Private Client Letter

Publisher: Private Client Bank AG, Zurich | T +41 44 253 73 00 | info@privateclientbank.ch | privateclientbank.ch 1 October 2020 | Q4/20

A great crossing

Private market investments are experiencing a boom. There are plenty of good reasons for this. However, those aiming for success should also recognise the pitfalls. Genuine entrepreneurship is required, and this cannot be delegated.

"Hup!" shouts Obelix. And with a mighty heave, he launches Asterix from the ship's deck, right through the thick fog cover, into the bright and starry night. Asterix quickly scans the skies in every direction, searching for the North Star: "That way!" Seconds later, he lands back in the mighty arms of Obelix. Their ship is on a great crossing in the middle of nowhere. The two stalwart Gauls have lost their bearings and cannot see their own hand in front of their eyes. "Hup!" ...

For investors too, visibility is vital if they are to reach their destination – whether that means asset accumulation, asset preservation or anything else. Visibility comes in the form of analysis, business plans, media reports, anecdotes, rumours, and much more. However, the central element is the price, because it is only through this price that investors can ultimately decide whether to buy, hold or sell an asset. The price incorporates the present and all expectations for the future. For this reason, it is of great importance how and how often prices are determined for assets. In the case of exchange-traded, liquid investments such as bonds and shares, but also convertible currencies and many commodities, pricing is constant, and in the case of currencies it even takes place on the weekend and 24 hours a day. Such investments can be liquidated effortlessly and at short notice, the price is public knowledge, and can be ascertained quickly and easily.

So while visibility in public, liquid markets is generally excellent, the picture is quite different for a large proportion of interesting investment opportunities – starting with one's own property holdings and extending to participation in private, unlisted companies. The visibility spectrum ranges from a thin veil of uncertainty all the way to a thick fog. Not only are prices infrequently determined for such investments, in most cases one is also invested for a very lengthy period, similar to a great crossing.

The appeal of private markets

While there has always been private off-market trading in real estate, company shareholdings, debt securities and the like, demand for this type of investment has soared in recent years. Accordingly, a flourishing industry has developed with a variety of financial vehicles for investing in private markets. By definition, this industry is difficult to decipher, opaque and highly heterogeneous. Against this backdrop, data suppliers are attempting to shine some light in the darkness. As our chart on the next page shows, the Private Market business has expanded more than tenfold from 2000 until today. Private equity accounts for around 60%, making it by far the largest market,

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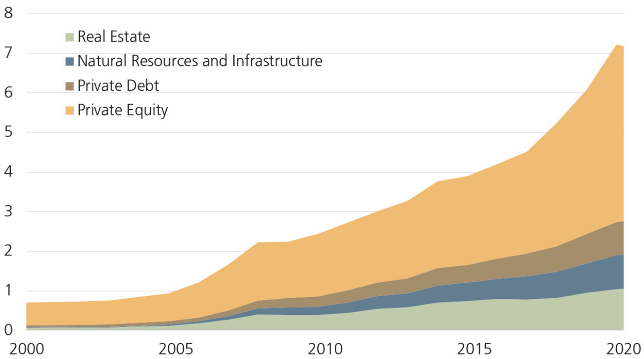
followed by real estate and private debt. Meanwhile, the global capitalisation of the stock markets alone, at around USD 90 trillion, is more than twelve times larger than the total private market volume, at least insofar as this is measurable.

PRIVATE MARKET INVESTMENTS, IN USD TRILLION

A GROWING INDUSTRY



Source: Prequin Ltd.

The boom in private investments is usually explained by the fact that higher returns can be expected in these markets. Studies by Steven Kaplan (University of Chicago) and various co-authors indicate that private equity can indeed outperform the stock markets. For example, a recent study found that private equity beats America's S&P 500 index by an average of around three percentage points per year – after costs. On the other hand, the dispersion of returns is quite high with private equity: the results for the top 25% of investments were considerably better than the stock markets, but those for the bottom 25% were many times worse. And it is probably anything but easy to identify the top performers in advance. Despite this only partially convincing finding, the hope for returns has been the most powerful driver of the rapid growth in private markets since the financial crisis of 2008. The de facto disappearance of key asset classes such as bonds or interest-bearing cash did the rest.

