Do Vintages Matter?

February 15, 2024

A common research mistake in alternatives is to conflate what is knowable (= the past) with what is not knowable (= the future). Let's consider private markets vintages:

- *Investors cannot know what the returns of future vintages will be;*
- *Investors do know what the realized returns of long past vintages were (whose investments have been realized); and*
- *Investors can (and do) spend time diligencing the financial performance of portfolio companies of recent past vintages.*

Consider Two Choices

Choice #1: Pretend you are back in 2010, and you have the choice of buying at NAV a portfolio of 2007 vintage private equity buyout investments, or a portfolio of 2010 buyout investments. The 2007 deals were probably underwritten to very different financial assumptions than the 2010 deals.

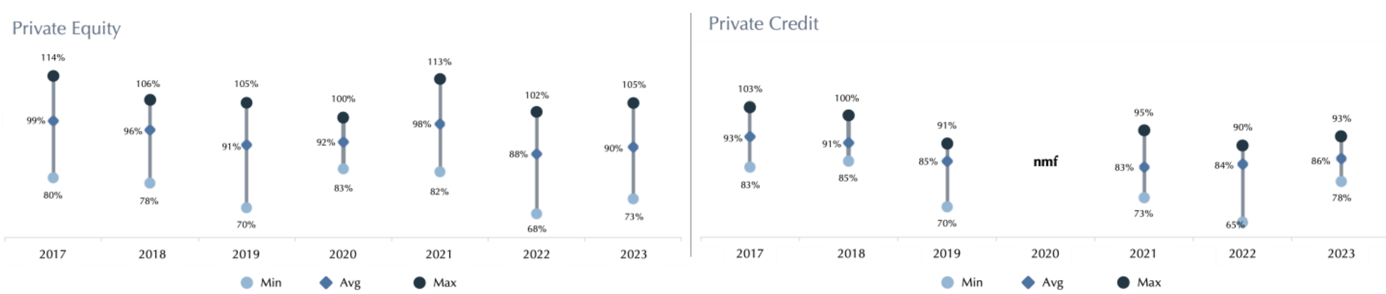
Choice #2: Today, what if you have the choice of buying at NAV a portfolio of 2021 vintage direct lending loans, or a portfolio of 2023 loans. The 2021 vintage loans were probably underwritten to much lower interest costs assumptions than the 2023 loans (SOFR base rates have risen from 0.05% in March 2022 to 5.32% in February 2024[1]).

For these two questions - if you would choose the more recent vintage, then you are de facto saying that vintages do matter.

It's also easy to show that past vintages matter by looking at the secondaries market for non-redeemable private markets funds. Secondaries are a big market, with annual volume reaching $112 billion[2] in 2023. Prices are quoted as a discount or premium to the most recent fund NAV. For secondaries on funds which are past their investment period (typically funds older than 3 years), there is a wide dispersion of transacted prices. Secondaries buyers place a lot of importance on vintage year and (if available) portfolio company financial information (else the entire secondaries market for past vintage funds would trade near 100% of NAV).

Secondaries market price dispersion

Secondaries transacted prices PE & PC private funds 3-7yrs old



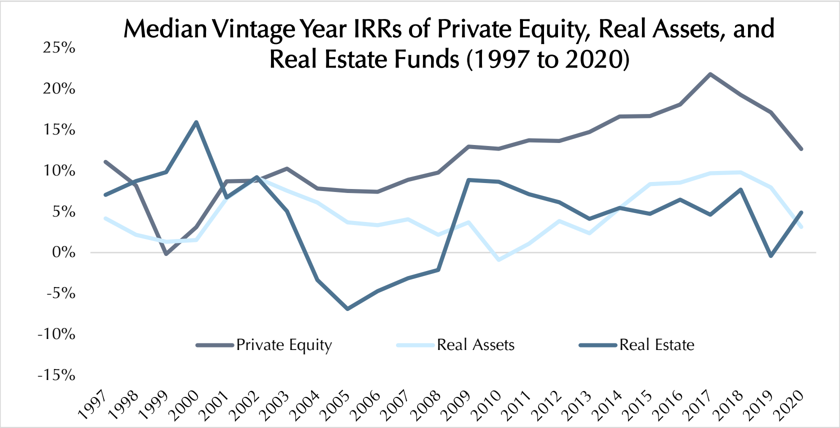
Source: Jefferies closed transactions

[1] Federal Reserve Bank of New York (https://www.newyorkfed.org/markets/reference-rates/sofr)
[2] Jefferies (Global Secondary Market Review: January 2024)

