Eighteen48 PARTNERS

Quarterly Perspectives

Q4 2023

Dear clients, partners and friends,

Most investors were pleasantly surprised at the strength in equity markets over the past twelve months. This phenomenon confirms our view that it is more prudent to focus on the 'micro' than the 'macro'.

In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of the short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?

Warren Buffett, 1994 Letter to Shareholders

Another point to note from last year is that the performance of the index masks a wide dispersion of earnings growth across companies. While global index earnings were broadly flat, a number of companies registered substantially greater profit growth in the 10-20% range. Contrary to what the media might suggest, it is not just the 'Magnificent 7'. This confirms our view that the environment is a rich one for active managers, a dynamic we openly welcome as a platform built to identify the best talent in our space.

While we are ever evangelical about investing and passionate about performance, '*produce superior long-term returns*' features as the fourth (not first!) 'spoke' on our firm's 'flywheel' to success. Robust returns are not some alchemist's creation — conjured up at our whim and will. Rather, they are, by our calculus, the consequential by-product of the first three 'spokes' — (i) *astute talent* backed by (ii) *aligned capital* that (iii) identifies and executes on *selective opportunities*.

All of these inputs are then combined with a heavy dose of patience. In the words of the late, great Charlie Munger, 'the big money is not in the buying and the selling, but in the waiting'.

Five years into our journey, we are beginning to enjoy the 'patience pay-off' — a material uplift in compounding and gradual distancing from typical bank and wealth management industry players. The exposures to listed assets combined with a focus in the private equity space on quality buyout managers alongside direct co-investments into profitable businesses has resulted in a track record for Eighteen48's endowment model that is in double digit territory on an annualised basis since inception. This is over twice the return of wealth management and large multi-asset fund peer groups. While we can never predict what's around the next corner, we remain true to our strategy and decidedly in the 'long game'.

As ever, we express our deepest gratitude to our clients for your confidence and loyalty, and to our partners, colleagues and advisors for your thoughtful contribution and unwavering commitment.

Julien Sevaux
Tarek AbuZayyad
12 January 2024

CIO Review

The recession that wasn't (yet)

2023 began inauspiciously. We entered the year facing what one well-known Wall Street CEO described as a coming 'economic hurricane' and with strategists having just predicted a negative annual return for the S&P 500 for the first time this century.[1] Retail investors were even more depressed than during the depths of the global financial crisis of 2008. A remarkable consensus of professional investors surveyed by Bank of America expected stagflation[2] to take hold; they held more cash in their portfolios than at any time since the bursting of the TMT Bubble more than two decades before, and had their lowest allocation to equities versus bonds since 2009.

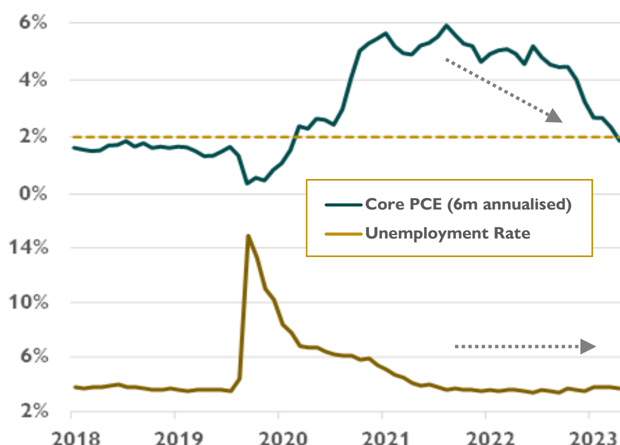
[1] Data from BCA Research.
[2] I.e. below-trend growth plus above-trend inflation.

With little prospect of resolution in Ukraine, inflation running well above targets, central banks aggressively tightening financial conditions and European energy prices still elevated, few were prepared to make a positive case for risk assets.

In the end, economic crisis was averted. Expectations improved throughout the year and US real GDP growth looks set to end the year at around 2.5%. Even the sluggish Eurozone is likely to have generated modest positive growth during 2023. This unforeseen economic resilience forced central banks to continue raising interest rates well beyond where markets expected at the start of the year; the effective Fed Funds interest rate ended 2023 at 5.4%, some three notches (of 0.25% each) higher than expected at the start of the year. Such was the improvement in the growth outlook that the yield on the 10 year US Treasury touched a 15+ year high of 5.0% in October, before pulling back into the end of the year as the Fed 'pause' became a likely peak.

Despite the concerns of the overwhelming majority of economists and market participants, the signs are that the fabled 'soft landing' is underway, as the Fed has so far managed to bring core inflation back to its target (indicated below on a faster 6-month annualised basis, now just below its 2% target) without inflicting significant damage to the economy (shown below by the unemployment rate, which remains below 4% and close to a multi-decade low):

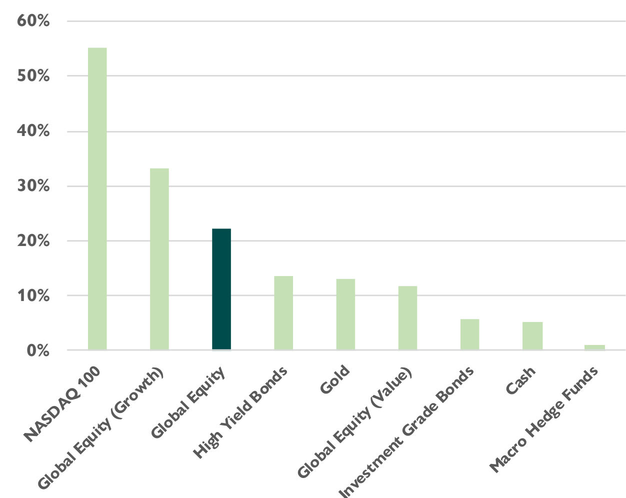
Figure 1: Signs of a soft landing underway



Source: Bloomberg

As this 'soft landing' unfolded, global equities returned 22% through the year, led by those large cap technology names which had been hardest hit in 2022 as rates rose from very low levels. The NASDAQ had its best year since the heady days of 1999, returning 55% and narrowly beating even 2009, while the 'Magnificent Seven' technology stocks[3] (henceforth, 'M7') together more than doubled, accounting for a remarkable 40% of the global equity index return and 60% of the 26% gain of the US S&P 500. 'Value' stocks which had outperformed in 2022 (by virtue of lower sensitivity to interest rates and/or their perceived inflation protection characteristics) returned only about half the broad index result, with popular 'inflation hedges' the banks and energy sectors lagging by 8 and 19 percentage points respectively.

