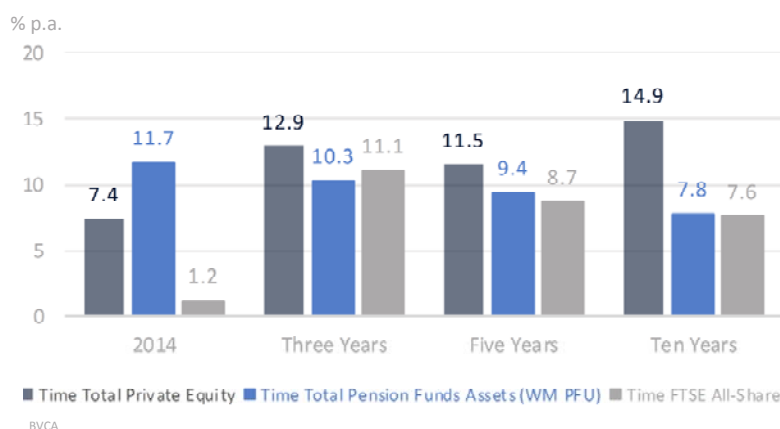


Stage 2: Ownership & Development



Stage 3: Exit

Over the longer term, private equity tends to give higher returns



The Advantages. The key reason to invest in private equity is the chance of an attractive return at a time when bond yields are at record lows and equity values are high. UBS reckon that pooled internal rates of return for US private equity for the 20 years to end-March 2016

*“The British Private Equity & Venture Capital Association (BVCA) thinks the **annual return on UK private equity** was 14.9% in the decade to end-2014.”*

*“The gap between the best and the worst fund managers is much wider than for equities and bonds. Thus, **there is a danger the investor picks the wrong manager and that the manager selects the wrong project.**”*



“Most PE firms follow a 2/20 rule – a management fee of 2% a year and a performance fee of 20%.”

were 12.6% a year versus a roughly but not directly comparable return of 8% on the S&P 500. The British Private Equity & Venture Capital Association (BVCA) thinks the annual return on UK private equity was 14.9% in the decade to end-2014.

One reason for these higher returns is that private equity by definition enables investors to gain access to opportunities not available in public markets. In other words, private equity firms take advantage of market inefficiencies.

Alternatives such as private equity also have the big advantage of typically low correlations with standard asset classes. We calculate that the correlations between UK listed private equity funds and the WMA balanced private client index since 1st January 2011 range from 11% to 45%.

In addition, those looking to diversify their portfolio further can choose exposure by vintage year, geography, industry, strategy and investment stage.

The Drawbacks. Returns depend crucially upon the capability of the private equity managers. The gap between the best and the worst fund managers is much wider than for equities and bonds. Thus, investors need to perform a thorough analysis of the private equity firm.

At the next level, the managers must undergo extensive due diligence of each business proposition and also understand the different dynamics ranging across the portfolio. Thus, there is a danger the investor picks the wrong manager and that the manager selects the wrong project.

Depending upon circumstances, investments in private equity will be more opaque. There is no continuous market or pricing, information is limited, valuations require a large element of judgment, regulation is lighter and buying assets takes time.

Most investments are illiquid and so difficult, perhaps impossible, to exit upon demand. A private equity fund will typically have a seven to ten year time horizon, with no redemption rights, and cash flow timings will be unpredictable.

There is a private equity secondary market but it still represents only 3%-5% of primary volume in the UK, according to BVCA. And it is important to note that the secondary market was effectively closed in the financial crisis of 2009.

Listed private equity firms tend also to be highly cyclical and high beta. The S&P Listed Private Equity index fell 80% between May 2007 and February 2009 but then gained some 400% over the next six years.

Finally, there is also a risk inherent in the high fee structures common to private equity funds. Most PE firms follow a 2/20 rule – a management fee of 2% a year and a performance fee of 20%. If returns are moderate, then the private equity firm may end up with most of the profits.

How to Invest. There are essentially four ways to invest. First, direct investment in individual private equity vehicles. The minimum investment requirement will be high. Most PE firms will have a minimum of \$250,000 and will seek as much as \$25 million. This route will offer the greater returns and better investor information but is for larger portfolios only.