Still, there are various well-founded reasons for a better return on private market investments. First, the so-called liquidity premium, which stems from the fact that the money put into such investments is usually tied up for a very long time. This means higher risks can be borne, which should generate correspondingly higher returns – at least on average. Away from the hectic pace of quarterly reporting and stock market prices, companies can take a long-term position that helps them to survive any lean years. A further argument is that more direct control by a few clearly identifiable owners is more efficient. In companies with a broadly diversified ownership that is constantly in flux, it takes a great deal of effort to ensure that management and staff cannot pursue their own interests in opposition to the welfare of the company. On the other hand, when ownership is more direct and focused via private market investments, there are fewer frictional losses – at least in theory. Naturally, this is only true if entrepreneurial owners are not replaced by fund managers with their own interests, for whom fat fees and short-term success – when in doubt, assisted by loads of borrowed money – are more important than healthy companies.

The pitfalls of a long voyage

Deciding on a private market investment is like embarking on a long journey. At the beginning, there is usually a fixed amount that can be called up by the managers of the investment vehicle in one or more tranches. The term tends to be five to ten years; in rare cases, significantly longer. During this period, the investment can only be sold at a steep discount, if at all. The advantage is that this creates an actual long-term commitment; the disadvantage is that there is virtually no flexibility.

The value of private market investments is determined and communicated at regular intervals, about once a year or quarterly. At the same time, there are also cases in which the investment sum is simply kept on the books for a very long time, while the actual value of the investment is to be found more in the realm of ideas than facts. In principle, this need not be a disadvantage. For example, constantly fluctuating prices on the stock markets can lead to costly errors, provoked by the constant interplay of fear and greed. Even the

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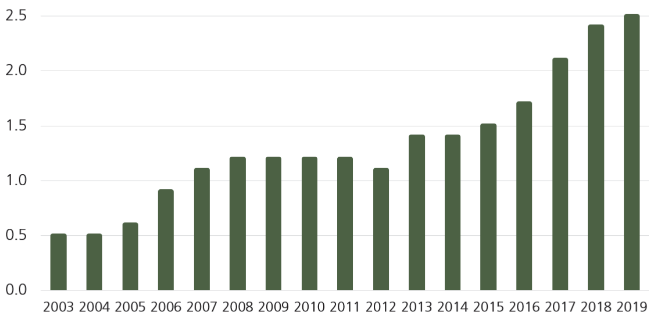
ancient Greeks told of Odysseus, who plugged his companions' ears with wax so they would not hear the siren songs. All this is not an issue as long as investors deliberately forego visibility, refrain from constantly comparing apples (private market investments) with oranges (market traded securities) and, above all, do not need cash. It is also not a problem as long as the ship stays on course and no unexpected events occur. However, that is anything but certain in stormy times.

PRIVATE MARKET INVESTMENTS STILL IN CASH, USD TRILLION

PLENTY OF DRY POWDER



Source: Bain & Company, Global Private Equity Report 2020, p.12. Figures for private markets in total, based on Prequin Ltd.

The success of private market investments ultimately depends upon finding a sufficient number of investment projects that can actually deliver the promised returns. The ongoing boom and the unprecedented creation of ever more liquidity by the central banks give rise to scepticism here. It is noticeable, for example, that the committed but not yet invested capital in private markets has risen sharply in recent years. As our chart illustrates, an increasing amount of so-called "dry powder" is available. While a certain volume is normal here, the growth in recent years is pushing enormous sums of money into the market, for which worthwhile investment objectives must first be found. So it would not be surprising if some investors were to realise in a few years that the ambitious targets and impressive figures have vanished into thin air.