Figure 2: Index performance during 2023



Source: Bloomberg

What does this tell us? (Nothing new to our clients and regular readers – but a useful real-time reminder.) The first message is that predicting macroeconomic developments is extremely difficult. The backdrop is just too dynamic and interconnected to make these predictions with any degree of consistency.[4] We have included the performance of the Bloomberg Macro Hedge Fund Index in Figure 2 above (far right column) for some more context. This was up 1.1% in 2023, well behind cash, and has returned just 2.3% annualised over the last 10 years – on a compounded basis, less than one fifth the return of global equities. Macro is very hard to get right. (See further the book review at the end of this letter.)

[3] Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, NVIDIA and Tesla.

[4] To take another recent and even more striking example, strategists began 2022 expecting inflation in OECD Developed Market countries to be 3.5% for that year; the actual reading was 8.7%.

The second is that predicting market movements is if anything even harder. Market participants were widely downbeat coming into the year thanks to the unfavourable outlook for growth and inflation – which turned out to be incorrect. But even if one could have predicted those correctly, alongside some of the major events of 2023 – such as the banking meltdown of March and April, the wilting of the Ukraine counteroffensive, military engagement between Hamas and Israel, and the spectre of Trump redux in the US – would that foreknowledge have given great cause for enthusiasm towards risk assets?

None of this is to say that we will not see an economic slowdown in the months or years ahead; and we will certainly experience market drawdowns – probably not far off the long-term historic rate of a 10%+ pullback around once a year and a 20%+ pullback around once every 3-4 years on average.[5] But 2023 was a reminder that markets move unpredictably and often sharply, and called to mind the great investor Peter Lynch's maxim (which concluded our October 2022 *CIO Review*) that: 'People who exit the stock market to avoid a decline are odds-on favourites to miss the next rally'.

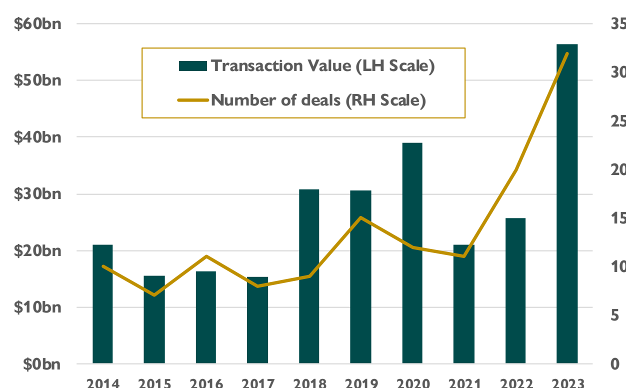
Portfolio Performance[6]

Our long-term, fundamentally driven approach – in line with that maxim – meant that instead of reducing risk, or indeed rotating some exposures into lower quality 'value' stocks which had outperformed over the year before, our activity 12-15 months ago was focused on rebalancing portfolios *back up to* target risk levels where they had fallen below target as markets declined. We did this through a combination of (a) adding to 'growthier' quality equity exposures which presented the best long-term upside, and (b) initiating – for the first time since our launch – an exposure to high yield bonds and senior loans, which we considered offered an outstanding 3+ year risk-reward payoff with a gross yield to maturity of c. 14% and low interest rate sensitivity.

Portfolios were therefore in line with their long term risk targets coming into 2023 and participated well in the strong risk rally through the year. Liquid growth portfolios mostly returned in the high teens for 2023 in US dollar terms, comfortably ahead of peer benchmarks. Those with a substantial exposure to private investments (which tend to lag public markets in both directions) are likely to see double digit net returns for the year.

Within marketable funds, our core Global Equity managers had an excellent year with an aggregate return of 30%, outperforming global equities by 8 percentage points despite having slightly lower exposure to the seven tech leaders noted above. Performance of our Specialist managers was more varied, with strong returns from technology and biotech exposures (now up 35-50% since we added on weakness in mid-2022), moderate positive returns from our industrials sector specialist, and negative returns in China. Biotech has seen a real turnaround on growing acquisition interest from Big Pharma which resulted in an all-time record number and value of take-outs during 2023, mostly in the fourth quarter.

Figure 3: Biotech take-outs reach a record high



Source: Bloomberg

Elsewhere we were pleased by the performance of our Equity Long/Short manager group, which together generated high teens percent returns in a year in which their peers – many of whom had reduced risk levels significantly during the volatility of 2022 and were slow to redeploy capital in 2023 – returned just 7.5%.[7] Our high yield and senior loans manager gained 12% for the year and has returned 16% since we initiated it 14 months ago.

