Public vs. Private Investment Opportunities

Gresham believes that the opportunity set for investment in U.S. businesses within public equity markets has declined while the opportunity set in private markets has increased. As a result, we suggest that our clients review their asset allocation policy for the purpose of reassessing their allocations between public and private investment opportunities.

In the public sphere, the raw number of opportunities to invest in individual U.S. companies has declined by about half in the last couple of decades. The decline has been most pronounced among smaller companies which have historically provided a better hunting ground for active management in finding attractive investment opportunities.

In addition to being fewer in number, the remaining opportunity set in public markets consists of larger and older companies. The presence of fewer, larger companies likely equates to more efficient markets which are typically barriers to outperformance.

By contrast, the opportunity set in private markets has expanded dramatically in the last 15+ years with over 7,000 private equity ("PE") sponsored companies currently in existence, and thousands more if one were to include venture capital ("VC"), on which we do not have data. These private investments are overseen by approximately 2,700 PE and VC firms according to a 2017 estimate.

Private markets are not immune to efficiency when large numbers of firms are active but, in our experience, the market for investment in our preferred focus area of smaller to midsize buyouts and VC firms remains attractive from a valuation and growth opportunity standpoint.

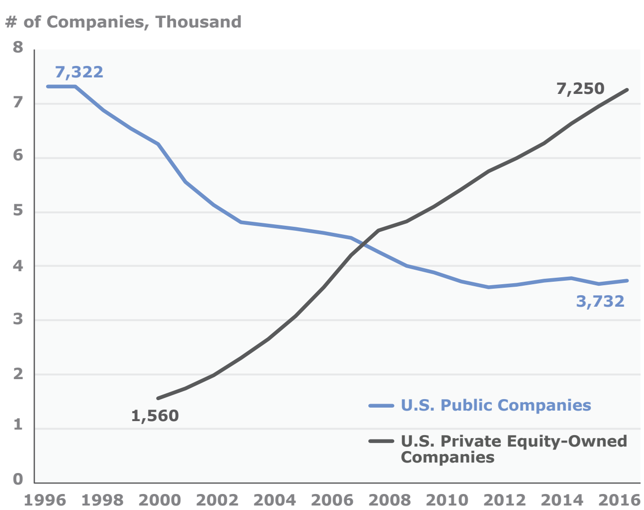
As a point of reference, the PE pooled return index (primarily buyout and growth equity funds) calculated by Cambridge Associates indicates a 25-year investment return from such funds of 13.5% which compares to a return from the S&P 500 of 9.6%, as of September 30, 2017. Further information is provided below on the high return premium from good manager selection in PE compared to other asset classes.

Introduction

A gradual but seismic shift in the opportunity set for investing in promising U.S. businesses between private and public venues has developed and warrants a reassessment of our clients' asset allocation between these areas. The premise of this discussion is that, while other assets will be included in an asset allocation, the heart of the growth component of an asset allocation will be a participation in profitable and growing businesses as a way to grow assets after taxes and inflation over time. The question we are raising is: what is the best way to implement that participation between public and private avenues, and within what limits.

As Chart 1 shows, while the number of listed U.S. public companies has declined by about half over the last 20 years, the number of PE backed privately held companies has

Chart 1. Number of Companies - Public vs. Private Equity



Source: Credit Suisse, Nasdaq and Pitchbook increased by a factor of almost five since 2000. This includes only holdings of PE funds (primarily buyout funds) and the total would be increased by thousands more if VC funds were included.

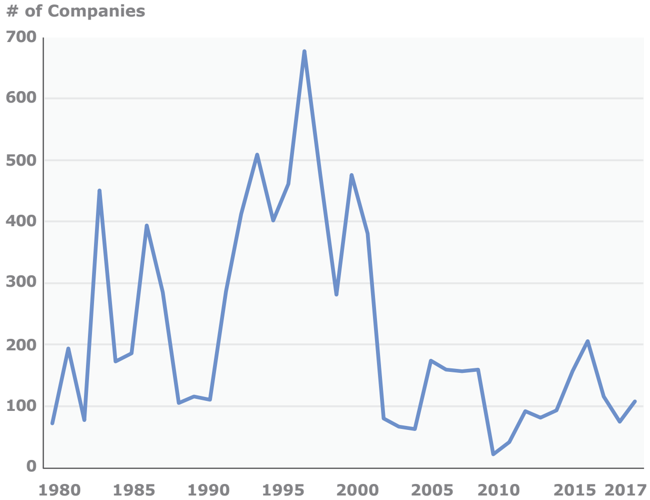
In general, fewer investment options make it harder for investors to find attractive opportunities in the public sphere. At the same time, the large expansion in private markets for investment in private businesses has greatly increased the investment opportunity set for investment in growing businesses by creating an expanded and rapidly growing market for the purchase and sale of private U.S. businesses independent of the public sphere.

