thesis
asset management

Thesis Market Commentary

When we sit down with our clients and advisors we undoubtedly get compared to our peers. People want to know that we are "thinking outside the box" and not following consensus to achieve consensus returns. In the old days clients would have a collection of gilts and a basket of UK listed equities with the allocations dependant on the amount of risk the client was able and willing to take. Thesis has always been a proponent of diversifying investments and as a result we have, over the years, invested in a wide range of different asset classes to spread the risk. One area which we have held for some time is private equity.

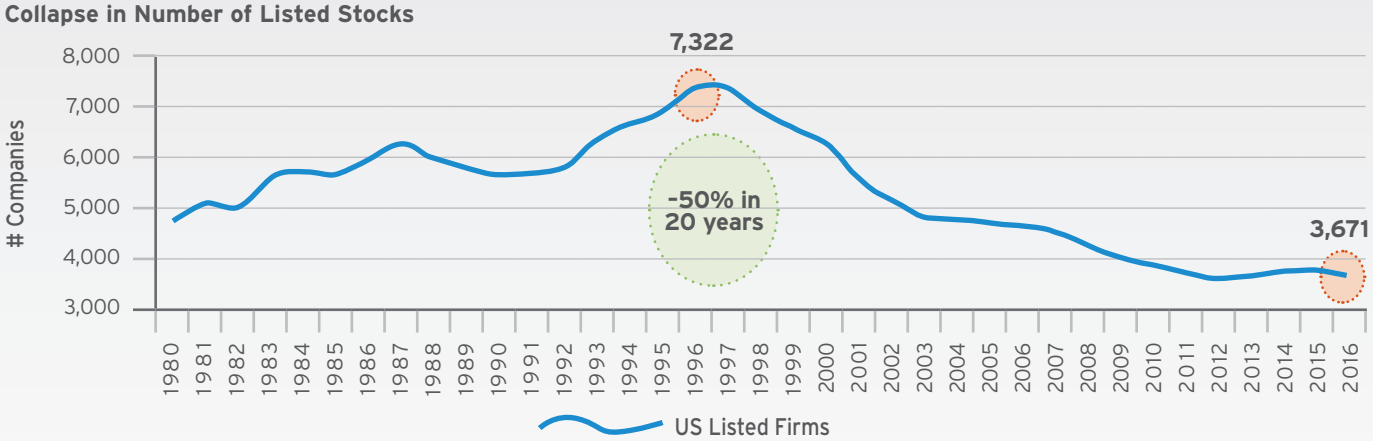
Private equity is investing in shares belonging to a company which is not listed and therefore public and freely available to all investors. As such, one danger includes investing in an illiquid asset which may prove tricky to sell. Often the companies are very high risk as they may be at the seed (pre-revenue) stage of their lives where they are "burning cash", often rapidly, to develop the initial idea before they can enter their revenue earning phase.

A chart which recently caught my eye was the fact that since 1996, the number of listed companies in the US has halved from 7,322 to 3,671. This therefore means that the pool of available listed companies in which one can easily invest has shrunk dramatically.

This halving of potential investable public companies is not a result of a limited amount of capital available. In 1976 c$41bn flowed from mutual and index funds into public markets. At the 1996 listing peak, that figure rose 44 times to c$1.8tn. In the subsequent 20 years the figure increased to over $10.7tn in 2016.

There have been two forces at work that have reduced the overall number of public companies. The first is that the average annual number of IPOs (Initial Public Offerings), when

Collapse in Number of Listed Stocks



Sources: Doidge, Craig, G. Andrew Karolyi, and René M. Stulz. "The U.S. listing gap." Journal of Financial Economics 123, no. 3 (2017): 464-87. doi:10.1016/j.jfineco.2016.12.002.; Mauboussin, Michael J., Dan Callahan, CFA, and Darius Majd. The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities. Global Financial Strategies, Credit Suisse.