Second, fund of funds. A private equity fund of funds invests in other private equity funds. Minimum investments are smaller and therefore accessible to a greater pool of investors. A fund of funds may invest in several firms and reduce risk through increased diversification. However, the downside is the additional layer of fees and PE funds still have a lifecycle of 10-13 years on average.

New funds are emerging for those investors looking for less volatile returns. These PE funds look to 'lock-up' investor funds for 20 years (ten years longer than normal) and to hold individual companies for around ten years. Target annual net returns are set at 10-12% per annum with lower management fees at 1%.

Third, private equity exchange traded funds (ETFs). There are some ETFs available on the market that track an index such as the S&P listed private equity one. (These ETFs invest into listed companies who subsequently invest into private equity). However, the market cap of these ETFs is usually low and there is a risk they could become illiquid in difficult trading conditions.

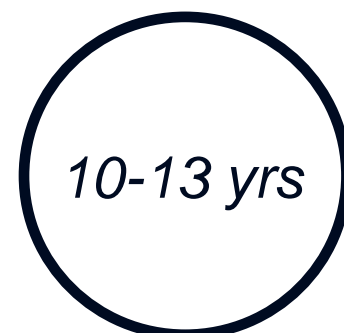
Fourth, listed private equity. These are usually closed-ended funds listed on a major stock exchange which will appeal to smaller investors wishing to invest in private equity but put off by illiquidity and the large minimum investment size. The advantages are daily liquidity and a clear valuation. There are 15 private equity investment trusts listed on the London Stock Exchange.

However, the gain in liquidity and price transparency comes at the price of lower expected returns. In addition, closed-ended funds will trade at a premium or discount to the net asset value of the underlying assets: in practice, this will likely be a discount. And, finally, detailed information may be scarce, as private equity firms understandably do not wish to put market-sensitive information into the public domain.

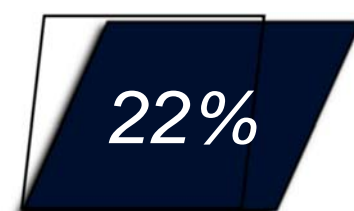
Conclusion. Taking all of the above into account, every investor should consider private equity as an alternative investment in today's low-return, low yield world. Larger investors can invest directly while smaller investors may wish to look at either ETFs or closed-ended funds.

The advantages are potentially higher returns and lower correlations compared with traditional asset classes as well as the ability to access investment opportunities not otherwise available. The disadvantages are the difficult decision of manager selection and the illiquidity of direct investment or the varied discount to NAV of listed investment.

The private equity model has become better understood over time and its attractive risk/reward characteristics mean it is often a core allocation in many institutional portfolios. A recent survey of 242 family offices by UBS and Campden Wealth Research found that on average they allocated 22% of their portfolios to private equity. The three largest US endowments – Yale, Princeton and Harvard – have long held roughly a quarter of their assets to private equity.



"PE funds still have a lifecycle of 10-13 years on average."



"A recent survey of 242 family offices by UBS and Campden Wealth Research found that on average they allocated 22% of their portfolios to private equity."

The Macro View

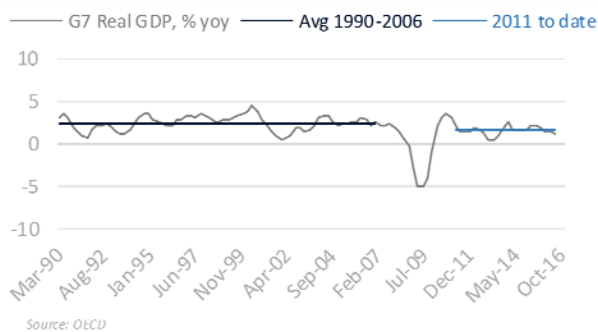
*“The second quarter showed the **UK as the fastest growing economy** with 2.2% yoy growth and Japan and Italy the slowest with 0.8%.”*

The developed world remains a slow growth, low inflation place while the emerging economies are split into those growing robustly and those in or near recession.