As discussed below, a principal cause of this dichotomy between public and private opportunities is diametrically opposed historical regulatory trends, detracting from the desirability of public listing while facilitating the expansion of private opportunities available to sophisticated investors.

Changes in Public Markets

The decline in publicly listed securities has two causes: a dearth of additions and de-listings. Additions come primarily from IPOs, which have declined dramatically, and spinoffs. See Chart 2 for the declining prevalence of IPOs in the last several decades.

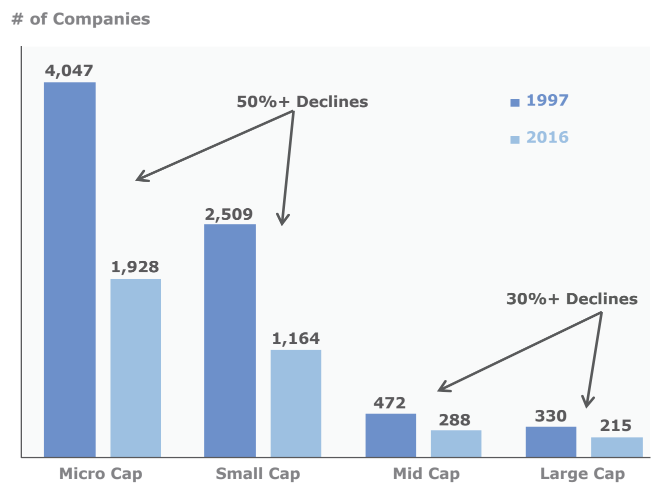
Chart 2. Number of U.S. IPOs by Year: 1980 - 2017



Source: University of Florida

The decline in IPOs reflects the perceived regulatory and other burdens of operating as a public company. The passage of Sarbanes-Oxley in 2002 and the difficulty experienced by managements in executing business plans while under the public microscope, are often cited as the principal causes of this burden. This challenge is most acute for smaller companies and as Chart 3 below shows that the decline in public listings has been most pronounced in smaller companies. Unfortunately, the universe of smaller companies is also where active management has historically found the greatest market inefficiency and the more attractive investment opportunities within the public sphere.

Chart 3. Number of Public Stocks Declined Most Heavily in the Smallest Market Cap Segments



Source: Center for Research in Security Prices

De-listings have occurred primarily due to business failure, M&A and take-private transactions. Increased M&A activity is in part ascribed to a more relaxed U.S. antitrust policy and a greater tolerance among regulators for industry concentration, another regulatory shift. Take-private transactions reflect both PE activity in taking public companies private and voluntary de-listings of companies to escape the regulatory burden on public companies.

Changes in Private Markets

While the decline in public listings and the reasons therefore, including regulatory burdens, have received public attention, there has been little comment on the opposite trend on the private side. Neither the growing opportunity set nor a more conducive regulatory environment on the private side, have received much comment, perhaps because they were occurring very gradually over many years. Here are the major regulatory changes which have facilitated greater investment in private markets.

- In 1979, the DOL revised the "prudent man" rule under ERISA which permitted pension and other retirement plans to invest in PE. While pension fund investing in PE and VC took off slowly, by 1994 it accounted for about half of all funds raised by PE firms.

- In 1996, Congress passed the National Securities Markets Improvement Act which allowed PE firms to avoid cumbersome state "blue sky" laws and to raise funds by simply filing Form D with the SEC. The Act also amended The Investment Company Act to permit up to 500 qualified investors in a limited partnership offering by PE firms, as opposed to the previous 100 investor limit.

- The qualified investor limitation was further increased to 2000 investors by the JOBS Act in 2012.

The need for PE and VC funds to publicly list their companies to obtain liquidity has also diminished as measures to achieve liquidity for investors have evolved within private markets themselves. The growth of late stage financing within VC and the trend within PE to sell to other, usually larger, PE firms means that privately held companies in the PE and VC universe may stay private longer and may never reach a public listing. Instead, they may be ultimately absorbed into a larger, possibly public, company down the line. As an example, in 2017 there were 44 PE backed IPOs compared to 1,179 PE backed exits. While there is some double counting in situations where one PE firm buys a company from another PE firm, the overall result is that PE and VC investments increasingly stay private longer than was the case years ago. The result is that more of the value creation process is occurring in the private sphere and less in the public sphere, especially for mid to smaller sized companies. As a result, we have seen hedge funds and some mutual funds invest a portion of their portfolios in these illiquid, private investments.

While the universe of privately-owned companies held by PE and VC firms is already large, the trend toward greater investment opportunity in the private sphere has plenty of room to continue expanding. There are about 176,000 private businesses in the U.S. with revenues in the range $10-$50 million, the range in which many of our current buyout and growth equity managers seek opportunity. While many of these businesses will die out or are unworthy of investment, a significant number of the remainder will experience generational changes or other developments that can lead to a sale and create an opportunity for a PE firm and its investors.