March 22, 2017

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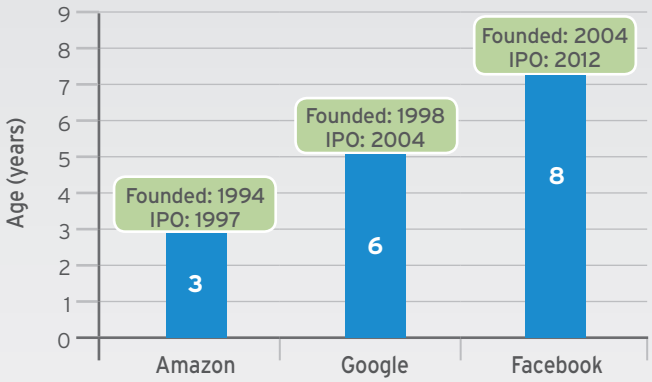
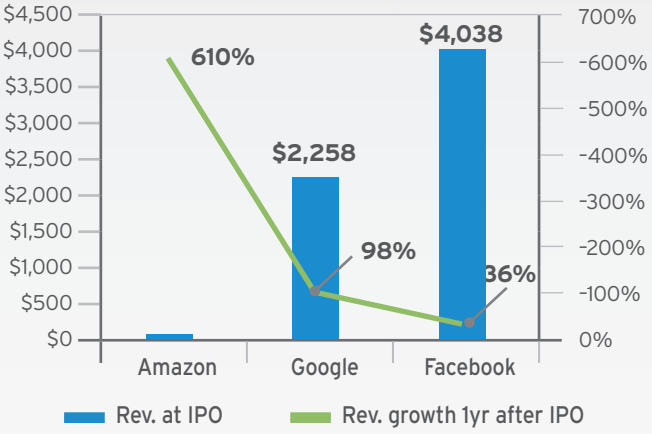
companies first become listed between 1980 and 1996 fell from 285 to the current rate of 136 in the following 20 years. The second reason is that companies have continued to delist. This may be as a result of them going bankrupt, being taken over or merging with another company. Since 1975 just over 400 companies on average have delisted each year.

Other research shows that public companies in the US are generally getting older, larger and are growing at a slower rate, on average, than they used to be. "New" companies appear to be taking longer before they list on the public markets. The ones that do IPO are typically more mature, larger and with higher existing revenues. This may result in lower potential returns for investors who subscribe at IPO as these companies may be past their fastest growing stage and hence are perceived to be less risky.

Age before IPO[1]



Revenue ($m) and % Growth at IPO[2]



1 Mauboussin, Michael J., Dan Callahan, CFA, and Darius Majd. The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities. Report. Global Financial Strategies, Credit Suisse. March 22, 2017

2 S&P CapitalIQ data accessed April 01, 2017. Revenue and revenue growth reflect the latest available LTM revenue as of the IPO quarter for each respective company

This was highlighted in a 2017 report by Mauboussin, Callahan and Majd when they compared the three tech titans; Amazon, Google and Facebook. The analysts found a trend that younger companies are spending more time under private ownership. This maturity under private ownership resulted in the companies producing considerably more revenue at IPO but with lower subsequent revenue growth.

The reason companies are staying private for longer is effectively two-fold. Firstly, public markets are not as attractive as they used to be and secondly, private markets work well for both companies and shareholders. Unlike public listed companies, management of private companies are often able to take longer term investment decisions as they are not required to report and focus on quarterly earnings. This allows them to concentrate on managing the business rather that constantly update shareholders on often random market movements. Historically companies that required capital had to list on the markets for further funding. This is no longer necessary as there is now a significant amount of capital available in the private markets for such ventures.

With a shrinking public market and more opportunities in the private market, many fund managers are exploring ways to invest more in this growing pool of opportunities. This is not an easy task to do as, by their very nature, private companies are not available to all investors.

Picking individual private companies in which to invest is notoriously difficult, especially with a company that is still at venture or pre-revenue stage. The failure rate for such companies is reportedly 75%. One way of investing is via a fund that explicitly contains private investments. This enables an investor to access a plethora of private companies via a liquid, freely tradeable vehicle. For example, HarbourVest Global Private Equity Ltd, a FTSE 250 listed investment trust with a market capitalisation of £1.2bn, contains exposure to c7,500 private companies.

Antagonists of private equity investing often raise three criticisms; that private equity funds are opaque, they performed poorly during the financial crash and the fees on the fund are extortionate.

Myth 1 – Private equity funds are opaque

By their very nature private companies will not be as transparent as listed companies which are required to report constantly to the market. Funds containing private

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equity will, at least annually using an external auditor, value their underlying investments. The listed funds themselves often report a monthly net asset value (NAV) figure. Historical evidence shows that investments within the funds are often carried in the report and accounts using conservative valuations as crystallised valuations, achieved when the private company is exited or sold, often come in above the latest carried valuations.