Long term compounding is a more important gauge of success in achieving the goals of our clients, many of whom have a multi-generational time horizon. Since Eighteen48's inception in July 2019, a $100 million portfolio fully invested in our core Growth composite (which has 40% in an actual private equity portfolio) would have generated over 10% annualised returns net of

[5] Data from Bank of America research, 1930 to present.
[6] **Past performance is not a guide to future results**. There is no guarantee that investment objectives will be met. Composite returns are shown after fees on a notional $100 million portfolio.
[7] Bloomberg Equity Long/Short Hedge Fund Index

all charges.[8] On a compounded basis this implies a total return comfortably in excess of 50%, more than double that of wealth management and large multi-asset fund peer groups. These returns have also exceeded the 9.4% annualised returns of global equities over the same period, with less than two thirds of the volatility.

Portfolio Activity

Research activity within marketable funds has continued to be focused on bolstering our 'reserve' bench of global equity managers (a focused group we underwrite and monitor to the same extent as our owned managers) as well as on specialist strategies in the activist space, where the team is evaluating several managers whom we consider to be truly exceptional and who have shown the ability to add real value to their portfolio holdings.

It was a busy year on the private investments front: initiating three new private credit relationships (on which, more below) and approving five private equity funds (of which three are re-ups with existing managers). Looking ahead, we are homing in on a new buyout relationship with a top-tier Industrials focused manager, an area where we have historically had relatively limited exposure. Within private credit we are looking to complement our existing commitments (across sponsor backed direct lending, non-sponsor backed direct lending, and railcar leasing) with other specialist credit strategies including healthcare royalties. Lastly, on the growth and venture side we continue – with invaluable introductions from our Advisory IC members and our broader peer network of institutional investors – to build out our relationships with leading managers in both the traditional mid-stage VC and bootstrapped growth spaces, located across the US from west to east coasts and within Europe.

Looking Ahead

The fifth year of this tumultuous decade brings plenty to worry about. What might be the defining events of 2024? Chief among these (according to a recent poll of investors by Citi) are geopolitics – in particular developments in Ukraine and the Middle East; the forthcoming US election; and the path of US rates as the Federal Reserve attempts to navigate the shifting inflation and growth backdrop.

These are real risks. The war in Ukraine no longer makes daily headlines but an outcome which is jointly acceptable to Russia, Ukraine and the inhabitants of Donbas and other disputed regions is difficult to imagine. Meanwhile American support for funding Ukraine indefinitely may be waning and the 'black swan' risk of nuclear engagement is ever present. Conflict in the Middle East – arguably linked to Ukraine in the context of the 'anti-Western' struggle for a more multipolar world – could ripple outwards as Iran-backed militias such as Hamas, Hezbollah in Lebanon and the Houthis in Yemen coordinate more closely. A wider war in the Middle East would be a human tragedy and could also impact global growth and inflation by disrupting oil supplies and driving up energy prices, creating a headwind for businesses and consumers.

Elections in the US (and elsewhere, with more than 40% of the world's population going to the polls this year) will undoubtedly have wide-ranging impacts – although recalling the shock Trump victory in 2016 and then the surprise stock rally which ensued, investors should have little confidence in the ability of pollsters or pundits to provide useful guidance here.

Lastly, the path of US rates will be significant for risk asset returns – and we have already seen in the opening weeks of 2024 some reassessment in bond markets of the pace at which the Fed is likely to cut rates later in the year. The Fed themselves have indicated that the policy rate is at or near a peak, and there are clear signs of normalisation in inflation measures, the labour market and the important services sector in the US. Investors should be careful what they wish for, as rate cuts driven by disinflation will surely be better received by markets than cuts driven by a marked slowdown in growth.

We suspect that policymakers are likely to err on the side of caution as long as unemployment remains historically low and equity markets are near all-time highs; the worst-case outcome would be loosening too soon and allowing a rebound in inflation to occur. Meanwhile the regular data releases remain volatile and the only certainty was well articulated last week by Richmond Fed President Tom Barkin: 'Forecasting is difficult, and conditions are ever evolving. As they do, so too will our approach. So, buckle up. That's the proper safety protocol – even if you expect a soft landing.'[9]

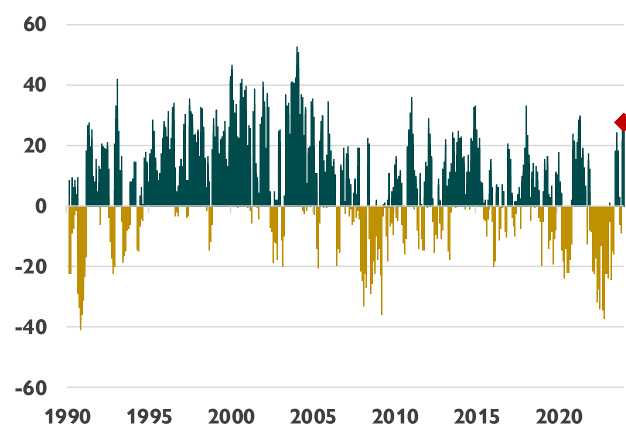
As the probability of this 'soft landing' has increased, investors have become more sanguine about the outlook

[8] Note that at a 10% rate of compounding, capital doubles every 7¼ years.

[9] Tom Barkin, speech to Raleigh Chamber of North Carolina, 3 January 2024

for risk assets. After the intense negativity of 2022 and early 2023, individual investors in the US are now quite optimistic coming into 2024, a setup which can present some risk in the short-term on challenges to the positive narrative.

Figure 4: Optimism returns among retail investors



Source: Bloomberg, American Association of Individual Investors. Chart shows the net proportion of respondents who are bullish minus those who are bearish.

This greater optimism is reflected in the somewhat higher index valuations at year end. The earnings of global equities as a whole have been broadly flat over the first three quarters of 2023, which means that the global index return through the year was driven almost entirely by valuation increase (from 16.2x to 19.5x historic P/E) plus a small dividend yield. Excluding the 'Magnificent 7' stocks, global index earnings will be slightly down in 2023 to date. (The M7 grew their earning by c. 20% over the first three quarters of the year, but rose in price by a great deal more.) S&P 500 earnings have also been broadly flat in aggregate, while the index P/E valuation increased from 18.2x to 23.0x during the year.