Real entrepreneurship counts

Investors wishing to avoid disappointments with private investments should not pour out money indiscriminately, and should know exactly what they are doing. In the case of publicly traded securities, the highly liquid market, constant pricing and intensive regulation all ensure transparency and serve as at least partial protection against abuses. In the case of private market investments, lower levels of transparency and control must be offset by know-how, strict attention, personal commitment and readiness to accept losses. In a relatively young, booming industry with innumerable self-described experts, who attract investor money and then charge high fees to lock it away for years, it is anything but easy to identify those that will be successful. It takes more than good salesmanship to be a good entrepreneur. And private market investments call for genuine entrepreneurship, along with passion for the business, be it biotechnology, infrastructure, real estate, e-commerce, forests or any other theme in this highly heterogeneous world. Let us add this: real entrepreneurship cannot be simply delegated.

So there is much to suggest that investing in private markets is something for entrepreneurial investors who have enough resources and perseverance to survive some lean years without having to rely on liquidity. It is true that there are efforts to convert less liquid private market investments into liquid investment vehicles. However, it is still costly to do so today, and there will need to be significant progress in technology (blockchain!) and regulation before these are really trustworthy, especially during extraordinary situations. Until then, investments in private markets will remain great crossings where not all adventurers will reach their destination. Only those who are well prepared should embark on such a journey. Like Asterix and Obelix, one needs – especially in the absence of a magic potion – great reserves of strength, intelligence and endurance to reach journey's end, defying all obstacles.

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IA, 30.09.2020

Zombie banking is reality

A close relative of mine made a telephone call to a bank in a European country seeking information about an account that was located there as part of an inheritance. She tried to reach her client advisor, but instead landed in a call centre. A mechanical voice announced, "Your call will be recorded for training purposes." And: "You may state your questions after the beep." That is rather presumptuous, thought the client, and said only that she wished to speak with her advisor. Instead, she was connected with a young man, probably a trainee, who wasted few words before coming to the heart of his concerns, namely the identification of the client. "Your code number?" No idea, what is that? "Your date of birth, first name, maiden name?" Since she was not listed in the system as a client, he unfortunately could not transfer her call. Did he have a manager she could speak to, my relative tried to counter. He could not connect her to that gentleman either, since he was only responsible for clients. Since he could not find her in the system, she was not a client.

Our once proudly client-friendly commercial banks have become semi-governmental bureaucratic monsters.

Somehow the desperate client did manage to have her advisor call her back, and after a good Kafkaesque hour, things were settled satisfactorily. The two ladies were able to arrange a meeting. Wonder upon wonder. "But what if I'm delayed in traffic? How can I reach you?" "It's very unfortunate, but only through the switchboard – we are no longer permitted to give out our direct numbers, for reasons of consumer protection."

This is what our once proudly client-friendly commercial banks have become: semi-governmental bureaucratic monsters. Every peep from a client or advisor must be recorded, ostensibly to improve business processes. Under cost pressure, the processes are rationalised in such a way that robo-advisors would actually be a blessing. The clients turn elsewhere and, provided it is reasonably efficient, only use e-banking tools, which is probably the whole point. The staff is continuously thinned and those remaining are desperately unhappy because they are denied what to them is the elixir of life: direct client contact. And all this in the name of consumer protection! The world has gone mad.

No wonder that the banks, namely in MiFid-blessed Europe, have become dysfunctional. When the mere question about an account barely squeaks past the bureaucracy monster, how will a loan application from an SMU fare? We all know that the figures for European banks are down; the ECB is forced to find unusual and perhaps dangerous ways to pump liquidity into the economy. But no one in my former profession mentions that there might, just might, be a connection between the appearance of zombie banks and over-regulation. Meanwhile, people are satisfied with banks that make their profits on supposedly low-risk government bonds financed by cheap central bank money. In de facto terms, we are not far from a system capitalised by the state; the former Eastern bloc would thus be creeping into the free West. A reverse take-over, so to speak.

Under such circumstances, the strategy of a bank such as ours is clear. We use stable technology platforms to outsource expensive back office functions and concentrate on client business, doing things quite differently from everyone else. Would you like to wager that you can make an appointment with us in just one minute? Or that we take time for a discussion, with no ticker in the background to measure advisor productivity? In this sense, it is easy to be a good banker nowadays.

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KH, 30.09.2020