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FROM THE CIO

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MACRO RISK ROTATION AND THE ZERO-SUM GAME

Year-to-date public markets have faced and cleared several macro hurdles including the US banking crisis, debt ceiling issue, and continuous worry of whether the US Federal Reserve can navigate a narrow and treacherous monetary path without producing runaway inflation or triggering an economic hard landing. New issues now dominate the media including the upcoming US presidential election, distrust of the DOJ, FBI, IRS etc., and concerns about the equity markets' narrow rebound in a concentrated handful of technology mega caps. On top of these issues, is the persistent and growing worry of geopolitical headlines between the US and China/Russia. These "macro wall of worry rotations" continue and are likely augmented in the minds of investors because of the intensity of the US presidential campaigns and the corresponding media coverage. Either way, old issues are overcome and get priced into equities, new ones rise to the headlines, and they all create an unsettled state for long-term capital allocation. It is part of human nature to get drawn into these headlines, but unfortunately reacting to them can cause one to steer off course in terms of long-term asset allocation. As one of my Partners, Viktor Izakowicz, said recently, "It's not about "market timing" it's about "time in the market". Viktor's comment reminded me of how the great Albert Einstein called compounding interest "the eighth wonder of the world".

David B. Pinkerton is the CEO and CIO of Alpha Leonis Partners

David brings over 37 years of experience and expertise in focused investment programs in both capital and private markets.

He holds a J.D. degree from Brooklyn Law School and a Bachelor's degree in Finance and Economics from the University of Delaware.

1 WHY PUBLIC EQUITY MARKETS HAVE BEEN AND WILL LIKELY TO CONTINUE TO LOSE 'MARKET SHARE'

With respect to the public markets, I want to state a few observations that are not temporal conditions but more structural and longer-term in nature. We believe that public equity markets have been, over the last twenty years, losing "market share" to the private equity markets and this is likely to continue. The reasons for this include the following:

1. The growth of the passive/semi-active ETF industry has meant that more and more allocators to the public markets simply (passively) buy an index and may not have the patience or ability to conduct fundamental research on stocks as they once held. In 2003, there were 123 ETFs with $102 billion in AUM in the United States, by 2021 that had grown to over 3,110 ETFs and holding over $5.3 trillion in AUM[1]. This implies there is significantly less research available on individual companies (no real demand for it) other than the largest most liquid and most popular companies. As a result, the public equity markets often fail smaller and mid-sized companies because of the lack of research and fundamental analysis which disables capital formation and proper pricing of their securities. As a result, many smaller companies stay private longer and often choose not to go public at all.

This ETF trend is mirrored by the overall decline in the number of companies that are in fact public. In 1996, there were over 8,000 US publicly-traded companies, now there are less than 4,000[2], and of those that remain they are predominantly very large, capitalized companies. Of course, there is still an ample appetite for the hot new thing and these types of companies will always have a market of investors seeking to "bag" the next Amazon.

2. The "short-termism" of public company management teams leads them to be focused on maximizing quarterly EPS over longer-term investments, and this often means they are punished for making investments that have longer paybacks. Only a few public company management teams that have significant size undertake the risk to invest in innovation that might have risker and longer-term payoffs. Privately-owned companies are oftentimes in a better position to underwrite such longer-term projects.

3. The private equity industry has had over 25 years of return proof and while databases have plenty of statistical biases, the most robust data indicates that private equity returns consistently outperform public equity returns over longer periods by as much as 590 basis points. Long-term average US public equity returns have been about 7.6%[3] per annum (in nominal terms) whereas median private equity returns have been 13.3% with top-quartile managers obviously doing better than this[4].

4. Because many ETFs/indices are used so pervasively as convenient asset allocation tools for "60/40 portfolios", they are more affected by "herd" movements/perceptions and hence have volatility in price that has little to do with fundamental valuation changes, but more about the liquidity needs of the other holders. With so many managers benchmarked against these indices it creates the classic "crowded trade risk". Stepping away from that mentality and moving towards less crowded trades through properly constructed private equity portfolios can extract diversification benefits. Diversification only works when the specific risks of one company will not be the same as the other companies. We believe more and more allocators are appreciating this and starting to understand that private equity, if

Source: [1] Oliver Wyman, The Renaissance of ETFs, 2023; [2] National Bureau of Economic Research, *Why Are There So Few Public Companies in the U.S.?* ; [3] Credit Suisse Global Investment Returns Yearbook 2023; [4] Cambridge Associates LLC, US Private Equity Index (25 years)

structured properly, can be a better diversified exposure to the US economy than an ETF that is driven by only a handful of large public companies.

5. Finally, because the public equity markets are essentially a zero-sum game, meaning for every trade there is a winner and a loser, a significant portion of the public equity markets essentially represent what is equivalent to a gambling function.

The famous "Jack" Bogle founder of Vanguard made the most prominent articulation of this last point. In his book "The Clash of Cultures; Investment versus Speculation", he summarizes this issue succinctly in proclaiming the majority of activity in the public markets is trading and speculation and not investing. Click here for a succinct summary.