Myth 2 – Poor historical performance

During the financial crisis many investors sold what they perceived to be illiquid investments including investments in private equity. The share price for a listed fund often moves independently to the fund's underlying NAV, the value for the underlying investments. Despite relatively stable NAVs for many private equity funds during the crisis, many investors sold the funds which resulted in a large discount – the difference between the share price and the NAV. As highlighted in the chart below this discount reached 60%, or in other words this allowed investors to buy assets worth £1 for only 40 pence. Longer term holders though have seen this discount narrow over time. Savvy investors who bought at these distressed levels made significant gains.

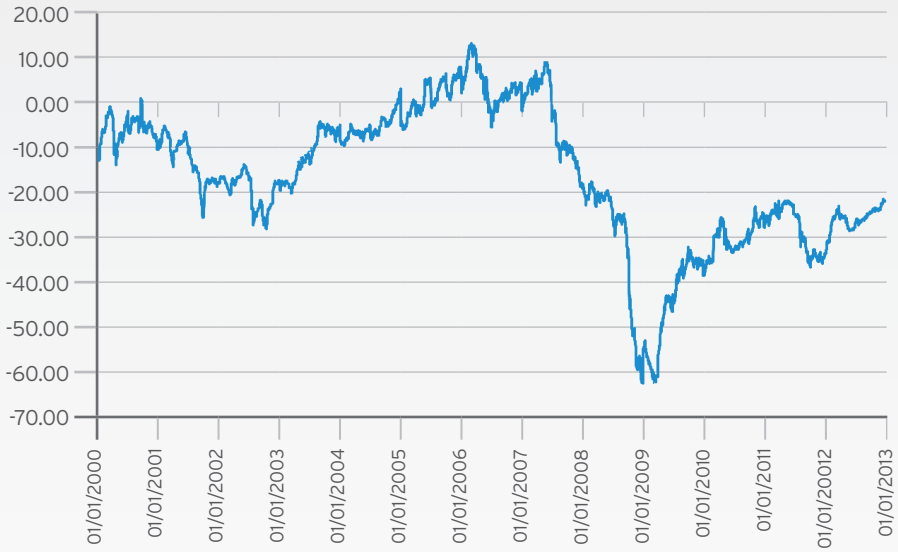
In terms of performance some of the listed funds have very long and successful investment track records. For example Pantheon International Plc was established in 1987. Since inception this fund's NAV has returned 11.9% annually whilst its share price has returned 11.5% pa. This supports the fact that there is a close correlation between the NAV and the share price over time.

Myth 3 – Extortionate fees

The European regulation MIFID II was introduced in January 2018 to improve transparency across the financial industry. As such investors, rightly so, must be informed of the true total cost of investing in a fund or a product. This has led to more in-depth conversations about the trade-off between value and cost. Continuing to use Pantheon International Plc (PIP) as an example, PIP charges investors c1.3%pa based on an annual management fee and a potential performance fee. Under MIFID II rules we are required to report that the total cost of investing in PIP is closer to 4.2% than the 1.3% they disclose. This is a higher figure as PIP invests in funds of private equity funds who themselves charge a fee. Why are we willing to pay such an extortionate fee? Firstly, access to private companies is a highly specialised skill and there are no low-cost trackers available. Secondly, there is little pricing pressure in the industry. This is evidenced with the fact that private equity fund managers are still experiencing record fund inflows. Thirdly, the fees are very high at 4.2% as the majority of the fees are performance related where the managers have been rewarded for their success. Since inception in 1987, PIP has returned 11.5% pa to shareholders (after all fees) whilst the MSCI World index has returned 8.0% pa. If PIP charged no fees then according to the principles of MIFID II disclosures, investors might have received 15.7% pa, double the MSCI World index return. This though would have been impossible to achieve without employing the skill of a specialist such as PIP.

Many Thesis clients have benefitted from our knowledge and willingness to invest in private equity funds and also into the underlying private equity fund managers who benefit from the premium fees they charge for accessing private companies. We will continue to look for new opportunities as this area looks certain to grow further as more companies choose to remain private for longer as they shun the public markets.

Daily discount for UK listed private equity investment trusts excluding 3i Group



Robert Clough

Investment Manager **Email:** *robert.clough@thesisam.com*

NEWS&VIEWS

Summary

- Escalating trade tensions
- Mixed data from the US
- Theresa May to stand down
- European Central Bank turns more dovish
- Modi secures a second term
- Government bond yields fell to multi-year lows

