Whitepaper 2022

Market Timing or *time in the market?*

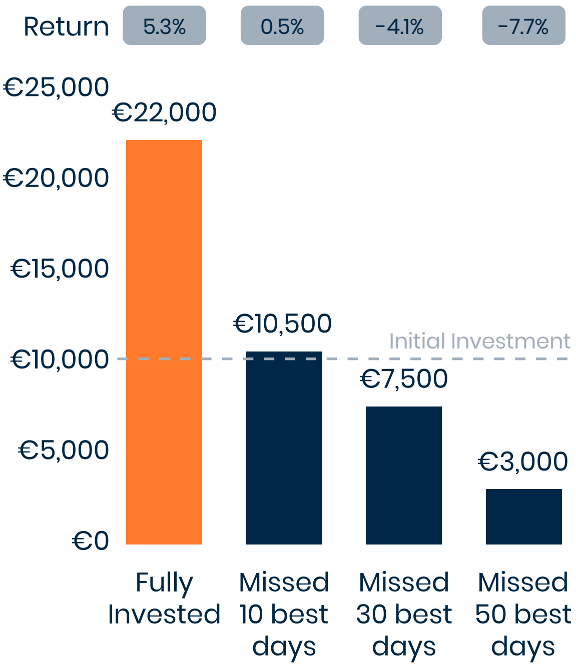
Moonfare | PRIVATE EQUITY INSIGHTS

THINKING IN DECADES

The advice to stay invested is almost as old as investing itself. For some it is even a mantra. Others ignore it when the economy enters the later stages of the business cycle, often to their detriment.

When it comes to investors' portfolios, attempting to time market downturns has often proven to be too difficult a task to outweigh the benefits of staying the course.

Figure 1: Value and annualised total return of a €10.000 Investment in MSCI Europe (2014 – 2018)[1]



Source: J.P. Morgan Asset Management, 2019.

Years of above average global equity returns, increasing geopolitical tensions, and a gradual tightening of the yield curve, have led many investors questioning the direction of financial markets. However, times of risk are often also times of opportunity.

When it comes to investors' portfolios, attempting to time market downturns has often proven to be too difficult a task to outweigh the benefits of staying the course. Maintaining a long-term outlook is widely cited as the recipe for long-term investment success. Investors disciplined enough to consider a horizon longer than a decade have very rarely lost money, as even a 50/50 large cap equity and bond US portfolio has never suffered a negative return in any 10-year rolling period recorded[2].

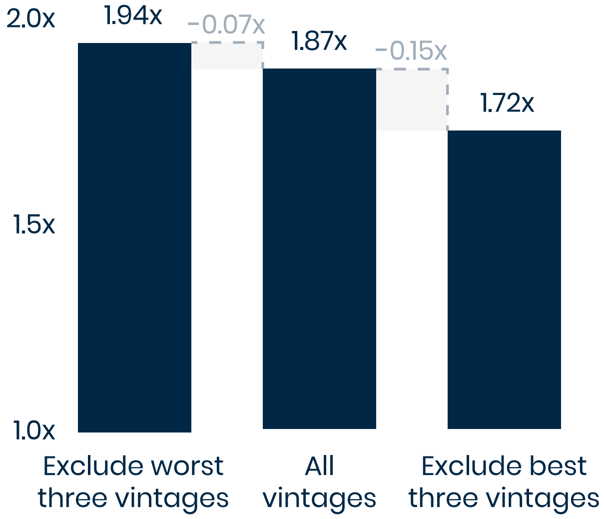
Trying to time the market can also limit the upside potential of investors' portfolios. Figure 1 brings home this point, showing that missing only the 30 best performing days of MSCI Europe since 2014 would have resulted in a 9.4% decline in annualised returns compared to the fully invested portfolio. In addition, the fully invested portfolio would have returned nearly double the amount compared to a portfolio that missed the best ten days of the market.

CONSISTENCY PAYS

Stay invested. The mantra also holds true for private equity. HarbourVest modeled all its private equity fund commitments from 1992 to 2001. Based on this analysis, the downside of missing the three best vintages is more than twice as high as the upside of avoiding the three worst (Figure 2).