These valuations may appear full but come with two important caveats. The first is the contribution (whether justifiably or not) of the M7 to index returns and valuation. This impact was most pronounced in the US, where the remainder of the S&P 500 (which we recently saw termed the 'Mediocre 493') were up c. 10.5% only and ended the year valued at 20x P/E. Global equities ex-M7 rose by c. 13% and ended the year at 17.5x P/E. These levels would put global equities almost exactly in line with their 30 year historic median P/E valuation.

The second, and more important caveat, is that we do not invest in passive indices and hence the characteristics of our portfolios are usually quite different to the index. The earnings growth of two of our four core global equity managers which have just reported (and which both comfortably outperformed the global index in 2023) provide a good illustration. While global equity index earnings per share (EPS) were approximately flat, the EPS of Manager A's portfolio grew by 11% in 2023 with c. 10% exposure across only two of the M7 names; while the EPS of Manager B's portfolio grew by 8% with c. 5% exposure across two M7 names. These active managers have been able – unconstrained by index weightings – to select businesses which consistently outgrow index earnings, at valuations which do not reflect their superior earnings power over time.

The 'Roaring Twenties' have been no stranger to turbulence so far: the COVID pandemic; wars in Ukraine and the Middle East; energy price shocks; surging inflation and the extreme policy responses to it; a banking crisis; two deep equity bear markets and a generational decline in the value of government bonds. Despite all this, global equities have annualised at over 8% (and US equities at over 11%) over the first four years of the decade with little change in valuation levels and even as benchmark 10 year bond yields have more than doubled.

Many investors have not participated in these returns as fully as they should have done. We will not be alone this quarter in quoting Charlie Munger, Warren Buffett's erstwhile investment partner at Berkshire Hathaway and arguably the architect of Berkshire's 'wonderful company at a fair price' approach. Munger died in November aged 99, leaving a trove of thoughtful and often trenchant counsel. Among this was the observation (about the 'father of value investing', Benjamin Graham) that:

Graham, great though he was as a man, had a screw loose as he tried to predict outcomes for the stock market as a whole. In contrast, Warren and I are almost always agnostic about the market.[10]

History suggests that spending less time trying to predict the unpredictable and more time on investment fundamentals is a winning strategy over time. (See also Buffett's advice at the start of this letter.) With valuations in 'normal' territory and sustainable growth evidently available, we are confident in the long term prospects for our managers and underlying owned businesses.

Edward Clive

Chief Investment Officer

[10] Poor Charlie's Almanack, 3rd ed. 2014, p. 252

Sixteen02 Global Equities

The Institutional Share Class (US$) returned 44.4% as of 29th December 2023 versus MSCI ACWI of 22.2%.

Figure 5: Five Largest Holdings as of 31 December 2023

1	Eli Lilly and Company
2	Microsoft Corporation
3	NVIDIA Corporation
4	Salesforce, Inc.
5	ServiceNow, Inc.

Holdings shown in alphabetical order

The S02 portfolio delivered broad-based performance in 2023, with approximately 85% of its stocks generating positive returns and approximately 63% exceeding 25% gains. Some of your healthcare stocks (such as Eli Lilly) and financials (such as Blackstone) did better than the average technology stock suggesting it was a year for picking stocks rather than sectors.

In 2022, big tech, software and semiconductor companies were rather unfairly chastised as not fit for a new economic environment characterised by high inflation and rising interest rates. One year on, these businesses were amongst the best performers, primarily due to their ability to deliver superior earnings growth in a challenging year.

Salesforce, for example, faced a difficult year in terms of top line growth as its clients continued with cost optimisation. However, it managed to achieve a remarkable 800 basis point margin improvement and implemented buy-backs leading to a 44% upward revision of analyst expectations for 2023 earnings per share. Similar stories unfolded at Meta (+81%) and Amazon (+61%), while Nvidia's Gen AI-driven earnings inflection surprised analysts prompting a 182% estimate revision.

Since 2022, these sectors have had to navigate varying degrees of earnings recession. However, recent quarterly calls have hinted at promising green shoots of recovery. Notably, management teams across your portfolio companies have exuded confidence about delivering another year of robust earnings growth.

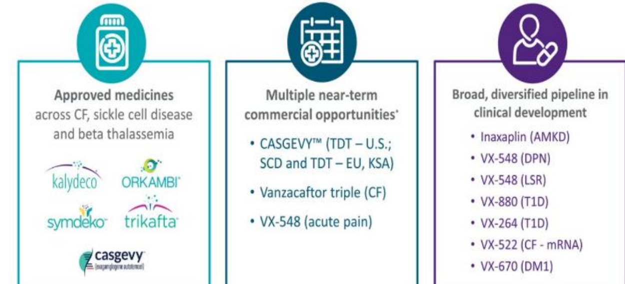
The volatile market conditions of 2023 presented numerous opportunities to upgrade your portfolio. In the fourth quarter, we capitalized on GLP-1 concerns to increase our holding in Dexcom at attractive levels. We replaced Zoetis with Vertex Pharmaceuticals as we see comparatively more attractive compounding potential going-forward in the latter than the former. We continue to like Zoetis but want to maintain the competition for capital at a high bar.

Pain = Gain

Cystic fibrosis (CF) is a rare and chronic genetic disease. It is a progressive, multi-system disease that affects the lungs, liver, gastrointestinal tract, pancreas, and other organs. It significantly shortens life expectancy, with a median age of death in the early 30s. However, earlier diagnosis and improved treatments can extend life expectancy to a median of 65 years.

