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Private equity – slower but steadier

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As policy easing in the US continues against the backdrop of economic resilience and fairly benign inflation, we have turned more positive on equities. While the market at large is also likely to tilt more toward risk assets, investors should remain vigilant and avoid concentration risk. One important way to maintain balance and diversification in portfolios is to employ alternatives, which can help smooth returns and cushion against event risk. Private equity is a key constituent of alternatives, and we expect it to outperform public equity markets over the course of the business cycle.

As the market starts to move from a "soft-landing" to a "no-landing" scenario for the US, risk appetite in financial markets is likely to continue to rise. Although the MSCI ACWI and the S&P 500 have risen 36% and 42%, respectively, to 20-year highs over the last 12 months, both still managed to rise 1.7% and 2.9% since 3 October, when US jobs data started to bring the no-landing potential into focus. This is likely to continue, and we believe investors would do well to tilt their portfolios toward global equities, which we have upgraded from Neutral to Attractive.

Notwithstanding this shift toward risk assets, investors still need to maintain discipline, and keep portfolios reasonably balanced and diversified. The surge in public market equities has surpassed private equity, and we provide key reasons below that investors might want to keep an eye on the segment and avail themselves of the current underperformance.

Be careful about following the crowd. There are good reasons for the underperformance of private equity over recent quarters but also good reasons this might not persist. For one, private valuations tend to not correct as much and tend to take longer to reflect information in quarterly net asset values (NAV). A lot of this has to do with the fact that public markets are more liquid and more accessible (especially to retail investors) rather than anything to do with the fundamentals of these investments. However, we also know that private equity is often equally—if not more—sensitive to policy easing. As we get deeper into the US Fed's easing cycle, we expect private equity to catch up and regain its lead over public equities. Over the entire business cycle, we believe private equity has the potential to deliver sustained outperformance of 2.5 percentage points over public stocks.

Better valuations, better buy levels. The lag in the performance of private equity actually provides discerning and observant investors with a good opportunity to position their portfolios for a smoother and less volatile—and potentially stronger—ride through the policy-easing cycle. Valuations have been stabilizing after leveraged buyout (LBO) entry multiples have fallen to 5% below their 2022 peaks, or around 11x EV/EBITDA at the end of 1Q24. This offers better-priced opportunities compared to public equities, which could start to dissipate as borrowing costs continue to fall. Notwithstanding the risk of milder US Fed rate cuts this cycle from a no-landing scenario, our base case remains for another 150 bps of cuts by the end of 2025.

Demand interrupted, for now. The view that the relative sluggishness of the private equity space is likely to be transitory, and potentially dispelled gradually by falling borrowing costs, is supported by observable indicators of activity and demand. Although fundraising has been more challenging—due to investor caution and a drying up of distributions—we are of the view that the latent strength seen at the start of the year remains in place. Already, transaction activity is improving and exits (into the public market) are gaining traction. Higher public valuations have made public listings more attractive again, and strategic buyers have cash on hand, as well as interest in mergers and acquisitions. This suggests to us that the segment is fundamentally in good health and that the current torpor can be reversed quite readily.

More generally, we continue to urge investors to use alternative assets to add diversity and resilience to portfolios. Private infrastructure, for example, can offer stable long-term, inflation-linked income with low correlation to traditional portfolio assets. Private debt can offer yields in excess of growth-sensitive public bonds. Hedge funds can smooth and deliver fresh sources of portfolio returns, and provide a cushion against event risk from geopolitics.

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