Not only is it extremely difficult to time the market or predict the direction of financial markets (as research in public markets has long shown[4]), but the long term structure and investment cycle of private equity funds creates further insulation from short term market fluctuations. Compared to public markets, "timing the market" in private equity is both less

Figure 2: The Impact of Missing Vintages on Total Value to Paid in Capital[5]

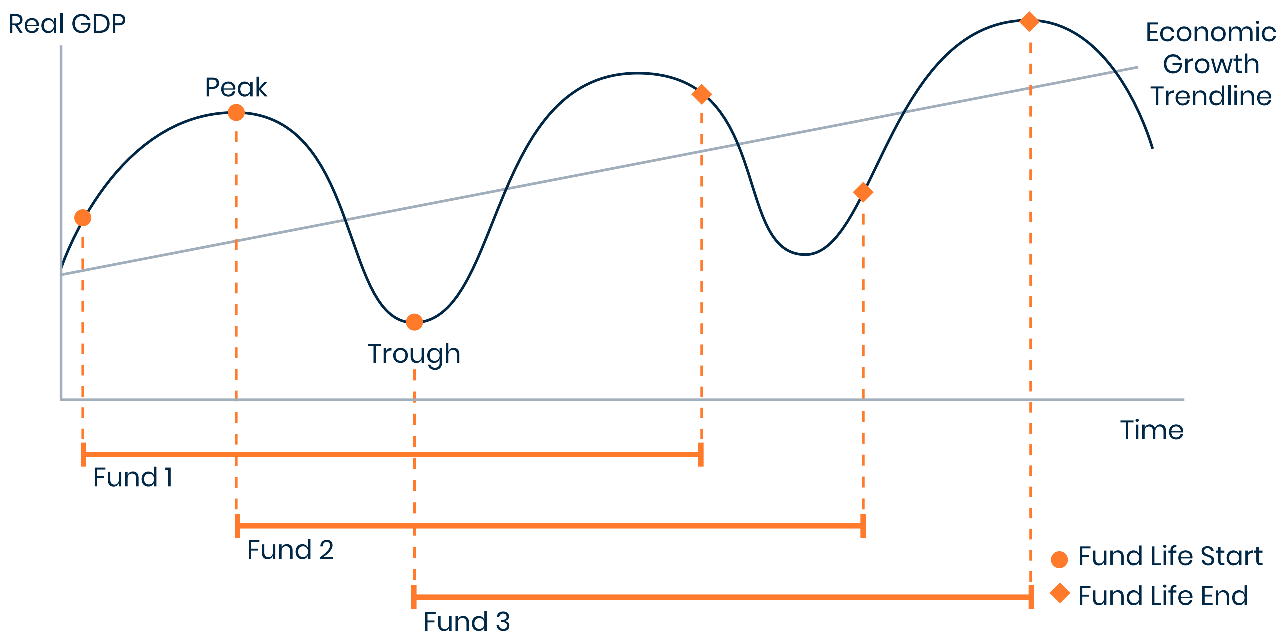


Source: HarbourVest, 2018. Data sourced from commitments between 1992 and 2001.

important and less relevant. Private equity funds are raised with the intention of investing in underlying companies within a period of circa 5 years, with the life of the fund normally extended to 10 years. Thus, a fund could end up investing both before and after a recession, while the exits could take place in totally different phases of the business cycle.

As HarbourVest found, "making even allocations over multiple vintages - irrespective of the state of the market and valuation perceptions - ultimately improves risk-adjusted returns"[6]. The analysis showed that an even vintage year pacing strategy produced the highest Sortino ratio[7] compared to other rules-based strategies. In other words, an evenly distributed private programme reduced the downside deviation of the private equity portfolio, while offering similar returns compared to other varieties of rules-based vintage allocations.

Figure 3: PE Funds and the Business Cycle - Illustrative Scenario

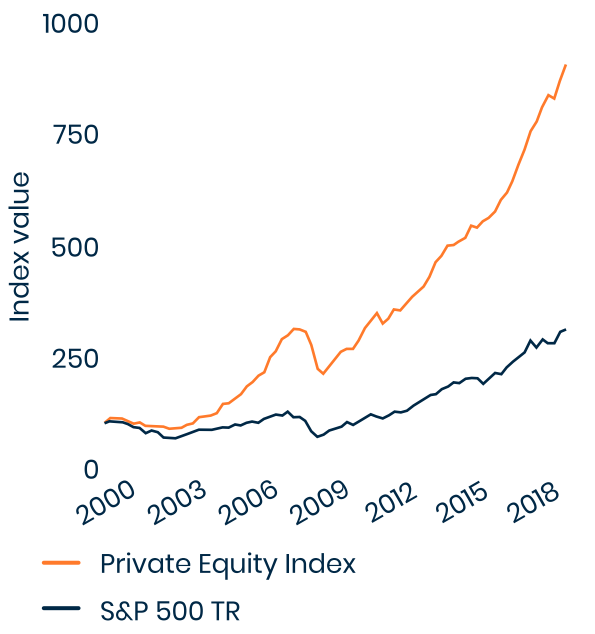


IF NOT PRIVATE EQUITY, THEN WHAT?

Private equity has historically produced impressive returns compared to other asset classes. Figure 4 shows the performance of private equity as calculated by Cambridge Associates' private equity quarterly index, charted along with quarterly total returns of the S&P 500 index.