We agree with Bogle's principles and accordingly, have largely over-emphasized private equity investing for most of our clients relative to our peers. In fact, some of our clients are approaching 70% of total portfolio allocations to private equity strategies, with the balance invested in absolute return strategies offered via hedge funds. These illiquid-heavy strategies, of course, aren't for everyone and the main criterion to absorb that much illiquidity risk is one must have a longer horizon for actually needing to use the capital.

Notable and very successful asset allocation models such as the Yale endowment started to recognize this as a distinct asset class in 1990, and today Yale's endowment hardly has any exposure to public equities (15%). On top of that, it has 40% in private equity, and 23% in liquid hedged strategies, so a total of 65% in alternatives[5]. Other longer-term endowment models have tried to emulate this asset allocation strategy as well.

Today our approach is similar for clients that are able to capture the illiquidity premium of this asset class. Such an allocation fosters the mentality of investing over speculation. Yes, there are speculative aspects of the private equity industry, but this is where disciplined underwriting and portfolio construction principles have their purpose.

2 TOO MUCH MONEY CHASING TOO FEW DEALS?

One of the headlines pertaining to private equity is the fact that the industry has grown substantially over several decades. I first heard the phrase "too much money chasing too few deals" back in the early 1990s and this often remains a "baited" headline serving a misleading narrative. To understand the role of the private equity industry in the US (and the rest of the world) it is important to have an appreciation of the taxonomy of the US corporate landscape, not just the increasing size of the private equity industry (supply of capital side) which undoubtedly has significantly grown its recognition over time. In the investing market, the first step in assessing a company's or industry's potential is to determine the addressable market.

According to the North American Industry Classification System, there are 18 million registered distinct companies in the US. The majority of these are very small of course, but here is the breakdown: There are 181,000 companies with revenues between $10-100 million, 24,000 with revenues between $100-500 million, 4,174 with revenues between $500 million and $1 billion and 5,334 with revenues exceeding $1 billion.

The universe of companies in the US with revenues greater than $10 million is over 210,000. Of this, only 4,000 are publicly traded which have a combined equity capitalization of approximately $40 trillion. It's difficult to estimate the valuation of the other private companies in total and research is largely dated to 2017, but the estimate is that private company net income was about the same as public company income, so it might be fair to assume that private company stock valuation approaches public company market valuation of $40 trillion.

Putting this into context, the AUM of the private equity industry is about $11.7 trillion and held by 18,000 firms[6], with about $3 trillion of uninvested capital or total dry powder. Most of that dry powder is held by the largest private equity firms such as Blackstone, Carlyle, Apollo etc. So relative to the total addressable market (say $30-40 trillion) the PE industry is not outsized. Of course, many of these companies are less dynamic, slower growing and may not represent good investments. However, we note that the "attractiveness" of an investment is partly a function of the price paid for it, and we maintain that the advantage of private equity stems from the ability to

Source: [5] Pitchbook; [6] McKinsey Global Private Markets Review: Private markets turn down the volume, March 2023

buy assets with legalized inside information (i.e., obtaining real, substantiated projections, deep fundamental analyses, and/or developing one's own financial forecast). These are often set aside by investors in the public markets where it's very difficult to get an edge in fundamental analysis.

Further, however, what gives a particularly enthusiastic outlook for the private equity industry, in addition to the above factors, is something much more structural and demographic in nature. Cerulli Associates, a leading consulting firm in the financial services industry, has published a report highlighting the fact that they expect the total amount of wealth being transferred from baby boomers to their heirs/successors to likely exceed $50 to $65 trillion between 2018 and 2043. The generation of other entrepreneurs that built many of the above 200,000+ companies in the US is coming towards retirement. This wealth and ownership will need to transfer to new owners over the next 20 years and the private equity industry is positioned to provide the liquidity to facilitate that transfer. Therefore, we believe that despite the relative growth of the PE industry over the last 20 years, the next two decades will offer a continued and ample supply of opportunities for the industry.

In conclusion, we believe private equity strategies should play a meaningful role in investors' portfolios who have some capacity to bear the illiquidity risks. Private equity serves the purpose of allocating capital to the best/most useful cases for a society, which is often driven by the entrepreneurs creating and commercializing these important innovations that are advancing the interests of humanity and societies alike. The industry has been a source of superior returns over the last 40 years, and we expect this to continue due to all of the aforementioned factors. Finally, we believe an increasing number of allocators will begin to appreciate the notion that a properly diversified private equity portfolio is a better suited substitute for listed equity allocation, which typically bears weak diversification and with higher systemic risk factor influences.

Respectfully,
David B. Pinkerton
Chief Investment Officer

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Alpha Leonis Partners AG
Zurich, Switzerland

Contact us for more information:
Alpha Leonis Partners AG
Löwenstrasse 28
CH – 8001 Zürich

contact@alphaleonispartners.com
www.alphaleonispartners.com

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