Vintage Diversification

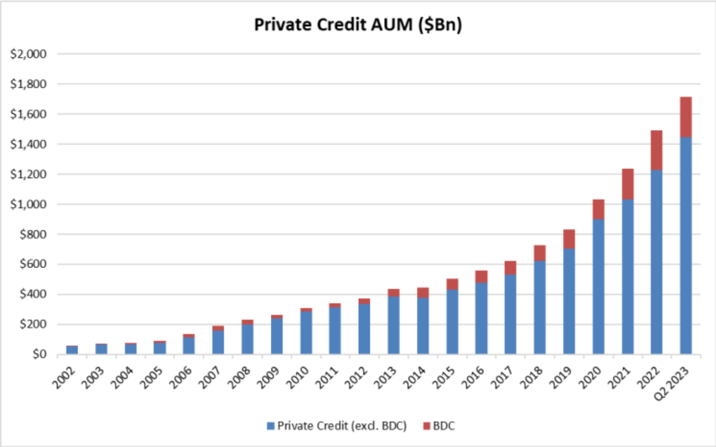
Would you invest all your assets in one market sector or in one investment manager? Probably not. Diversification is one of the few freebees that the market offers, because it allows investors to lower expected risk without lowering expected returns. As Harry Markowitz once said, "diversification is the only free lunch."

The below chart illustrates vintage dispersion across the private funds market with respect to the older private markets asset classes (PE/RA/RE).



Source: Private Equity: Cambridge Associates for Buyout, Control-Oriented Distressed, Venture Capital, & Growth Equity as of June 30, 2023; Real Assets: Cambridge Associates for Infrastructure, Private Equity Energy, Timber, Upstream Energy & Royalties as of June 30, 2023; Real Estate: Cambridge Associates for Real Estate as of June 30, 2023. Past performance is not indicative of future results.

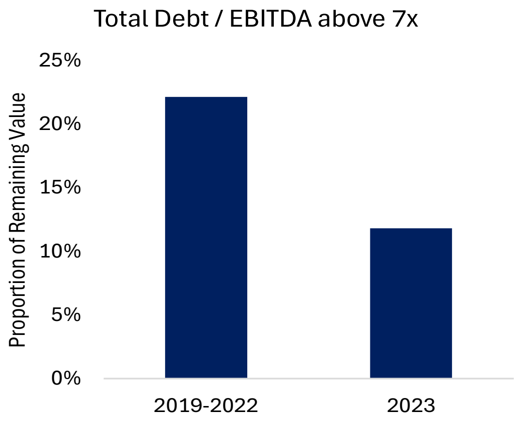
Private Credit (of which Direct Lending is the largest sector) is harder to study because these funds only really existed post 2010. Before 2008, lending to middle market companies overwhelmingly came from banks and finance companies, with only a small portion coming from BDCs. The modern private credit industry has never gone through a recession or credit cycle, having grown up in an era of ultra-low interest rates and consequently lower interest costs for companies – at least until the Fed began ratcheting up interest rates in March 2022.



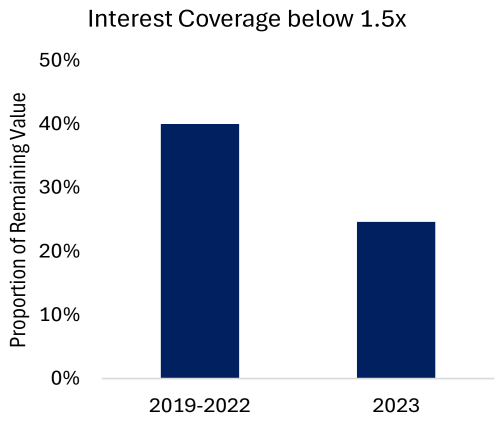
Sources: As of Q2 2023, retrieved on January 26, 2024. Preqin, Refinitiv, and Houlihan Lokey.

Higher interest rates have resulted in higher interest costs for middle-market borrowers. Aksia's private companies database includes accounting level information on over 1,750 private equity owned middle-market companies. What it shows is that, on average, companies that took out their loans before the rise in interest rates (older vintages) today exhibit worse financial metrics than companies whose loans were taken out after the rise in interest rates (most recent vintage).