Vertex has spent over 20 years searching for a cure. The company made the first commercially available CF medication in 2012 under the Kalydeco brand name. Since then, they have introduced three more drugs, expanding treatment options for previously ineligible patients. Vertex's commitment to innovation doesn't stop there. They have a robust pipeline of next-generation drugs aiming to treat 100% of the CF population. This dedication to expanding their portfolio has solidified their leadership position in the market and led to monopoly-like dominance as there are no other commercially available treatments with similar efficacy to that of Vertex's medications.

Figure 6: Vertex has a broad, diverse, and rapidly advancing pipeline



Source: Vertex Pharmaceuticals

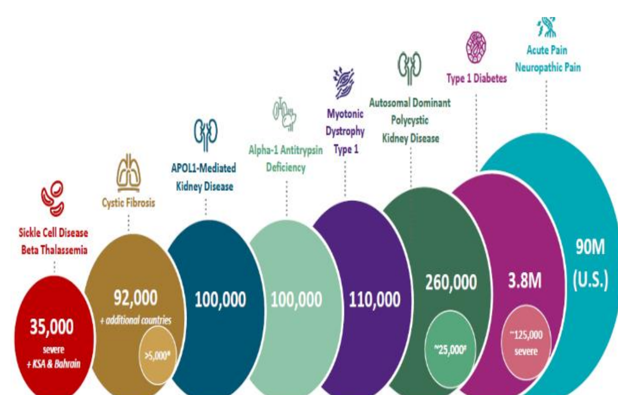
In collaboration with CRISPR Therapeutics, Vertex has developed a gene-editing therapy (Casgevy) that could treat Sickle Cell Disease (SCD) and Transfusion – Dependent Beta Thalassemia (TDT). Both these genetic disorders affect red blood cells. SCD alters their shape hindering blood flow, while TDT impairs their oxygen-carrying capacity leading to anaemia and other complications.

In December 2023, US regulators approved the commercial rollout of Vertex's gene therapy for SCD, marking a significant breakthrough. Similarly, their TDT therapy approval is expected by March 2024.

Vertex's pipeline even extends beyond CF, SCD and TDT and the company is in an enviable position of being able to stack new products on top of a long-duration CF business. The chart below shows the top pipeline

candidates and their addressable patient population. Vertex is slowly de-risking each of these candidates via clinical studies and making strong progress towards the stated goal of five launches over five years (2028).

Figure 7: Patient population in select markets addressed by clinical portfolio



Source: Vertex Pharmaceuticals

One of its projects, VX-548 (a potential treatment for both acute and neuropathic pain), holds immense promise. There has been no major innovation in the treatment of pain and existing pain management options often come with drawbacks: anti-inflammatories/ analgesics have side effects, and opioids carry addiction & abuse risks. In the US alone, over 90 million patients struggle with pain annually, highlighting the critical need for safer and more effective solutions. VX-548 has already yielded positive results in multiple phase 2 studies, and phase 3 results for acute pain treatment are imminent.

Should it reach commercialisation, we believe VX-548 presents upside optionality in that Vertex's earnings compounding potential could inflect significantly higher into the 20%+ range.

Though even without this optionality, we expect Vertex to compound earnings in the mid-teens range as: (1) the untreated CF patient population in key markets like the US, Europe, and Canada still exceeds 20%; (2) SCD and TDT products drive incremental growth from their commercial rollout; (3) management implements significant margin expansion opportunities, and (4) Vertex generates significant cash and has a net cash balance (approximately.12% of market cap), which it could use for shareholder returns in addition to funding its R&D pipeline.

History Rhymes...

The past two years have been a wild ride — a market rollercoaster that has left even seasoned investors somewhat dizzy. However, trying to make sense of it what emerges is a powerful reminder — buying during times of panic, when "blood is in the street," can be a rewarding strategy.

History attests to this approach. Between 1950 and 2021, there have been eight instances wherein the S&P plummeted 25% or more. As the table below shows, the subsequent one- and three-year returns after each trough were consistently positive double digits.

When the market bottomed on October 12, 2022, the future was shrouded in uncertainty. Would the S&P rebound? We now know the answer: a healthy 21.6% climb. Will history rhyme again over the next three years?

Figure 8: S&P500 has been down 25% or worse since 1950

Peak	Trough	+1 Year	+3 Years
12-Dec-61	26-Jun-62	32.7%	58.8%
29-Nov-68	26-May-70	43.7%	55.8%
11-Jan-73	03-Oct-74	38.0%	55.3%
28-Nov-80	12-Aug-82	58.3%	83.2%
25-Aug-87	04-Dec-87	21.4%	45.7%
24-Mar-00	09-Oct-02	33.7%	54.0%
09-Oct-07	09-Mar-09	68.6%	102.6%
19-Feb-20	23-Mar-20	74.8%	76.5%
03-Jan-22	12-Oct-22	21.6%	?
Average		**43.6%**	**66.5%**
Median		**38.0%**	**57.3%**

Source: CAPIQ

As we tenderly step into 2024, a cacophony of macroeconomic forecasts bombards us. Soft landings, mild recessions, Fed rate cuts, and Mag 7 de-rating – the list goes on. Nonetheless, 2022-2023 taught us a valuable lesson — obsessing over macro trends and timing the market is a fool's errand.

Instead, it pays to stick to our core principles of investing in resilient companies, the ones that weather storms and steadily compound earnings over the long term.

You make most of your money in a bear market, you just don't realize it at the time.