Indices	Value as at 31/05/2019	% Change on month	% Change year to date	% Change on 12 months
FTSE 100 Share	7161.71	-3.46%	6.44%	-6.73%
FTSE All Share	3923.87	-3.54%	6.77%	-7.07%
S&P 500	2752.06	-6.58%	9.78%	1.73%
Dow Jones	24815.04	-6.68%	6.38%	1.64%
Euro Stoxx 50 EUR	3280.43	-6.66%	9.30%	-3.71%
Nikkei 225	20601.19	-7.45%	2.93%	-7.21%
MSCI Emerging Markets	998.00	-7.53%	3.34%	-10.95%
UK Treasury 4.25% 2027	128.65	1.98%	1.88%	1.25%
Sterling/US$	1.26	-3.17%	-0.93%	-5.00%
Sterling/Euro	1.13	-2.71%	1.64%	-0.68%

SOURCE: BLOOMBERG

The threat of a slowing global economy, escalating trade tensions with China and weakening inflation were front and centre as risk assets sold off and bond markets rallied in May. This negative outlook scenario has resulted in rising expectations for future Federal Reserve (Fed) accommodation, with the market already pricing two rate cuts through 2020. The Fed is at odds with the financial markets however, claiming that it would take a sustained period of inflation undershooting the target, before a cut became necessary. Recent data suggests the Fed may have fallen behind the curve.

USA

The early May announcement that the latest round of tariffs on $200 billion of Chinese goods were going to be raised from 10% to 25%, and the subsequent promise of retaliation from China, was enough to unleash a sell-off of more than 6% in the S&P 500 share index. Economic data released during the month was mixed, with forward-looking business confidence surveys showing signs of deterioration and heightened concerns that the trade war could weigh on a global economy that is already slowing. May's headline manufacturing survey reading of 52.1 was also below expectations of 53.0 and showed a decline from 52.8 in April. The engine of the US economy, the consumer however remains upbeat, with US consumer confidence hitting a new high of 134.1, compared with 129.2 a month earlier.

UK

Theresa May announced her intention to stand down as Prime Minister and the race is now on to succeed her. The continuing Brexit uncertainty helped to push both shares and the Pound down, with more economically sensitive sectors, including financials, industrials and mining weighing heavily. In view of the political uncertainties, the Bank of England's Monetary Policy Committee voted to hold the base interest rate at 0.75%, whilst raising its growth forecast for the year to 1.6%. Data published for the manufacturing and construction Purchasing Managers' Indices however showed significant weakness as both fell into contraction territory at 49.4 and 48.6, respectively. The former was affected by inventory being run down after the stockpiling that took place in preparation for a possible hard Brexit, whilst the latter suffered from weak investment decisions.

> *"Theresa May announced her intention to stand down as Prime Minister and the race is now on to succeed her."*

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Eurozone

Growth surpassed expectations in the first quarter of the year, reviving after last year's sharp slowdown, but data still points to soft activity overall and it remains to be seen if momentum will keep pace in the second quarter. Sentiment in the Eurozone did however improve, breaking a streak of 10 months of deteriorating confidence. A solid improvement in industry confidence drove the rise, as firms assessed more positively their outlook for production. In addition, consumers also grew more confident along with the service sector. The European Central Bank has however turned more dovish and pushed back the timing of a possible rate hike, stating that key interest rates will "remain at their present levels at least through the first half of 2020".

Japan

Whilst official figures showed that Japan's economy grew at 2.1% over the first quarter, beating expectations of a 0.2% contraction, the re-escalation of US-China trade frictions saw Japanese equities end the period lower. The heightened concern among Japanese goods producers was evident in the flash manufacturing Purchasing Managers' Index falling from April's 50.2 to 49.6 in May. The index now sits below the 50-point threshold that separates expansion from contraction in the manufacturing sector.

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Emerging Markets

Emerging Markets suffered a steep correction during the month but there was some divergence in market performance, with China being amongst the poorer performers on the back of escalation of trade tensions, while India outperformed as Prime Minister Narendra Modi secured a second term in office. Modi's ruling Bharatiya Janata Party surpassed expectations and captured more seats than it did in the previous election, providing an extremely strong mandate for government and a supportive investment backdrop. In Latin America, Brazilian economic news was a lot less promising as its economy contracted for the first time since 2016 and inflation came in below expectations at +0.6%.

Fixed Income

Government bond yields (which move inversely to bond prices) fell sharply as the market was fearful the ongoing trade disputes will derail global economic growth. In addition to this, a downward revision to US inflation added to demand for government bonds. The corporate bond markets also came under pressure, given the threat of a slowing global economy. Credit spreads (the premium over government bonds that companies need to pay to borrow) increased, with high yield (higher probability of default) spreads increasing more than investment grade.

Ryan Paterson

Research Analyst **Email:** *ryan.paterson@thesisam.com*