Aksia



Source: Aksia



Source: Aksia

OK…if past vintages are not all equal, can an investor predict the relative performance of future vintages? Aksia advises on over $300 billion of alternative allocations for institutions as of November 30, 2023. Our opinion, which we believe is shared by most institutional investors, is that trying to time future vintages is a coin toss (expected alpha of zero). But it's hard to prove this. It is tempting to try to find a proxy for the performance of forward looking private markets "vintage timing" by comparing the returns of an "opportunistic" strategy to a "non-opportunistic" strategy. Unfortunately, these tend to be apples to washing machines comparisons (e.g., Cambridge Credit Opportunities Index is a collection of NPL's, distressed debt, structured finance and esoteric niche strategies – hardly vintage timing and not comparable to senior debt strategies).

How Investors with Existing Private Markets Investments Manage Vintages

Most institutional investors use pacing models to maintain a balance between their required cash outflows (to fund capital calls from private markets funds) and their cash inflows (cash distributions from previously invested private markets funds). They can do this because they have mature private markets portfolios, and they are long term investors.

The accepted rule of thumb is that pacing should be steady because it's impossible to know the future. A constant dollar amount (not percentage of portfolio) each year is the goal for most institutions.

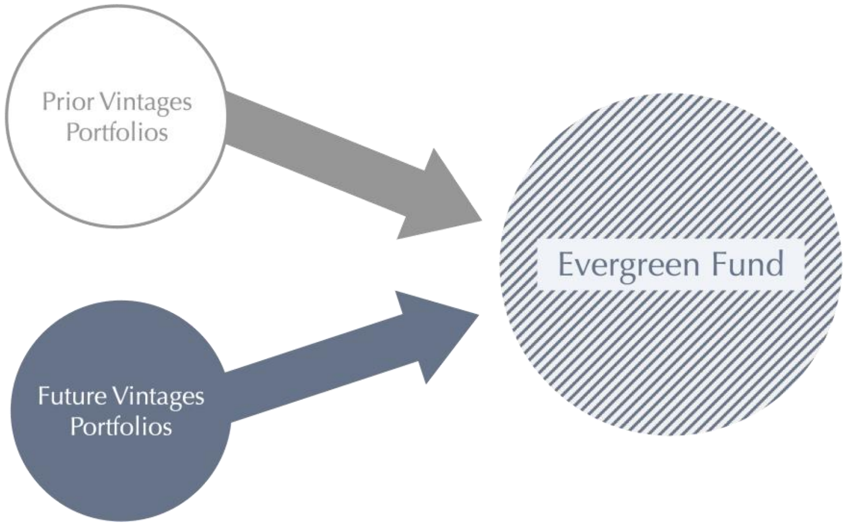
How a New Allocator to Private Markets Can Manage Vintages

If an investor is allocating to private markets for the first time, a sensible approach is to use some combination of the below:

- Allocations to traditional private markets funds (non-redeemable capital commitment funds);
- Allocations to secondaries (which can offer instant prior vintage diversification);
- Co-investments (no delay – money invested now); and
- Evergreen funds (see below).

Evergreen funds are a new'ish tool for investors, typically offering immediate investment, no future capital calls, no cashflow reinvestment work, and either periodic limited redemption liquidity or segregation into a runoff share class for redeemers.

An investor should conceptualize a new investment into an Evergreen fund as the sum of two separate portfolios:



Prior Vintages Portfolio diligence is similar to what a secondary funds buyer needs to do. Regardless of manager marks (and resulting fund NAV), investors should consider the vintages represented in the portfolio and the financial performance of the underlying portfolio companies.

Future Vintages Portfolio diligence is traditional manager and fund due diligence, but don't let anyone fool you by saying that you can easily pick what will be the best performing funds in the future. The wide past dispersions in private markets fund returns are the reality of an industry without benchmark hugging behavior. Some of the dispersion is skill, some is luck, and some is economic-cycle related.

Conclusion

Yogi Berra once said, "When you come to a fork in the road, take it."

In today's market, investors have an increasingly robust array of tools at their disposal for building and maintaining private markets portfolio allocations. As Yogi's quote may suggest, these approaches do not need to be mutually exclusive. The key is to ensure that whatever path an investor chooses to follow, the decision is driven by a thoughtful consideration of what is knowable (the past) and a humble approach to what is unknowable (the future).

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