Shelby Cullom Davis

Chandan Khanna

Portfolio Manager, Sixteen02 Global Equity

Parthipan Paramsothynathan

Senior Investment Analyst, Sixteen02 Global Equity

Private Investments

Private Equity Market Overview

Deal making – down but certainly not out

PE transaction value, at $611bn in the US through Q3, was down 25% on a soft 2022. Transactions over $1bn (-45% YoY) remained constrained by tight debt markets and a seller/buyer expectations mismatch, while the value of mid-market ($100-500m EV) deals rose by 9% Y/Y driven in part by a wave of take-privates in H1. Indeed, data from EY showed that take-privates accounted for an astonishing 68% of all PE deals in Q1 and 42% in Q2 as funds sought to take advantage of investor fatigue and dislocated valuations in the small cap space. We expect PE to continue to find public small caps to be a fertile area of deal flow in 2024. Given the difficulty in getting large platform acquisitions done, funds continued to lean into buy-and-build transactions to achieve scale platforms and arbitrage entry multiples – with these transactions now accounting for close to 80% of all buyouts by volume.

As in 2022, where transactions did happen, they generally involved GPs' highest quality assets at commensurate valuation multiples, with median buyout multiples at 15.2x EV/EBITDA in the US and 11.2x in Europe (see charts below). We expect these aggregate multiples to soften in 2024 as GPs begin to exit the substantial 'inventory' of other owned businesses which has been waiting on the sidelines. Combined with higher debt costs and limited debt availability, this meant that transactions were funded with less debt (an average of 5.1x) and more equity than at any other time in the last 10 years. The combination of high-quality companies and relatively low levels of expensive leverage should make this an attractive direct lending vintage (on which more later).

Figure 9: US Buyout – Median EV/EBITDA

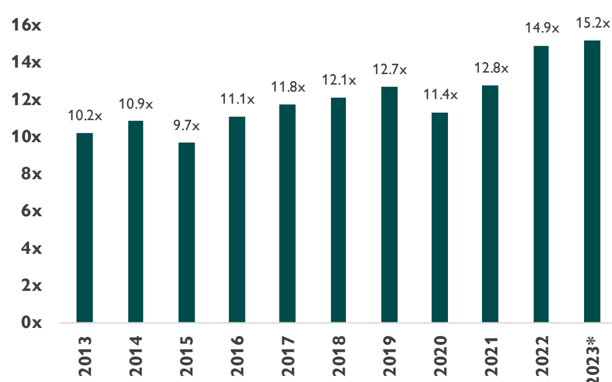
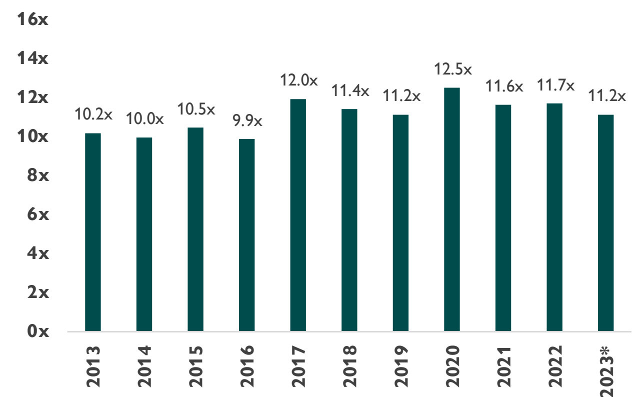


Figure 10: European Buyout – Median EV/EBITDA



Source: Pitchbook (YTD to 30 September 2023)*

Whilst the mantra that there are always buyers for high quality businesses held true, the market's definition of quality has certainly evolved, with data from JMI, one of our Growth managers, showing that for US publicly listed software companies, one percentage point of growth is now worth 2.4 points of margin, down from 11.5 points during the peak in 2021 – growth still pays but profitable growth is the most highly rewarded.

PE exit activity, unsurprisingly, was muted, with LPs receiving $37 in distributions for every $100 in capital called by US funds as of 30 September (Pitchbook data) as IPO markets remained all but closed during the period (albeit warming up somewhat in Q4); whilst PE exits to sponsors and corporates were down 32% and 35% respectively Y/Y. As in 2022, corporates represented the lion's share of exit activity at 55%, as boards sitting on healthy balance sheets went on the hunt for strategic assets. We have particularly benefitted from this in the biotech space as Eli Lilly, Roche and Novartis all announced acquisitions of companies within our Nineteen01 portfolio at valuations in excess of $1bn.

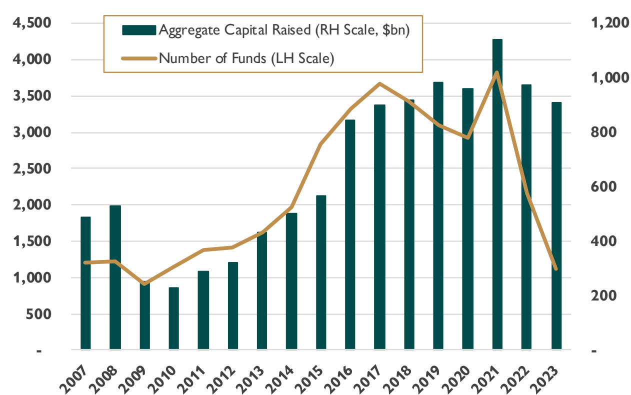
With a record $1.5tn of PE dry powder and some $5tn in PE cost basis from 2014-21 that will be looking for the exit in the coming years it is no surprise that many are expecting a busier exit market in 2024. This push for liquidity will also undoubtedly mean that other liquidity options including continuation vehicles, NAV financings and strip sales become ever more commonplace – as ever, necessity is likely to be the mother of financial invention.

Fundraising – the haves and have nots

Overall illiquid fundraising activity, at $908bn as of 20 December, was down just ~7% vs 2022 and ahead of what at the time was a record 2017. This seemingly resilient headline figure, however, was raised by the smallest number of managers since 2009, with just 1,118 funds reaching final closes vs an average of over 3,000 in the 5 prior years. Evidence of this 'flight to scale' was easy to see when one considers that CVC (€26.0bn), EQT (€21.5bn), CD&R ($23.5bn) and Blackstone Real Estate ($30.4bn) together accounted for more than 10% of the total capital raised in 2023.