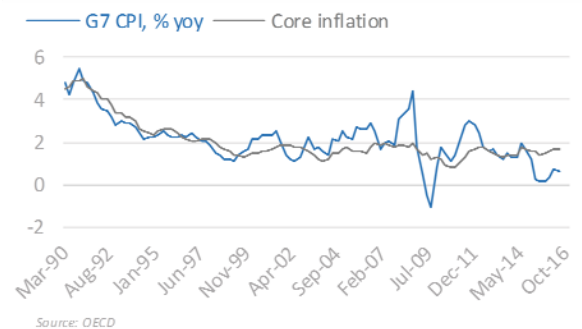
Starting with the advanced economies, the final numbers are in for the second quarter, showing the UK as the fastest growing economy with 2.2% yoy growth and Japan and Italy the slowest with 0.8%. Looking ahead, according to a survey by The Economist, G7 growth will pick up to just 1.5% in 2017 as an annual average, led by the US (the only country expected to manage 2% growth) and trailed by the UK (with a Brexit-induced slowdown to 0.7%).

Across all major economies, ageing populations, weak capital spending, neutral-to-austere fiscal policies and tentative structural reforms are present to differing degrees. In addition, world trade growth could be the slowest since the 2008 recession.

G7 growth during this upswing has been well below past norms



... and G7 inflation is also extremely subdued



“Euro Area experiencing slow recovery - roughly 1.5% a year over the past three years versus 2.3% a year in the decade to 2008.”

But the narrative differs across regions and countries. The US grew slowly by just 0.2% or 0.3% a quarter in the first half of 2016, held back by falling fixed investment and weak net exports. However, growth in the third quarter is slightly above par at a 2%-2.5% annual rate. With a mild growth correction out of its system, the US economy may be set for par growth for a while.

Meanwhile, the Euro Area is experiencing a steady but slow recovery from the 2012 sovereign debt crisis. This upswing has been slower than past recoveries – roughly 1.5% a year over the past three years versus 2.3% a year in the decade to 2008 but the eurozone is in better shape after reforms since the debt crisis. Plenty of spare capacity suggests this expansion has some way to run.

In contrast, Japan has had a stop-start economy, with four down quarters out of the past ten including a self-inflicted recession in 2014 when the government raised sales tax. In theory, “Abenomics” makes a lot of sense but only one of the three arrows has been truly fired, by the Bank of Japan. Thus, we think the Japanese economy will grow by 0.5% in 2016 and 1% in 2017.

Brexit was the political story of the third quarter but the economic impact has been much less than feared ... so far. The UK economy has slowed but may still

grow by say 0.3% qoq in the third quarter. Looking ahead, we expect stagnation rather than recession, with the lower pound helping exports but uncertainty dampening consumer durable and investment spending.

Within the emerging economies, there is a big divide between manufacturing nations with a growing class of middle-income consumers on the one hand and commodity producers on the other. Weaker oil and commodity prices benefitted the former at the expense of the latter. Emerging economies' growth of around 4% is the slowest for six years.

Turning to inflation, headline inflation for the G7 has been exceptionally low – below 1% yoy since December 2014 – thanks to weak oil and commodity prices. Core inflation (ex-food and energy prices) has been higher but still benign, at 1.6% yoy in July. Talk of deflation may be fanciful but it is true that inflation remains anaemic during this recovery.

The exception is the US where core inflation is over 2% and slowly picking up. The key reason is rising wage inflation and weak productivity. Taken together, the result is upward pressure on labour costs per unit of output, which rose by 2.6% yoy in the second quarter. The little remaining slack in the US labour market will keep wage costs under control a while longer but this bears watching.

The global economy's performance might be better if governments used their budgets to provide economic stimulus. To be fair, after the 2008-09 recession, budget deficits blew out. In 2010 Japan and the UK ran deficits of over 10% of GDP and the US over 13%. The dilemma was whether to get deficits under control or support growth.

Mostly, governments chose to reduce deficits as fast as reasonably possible and to let central banks sustain growth. Even so, in 2016 Japan's deficit is around 4.8% of GDP, the US's 3.8% and France's 3.4%. There is some room to take the foot off the fiscal brake, but not much.

Thus, the major central banks brought interest rates down to zero or even below and indulged in massive quantitative easing. At end-June, central bank balance sheets were worth 20% of GDP in the UK, 24% in the US, 29% in the eurozone and a massive 85% in Japan.

Crucially, the US Federal Reserve has started to part ways from the rest. Having raised interest rates for the first time last December by 25 bps, the FOMC left rates unchanged in the first half of 2016 but now says it is likely to increase them by 25 bps in December and by another 50 bps next year.