Finally, we should note that low interest rates and accommodative lending conditions prevalent in recent years have undoubtedly boosted PE returns and have likely facilitated the interest in and growth of the large buyout fund sector within the PE industry. The potential for tighter monetary policy and higher interest rates may result in more of a headwind for buyout funds than has been the case in recent years.

Investor Liquidity

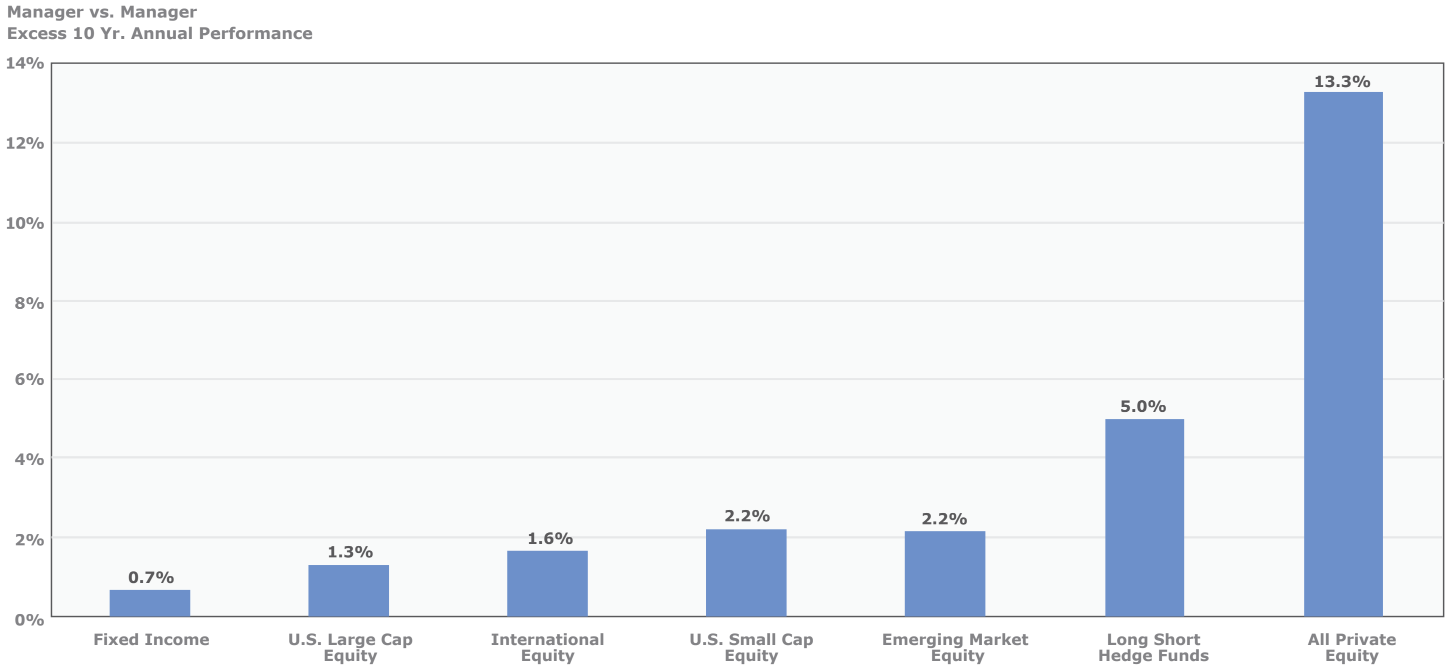
For individual investors such as our clients, the primary limitation to private market investments such as PE has always been the lack of liquidity over long periods and the inability to predict the timing of capital calls and distributions. Moreover, the tendency of PE and VC firms in recent years has been to hold investments longer in private form before achieving liquidity. Whereas historically an investor might have expected full liquidity from a given PE fund within 10-12 years, PE firms have been taking longer to liquidate investments which they feel have significant further upside.

Private Equity Performance

The PE pooled return index (primarily buyout and growth equity funds) calculated by Cambridge Associates indicates a 25-year investment return from such funds of 13.5%, which compares to a return from the S&P 500 of 9.6%, as of September 30, 2017.

Manager selection is at a usually high premium in PE as compared to other asset classes. As Chart 4 below shows the top quartile PE managers outperformed bottom quartile managers by over 13% per year during the 10 years illustrated. The performance premium in all other asset classes was much smaller.

Chart 4. Excess Performance of Top Quartile vs. Bottom Quartile Manager



As of 12/31/16. Excess performance for each asset class consists of the manager at the 25th percentile vs. the manager at the 75th percentile. Private equity data is through 9/30/16.
Sources: Morningstar SMA Database, Barclays Capital, Russell Investments, Morgan Stanley, Hedge Fund Research, Inc., Cambridge Associates

Disclosure

Past performance is no guarantee of future results.

Additional information about Gresham and its services can be found at www.greshampartners.com.