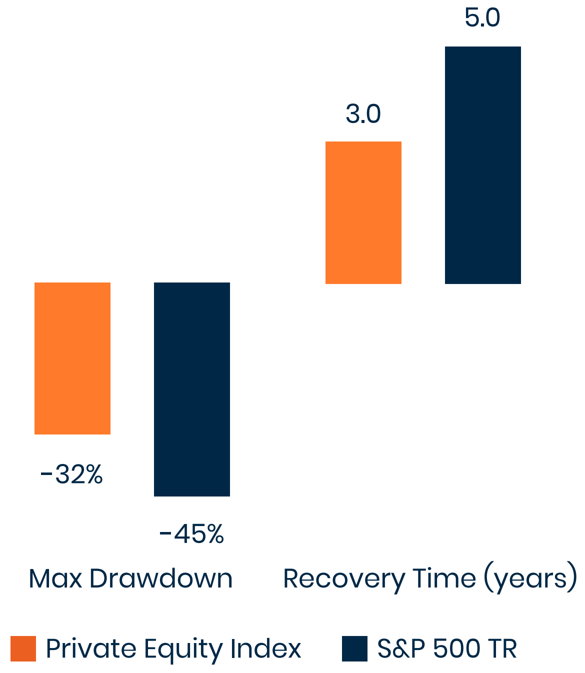
Is allocating to private equity at a later stage of the business cycle still the optimal asset allocation strategy? Based on past charts one could make that argument. Even in the event of the 2008 market crash, private equity exhibited better results compared to public equities. Compared to the S&P 500, private equity not only exhibited a lower maximum drawdown but also a faster relevant recovery time, drawing less impact on investor returns. Private equity strategies also tend to navigate muted market dislocations more favorably than public equities. Since 2001, private funds outperformed the S&P 500 Total Return (TR) Index in 19 of the 20 quarters in which public equity returns were negative, showing an average outperformance of 4.6% during these periods[9]. Apart from

Figure 4: CA Private Equity Index vs. S&P 500 TR Index Historical Performance, as of Q2 2019[8]



Source: Cambridge Associates, 2019 and Yahoo Finance.

Figure 5: CA Private Equity Index vs. S&P 500 TR Index Drawdown Metrics



Source: Cambridge Associates, 2019 and Yahoo Finance. Data from 2000 to Q2 2019. Moonfare Analysis.

being more insulated from the ups and downs of marking to market and less exposure to investment flows driven by short-term traders, there is also often a qualitative difference in the capacities of the underlying companies to respond to downside scenarios. A study conducted by Harvard, Stanford and Northwestern for the US National Bureau of Economic Research examined the difference in performance between those companies that were backed by private equity funds against those that were not. The results revealed that during the 2008 financial crisis, the private equity-backed companies experienced more equity and debt inflows leading to "higher asset growth and increased market share during the crisis"[10]. This could be explained by the willingness and capacity of private equity funds to support their portfolio companies via operational know-how and financial resources, enabling them to better respond on aggregate to the adverse economic environment.

STAY INVESTED, STAY INVESTED…

Investors concerned about the current state of the business cycle may argue for replacing equities with fixed income or cash. However, as described above trying to time the market is a difficult and potentially risky way of managing your portfolio. In our opinion, there is a lot of wisdom in the old mantra: stay the course, stay invested.

REFERENCES

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FOOTNOTES

1 J.P. Morgan Asset Management, 2019. Data as of December 2018.

2 J.P. Morgan Asset Management, 2019. Large cap equity represents the S&P 500 Composite and Bonds represents the Strategas/Ibbotson US Government Bond Index and US Long-term Corporate Bond Index.

3 As of May 2018, HarbourVest, one of the most renowned fund of funds investors, had committed more than $34bn in newly-formed funds, enabling us to trust their investment portfolio as a worthy example of a private equity program.

4 Morningstar, 2018.

5 HarbourVest, 2018. Figures as of September 2015.

6 HarbourVest, 2018.

7 Sortino ratio: (Portfolio Return - Benchmark Return) / Downside Deviation

8 Private equity index data from Cambridge Associates. The CA Private Equity Index is a pooled horizon IRR calculation based on quarterly data compiled from 2,193 private equity funds (buyout and growth equity), including fully liquidated partnerships, formed between 1986 and 2019. S&P 500 Total Return Index data from Yahoo Finance. S&P 500 TR Index data are annual compounded return calculations and are shown for reference and directional purposes only. The CA PE Index is not an investable index and is used solely for illustrative purposes. Both indices based at 100 as of 01/01/2000.

9 Pitchbook, 2019.

10 Bernstein, Lerner, and Mezzanotti, 2018.

Magnus Grufman
Head of Investments

Tony Cotzias
Supply Analyst

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Moonfare Germany
Karl-Liebknecht-Str. 34
10178 Berlin Germany

team@moonfare.com

Private Equity Insights
21 Buckingham Gate
London SW1E 6LB UK

info@pe-insights.com