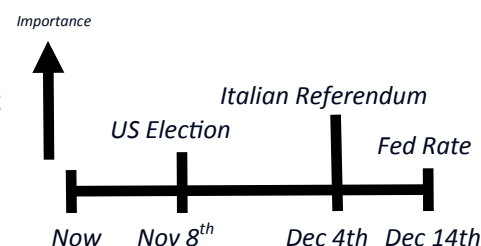
In contrast, the Bank of Japan is capping the ten year JGB yield at zero and has vowed to overshoot its 2% inflation target; the ECB will continue to purchase €80bn a month until March 2017 and possibly beyond; and the Bank of England cut rates by 25 bps and has re-opened its asset purchase scheme to add a further £60bn.

Looking at the quarter ahead, three risks stand out – a No vote in an Italian constitutional referendum, a Trump win in the US presidential election and a Fed rate rise on 14th December. Of those we fear the outcome of the vote in Italy most. If the vote is No, then PM Matteo Renzi has said he will step down and it is easy to imagine it could be the first step on the road to euro collapse.

“Emerging economies’ growth of around 4% is the slowest for six years.”



US Core Inflation



“Three risks stand out – a No vote in an Italian constitutional referendum, a Trump win in the US presidential election and a Fed rate rise on 14th December.”

“The yield on the UK 10-year gilt fell from 1.37% at the close on Thursday 23rd June to 0.93% by the close on Monday 27th June.”

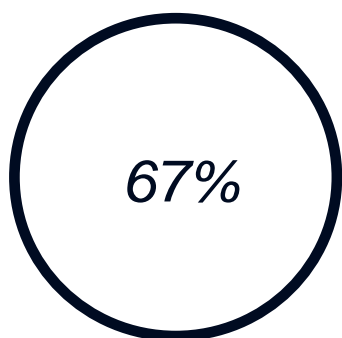
The Investment Outlook

Markets were ruled in the third quarter by the aftermath of the UK’s decision to leave the European Union. The initial reaction was much as expected following the surprise result – government bond markets rallied, equity markets fell sharply and sterling plunged.

The yield on the UK 10-year gilt fell from 1.37% at the close on Thursday 23rd June to 0.93% by the close on Monday 27th June. The FTSE 100 stock index fell by 5.6% over the same period, the FTSE 250 mid-cap index of more domestically focused companies by 13.6% and sterling by 11.1% against the US dollar.

However, while government bond markets remained strong, equity markets rebounded sharply after only two days of falls, leaving the weaker pound as one of the few notable indicators that Brexit might be negative, not just for the UK but the global economy.

The US Treasury market rallied in sympathy, with the 10-year yield falling from 1.75% to 1.44% in the two days following the vote. With the Federal Reserve deciding not to raise interest rates in September and the presidential election coming up in November, the next opportunity for US rates to rise is on 14th December. The market currently reckons there is a 67% chance of a December rate hike but the trajectory for rate rises is set to be much shallower than forecast this time last year.



“The market currently reckons there is a 67% chance of a December US rate hike.”

UK gilts rallied after the EU referendum but yields have since risen



Following the Brexit decision, gilts were further buoyed by the Bank of England’s decision to lower interest rates to 0.25% and to signal that a further cut is not being ruled out. However, after a 30 year plus bull run, fears of higher, imported inflation (due to the weak pound) plus a possible switch in emphasis from monetary policy to fiscal policy (signalled in PM Theresa May’s conference speech) resulted in the 10-year yield rising to 1%.

As a cautionary note, though, the 50-year gilt has lost over 25 points of capital since its peak in August – an example of the sort of capital losses that can occur in a ‘safe’ asset class.

European government bonds also fared well after the Brexit vote, with 10-year bund yields turning negative. Only after press reports suggesting an earlier

end to quantitative easing from the ECB did the yield turn positive again.

It is possible that recent weakness in government bonds will persist for a while yet as investors worry about inflation, a Fed rate rise in December and perhaps higher government spending (via infrastructure projects). However, as HSBC points out, there are no signs of inflation yet, both the developed and emerging markets show no signs of deleveraging and central banks are repressing yields.