On the other side of this dynamic, it seems clear that with some 4,000 managers currently fundraising (Preqin data), many will not survive as committed capital vehicles, while many more facing the prospect of raising in 2024 may be open to alternatives. We expect the trend of PE consolidation to gain further momentum in the coming year.

Figure 11: PE Fundraising since 2007



Source: Preqin

Private Credit: Worth the Wait?

In April we wrote about our selective move into private credit as the end of the era of cheap and plentiful 'covenant-lite' debt shifted expected returns for high quality senior credits into the low teens (Quarterly Perspectives, Q1 2023: *Good things come to those who wait?*). Our focus has been on building a portfolio that can deliver a ~10% current yield plus additional upside from capital gain over a meaningful duration, whilst not betting solely on rates staying higher for longer. Given the luxury of a blank sheet of paper we have also sought to avoid firms with large portfolios of 2017-21 deals that are heading into what could well be difficult re-financings. We have been pleased to make three commitments for yield-seeking client portfolios, with a final manager expected to round out the initial portfolio in H1 2024. Summaries of ITE Rail, GoldenTree Private Credit and MGG are provided below:

ITE Rail Freight Fund

In April we made a commitment to ITE Rail. Founded in 2013 by David Smilow and Jason Koenig, ITE manage $6bn across several transportation equipment leasing strategies. ITE Rail, the firm's flagship fund, is the fifth largest owner of railcars in the US, managing a $4.7bn portfolio of more than 65,000 freight railcars and railcar repair, maintenance, and storage assets through an evergreen structure with annual liquidity. These assets have delivered consistent double digit returns through the cycle, including an 8% annual yield and, given their essential nature and attractive industry supply and demand dynamics, benefit from consistently high utilisation rates and long contract durations with investment grade counterparties. The fund was opened to new capital ahead of successfully completing a large transaction in Q4 which we believe will prove highly accretive.

GoldenTree Private Credit I

In August, we made a commitment to GoldenTree's first dedicated fund focussed on performing private credit. The fund represented an opportunity to deepen our relationship with a leading credit manager with $50bn AUM and a more than 20-year track record of top quartile returns across the credit landscape, including in performing credit through prior Master Fund investments. The fund is already more than 50% invested in 24 senior loans to large (average ~$300m EBITDA) companies, either listed or backed by top tier sponsors. The fund has a $1.5bn hardcap and has commenced paying coupons quarterly at a 10% yield through its levered sleeve, which targets net IRRs in the low to mid teens.

MGG Fund IV Evergreen

In December, we approved a commitment to MGG Fund IV. MGG was founded in 2014 by Kevin Griffin (previously Head of Privates for Octavian) and Greg Racz (previously President and Chief Legal Officer of Hutchin Hill and co-founder of Octavian) and is focused on making senior loans to entrepreneur and family-owned companies operating in the underserved and less competitive US lower to middle market. The firm's proactive sourcing and focus on fundamental credit, legal, accounting and management team due diligence has allowed it to earn excess returns with the security of strong protective

covenants. Fund IV will hold its final close in Q2 2024 and has a $1.5bn target across its drawdown and evergreen sleeves.

Charles Magnay

Head of Private Fund Investments

David Schofield

Investment Manager, Private Investments

Direct Private Opportunities

At the end of our fourth full year since inception, it feels an opportune moment to reflect on our approach to sourcing and what has come 'through the funnel' in 2023. Taking a proactive approach to sourcing to ensure that we have the best possible access to dealflow from established GPs, independent (or 'fundless') sponsors and emerging managers has been a core focus; ultimately the only way to consistently invest in great companies alongside great sponsors is to build a sourcing engine that is set up to consistently find them. We are pleased that each of these three sources delivered substantial deal flow in 2023 as we have honed our approach and continued to build our reputation in the market as a group that can move and execute decisively. Tellingly, the three deals that we have completed during the year have included one of each of from these sponsor types.

In total, we reviewed 115 transactions in 2023 – more than two per week in a year where M&A volumes were down ~50% from 2022 levels. The breakdown of deal flow by sponsor type shows that our largest single source of flow is from our network of independent sponsors, with 55 deals reviewed from 48 such groups. These groups represent a differentiated source of deal flow that is traditionally difficult to access – more than half of these deals were shown to us directly rather than through intermediaries, allowing us access earlier in the underwriting process. We remain highly selective and, though adding several groups to our approved list based on the strength of their team and track record and progressing three opportunities to deep diligence, we ultimately did not transact with any new independent sponsors this year.

This year saw a significant increase in the number of transactions we reviewed from emerging managers and established managers that we are not investors with, as emerging managers found themselves with sub-scale funds and requiring third party co-investment, whilst established managers sought to broaden their network of prospective LPs. Of the 47 deals reviewed from this channel we did meaningful diligence on five and completed one transaction, Sureserve, alongside Cap10 Partners.

Unsurprisingly, our highest conviction source of deal flow, measured by 'hit rate', are transactions alongside managers that we are existing investors alongside, either as co-investors or as LPs in their funds. We reviewed 14 opportunities from this group of managers and transacted on two: Gruppo Florence, alongside VAM, a fundless sponsor and company we had previously backed, and Atlas Technical Consultants alongside GI Partners.

As we close the book on a year that saw our first full exit event as well as continued double digit organic growth in our portfolio, we remain excited by the opportunity set in our existing network of manager relationships as well as the sourcing flywheel that continues to develop as we build on our track record.