Given this backdrop, investors should consider buying US Treasuries if the 10-year yield approaches 2% (currently 1.74%) and gilts at around 1.25%. In the meantime, we would expect index-linked bonds to outperform straight bonds, despite the breakeven rate of inflation now being at a two-and-a-half-year high of over 3%. Corporate bonds are likely to track government bonds and will become more attractive if spreads widen.

The performance of equity markets was impressive in the third quarter. In the US, the S&P 500, the Dow Jones and the NASDAQ all hover around all-time highs. This is despite continuing concerns about the repercussions of Brexit, the possibility of a President Trump and a slowdown in China.

As we enter the US third quarter earnings season, investors will look for signs that corporate earnings are finally starting to turn upwards again. While this might be true in aggregate, as the higher oil price feeds through for energy companies, the US market is not cheap. Barclays calculates that it trades on a trailing P/E of 19x, close to a 25% premium to the rest of the world.

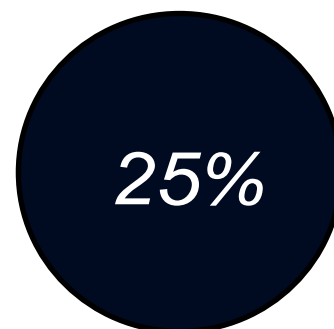
In a volatile quarter, UK equities finished higher as the FTSE 100 and the FTSE 250 indices pushed towards the all-time high reached in 2015. For the quarter, the FTSE 100 was up 6.1% and the 250 up 9.9%.

The key reason for the strong performance was the fall in sterling, which meant overseas earnings were worth more when converted back into pounds. With approximately 75% of FTSE 100 constituents' earnings coming from overseas, the index has certainly benefitted. In contrast, in USD terms, the FTSE 100 was actually down around 5% year to date.

Whilst companies with large overseas revenues were winners, more domestically focused companies (such as banks, house builders and high street stores) struggled to recover. The FTSE 250 mid cap index is also more domestically focused but the index also benefitted from better than expected economic news and speculation that UK companies could be targets for foreign takeovers.

If the better than expected economic news continues and UK interest rates and sterling remain low, UK equities should be able to move higher.

European equities also finished the quarter strongly. As the economic data has slowly improved, European equities have seemed to lag. Indeed, Barclays estimates that European equities have lagged the US by 19% since March 2015 and JPMorgan thinks they are now slightly cheaper than fair value. With the Italian constitutional referendum due on 4th December and elections due in France and Germany in 2017, investors should be wary of European equities. However, valuation grounds at least warrant some exposure.



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“With approximately 75% of FTSE 100 constituents’ earnings coming from overseas, the index has certainly benefitted. The FTSE 250 mid cap index also benefitted from speculation that UK companies could be targets for foreign takeovers.”



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Source: Bloomberg

*“All eyes were on sterling in the third quarter as it consistently hit **31 year** lows against the US dollar.”*

Emerging markets have also performed well and, according to JPMorgan, are under-owned and under-valued, trading at a discount to developed markets – the former trade on a P/E of 12.2x and the latter on 16.2x.

Japanese equities have recovered from the Brexit vote slide but a stronger (safe haven) yen has acted as a stiff headwind. Economic reforms have so far not had the desired effect on markets but Japanese equities are relatively cheap. We suggest a modest holding but with the yen exposure hedged.

In currencies, all eyes were on sterling in the third quarter as it consistently hit 31 year lows against the US dollar. The pound is now about 18% lower against the dollar since the vote and the FT reports that it has hit a 168-year low on a trade-weighted basis. In the short term the currency looks oversold but talk of a “hard Brexit” is likely to keep it under pressure. Investors with exposure to overseas currencies should remain out of sterling for the moment.

In commodities, we have seen the oil price rebound from its early 2016 lows, with both Brent and WTI trading above \$50 per barrel. Whether or not this proves to be inflationary remains to be seen but investors should still consider some exposure to gold, despite its relatively lacklustre performance over the last 3 months.

In summary, the third quarter was dominated by the UK’s Brexit vote, stronger asset markets and a much weaker pound. With interest rates likely to stay low, both equity and bond markets should continue to find support. “Buying the dips” therefore remains a sensible strategy, despite worries about the US election, the continuing saga of Brexit and concerns about a Chinese slowdown. Investors concerned about inflation might consider some exposure to index-linked bonds and gold.

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