Oliver Mayer

Head of Direct Private Equity

David Schofield

Investment Manager, Private Investments

What we have been reading …

What I Learned About Investing From Darwin *by Pulak Prasad*

'Don't be lazy – be *very* lazy.' Rarely is a fund manager quite so open about his or her preferred level of activity.[11] Pulak Prasad – who has generated outstanding returns since 2007 as founder of leading Indian equity manager Nalanda Capital – is refreshingly direct throughout this book, regarding both his investment philosophy and approach, and also the various missteps and consequent learnings along the way (at Nalanda and formerly as a private equity investor at storied GP Warburg Pincus).

Highly recommended to us by one of our external Investment Committee members, this is an unusual investment book in two ways. First is the deft and engaging style, which makes it a genuinely enjoyable and frequently entertaining read. Second is the use of evolutionary biology – of which Prasad is a highly informed amateur – to illuminate the key elements of the author's investment approach along the way.

The book is structured along the lines of Prasad's three core tenets: 'Avoid big risks', 'Buy high quality at a fair price', and, as above, 'Don't be lazy – be *very* lazy'. The first of these uses plants, stags, dodos, cheetahs and the bumblebee to illustrate how a great investor should above all be a 'great rejector'. This means that Nalanda will inevitably miss out on some great success stories along the way; but 'our success is contingent upon our being *comfortable* with missing out on Teslas and Eichers[12] because *on average* avoiding Type 1 errors[13] works wonders over time. It has done so for us.'

The second section, which explores the nature of high quality businesses, covers familiar ground but with a dazzling variety of new perspectives. An experiment in Siberia involving the selective evolution of silver foxes illuminates the importance of ROCE, or return on capital employed, as a single signifier of business quality characteristics. The robustness of proteins or sea urchins is critical to their successful evolution over time – as for similarly robust corporate bodies. This section also contains one of our favourite chapters, *The Perils of a Pavlovian*, which (via the dung beetle's magnificent horns) highlights the futility of macro analysis as a useful tool for long-term investing. Prasad begins the chapter with a timeless quote from Warren Buffett (and we wholeheartedly agree):

In our view it is folly to forgo buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable.[14]

He also flags up an IMF paper from 2018 (*How Well Do Economists Forecast Recessions?*) whose author reported that economists as a group had failed to predict 148 of the last 150 recessions worldwide, and stated that 'the record of failure to predict recessions is virtually unblemished'. Prasad's solution: ignore 'headline harassment' and focus exclusively on the ultimate sources of success for a business.

The final section exhorts investors to be (extremely) long-term and to ignore market movements in determining their hold period. Clients of ours who own strategic operating businesses will identify with this approach. Should you sell just because the valuation of your business has risen? Probably not. Would you sell when the valuation has gone *down* (which sounds illogical, but is a much more common urge among stock investors)? Almost certainly not.

That said, the former of these – Prasad's determination to maintain his positions regardless of valuation, all else equal – presents the greatest intellectual challenge of the book, even to those who agree wholeheartedly with his focus on owning high quality companies for the long term and buying them at attractive prices. Is there ever a justification for selling a great business purely on the basis of valuation? Surely the price today is equally as important as the entry price, and excessive valuation introduces unacceptable risk? Interestingly, the pantheon of 'high

[11] As an aside, we are reminded of a recent interview with Nicolai Tangen, founder of the $20 billion 'quality growth' fund manager AKO Capital and now manager of the giant Norwegian Sovereign Wealth Fund, in which he mused: 'So if you can sit there and compound – it is such a wonderful idea. Is it easy? No, it is super tough. You come home from work, and your wife asks, "What have you done today?" And you say, "Nothing." Next day – the same. You just feel like a failure. So therefore you feel like you have to trade a bit. But it is mostly not very profitable.'

[12] Manufacturer of the Enfield Classic motorcycle and a great Indian turnaround story, which on Nalanda's calculations returned 70x capital from 2007 to 2021.

[13] Errors of commission; as opposed to 'Type 2' errors of omission.

[14] Berkshire Hathaway Annual Letter, 1994

quality' investors ancient and modern seems to agree with him:

- Philip Fisher: 'If the job has been correctly done when a common stock is purchased, the time to sell it is – almost never' *(Common Stocks & Uncommon Profits, 1958)*
- Warren Buffett: 'Regardless of price, we have no interest at all in selling any good businesses that Berkshire owns' *(Berkshire Hathaway Annual Letter, 1983)*
- Terry Smith: 'I have also learnt that selling a stake in a good company is almost always a mistake' *(FT, 2015)*

In fact, Buffett (who is quoted extensively throughout Prasad's book) provides a striking qualification to his comment above – in the same 1983 letter – describing the reluctance to sell as an attitude which 'hurts our financial performance'. And indeed, talented managers do exist who have generated significant additional value-add from rebalancing their portfolio holdings far more frequently than Prasad or Buffett.

The answer to this conundrum is probably two-fold: time horizon and quality – perhaps most pithily summarised by the late, great Charlie Munger as follows: 'If you buy a few great companies, then you can sit on your ass' (Berkshire Hathaway Annual Meeting, 2000). If, like Prasad, your time horizon is truly multi-decade and your focus on business quality is absolute, then the long-term compounding of such business value should handily outweigh the impact of fluctuations in valuation over such time horizons. That said, the debate about whether even the highest quality stock should be owned at *any* valuation remains very much alive.

There are, as ever, many ways up the mountain, and Prasad necessarily takes an unconventional path – one which requires climbing partners with both exceptional reserves of patience and heads for heights. This path has generated outstanding returns for him and his investors and thrown up some novel insights along the way. This thoughtful and enjoyable book well deserves its place alongside Prasad's heroes on the long-term investor's bookshelf.

Edward Clive

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