IAPF ANNUAL INVESTMENT CONFERENCE 2019

'Evolution'

AVIVA INVESTORS

Capital formation
The evolving role of public and private markets

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CAPITAL FORMATION
THE EVOLVING ROLE OF PUBLIC AND PRIVATE MARKETS

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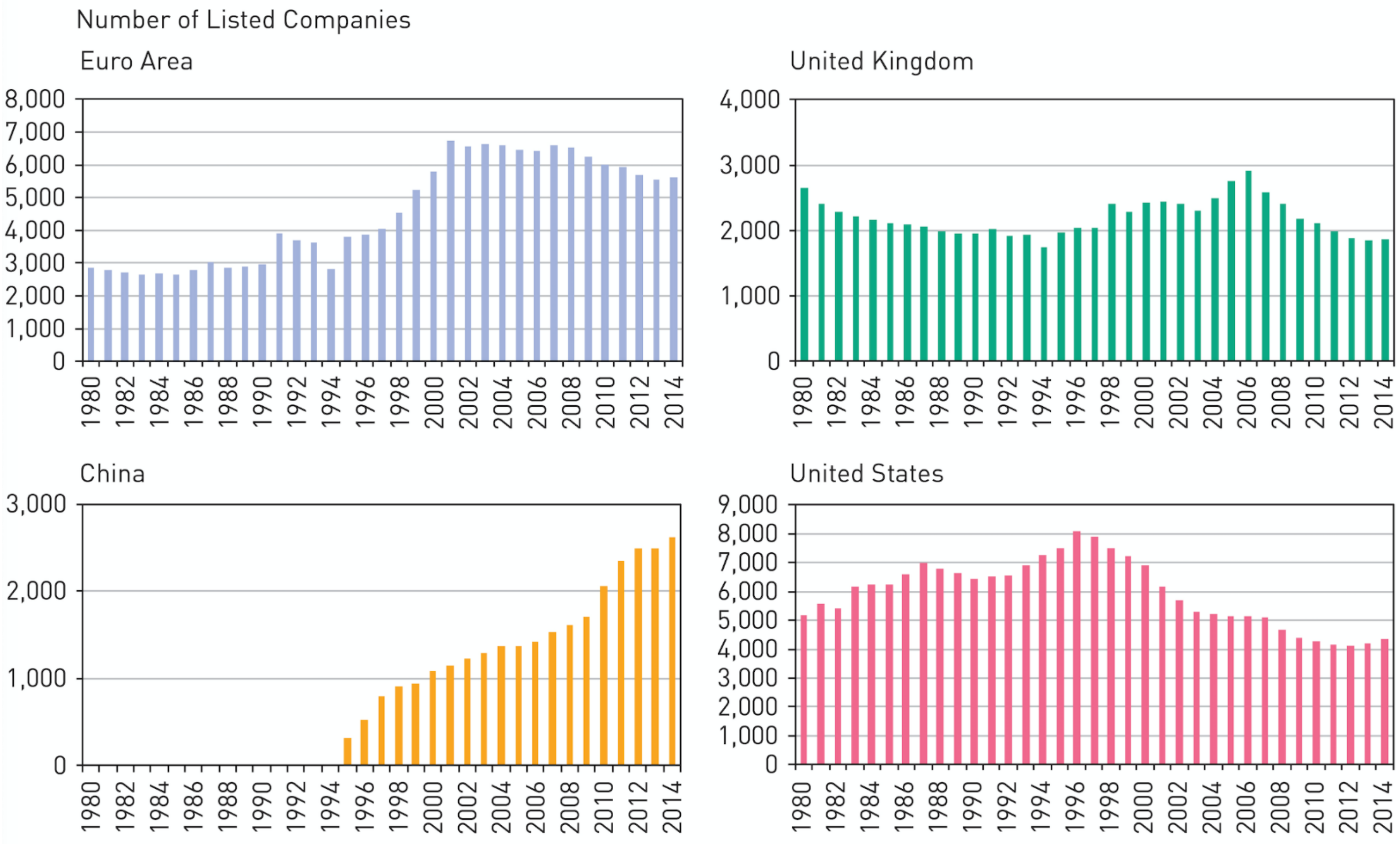
BACKGROUND TO THE REPORT

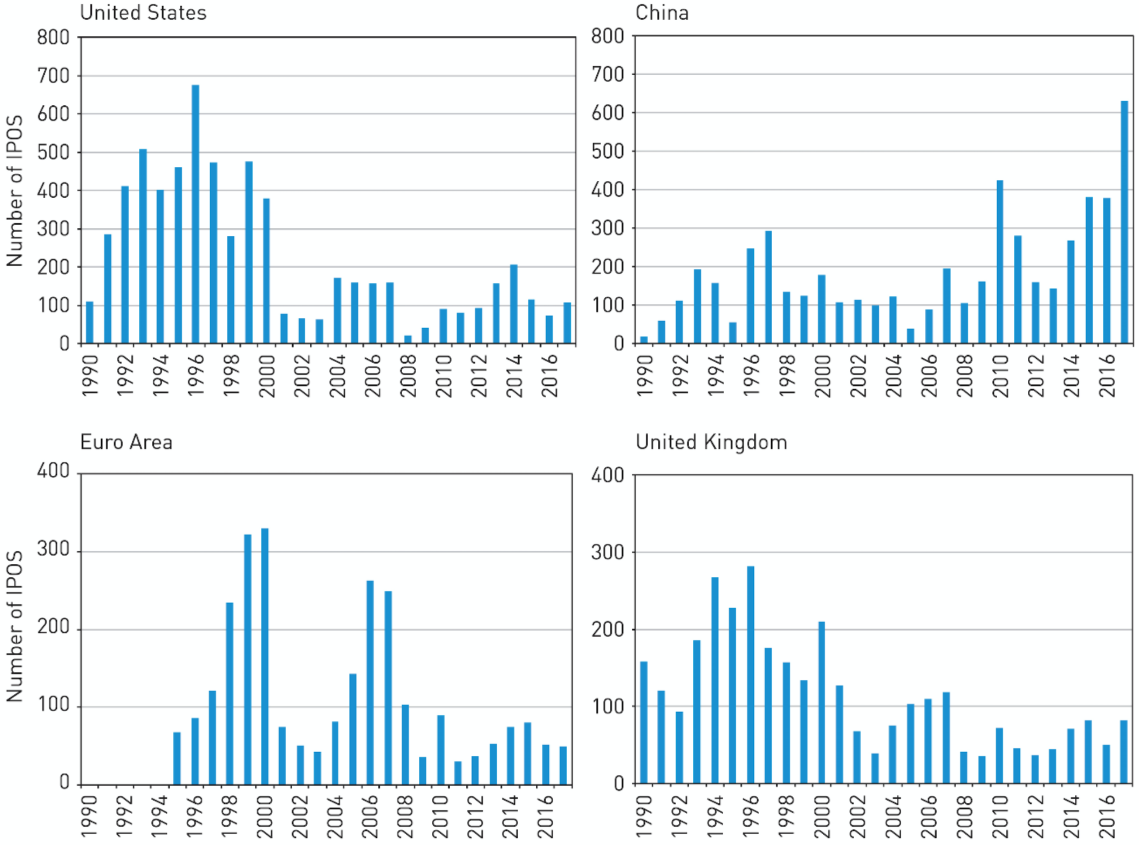
Some motivational slides.

THE NUMBER OF PUBLICLY LISTED COMPANIES IN DEVELOPED MARKETS HAS BEEN DECLINING SINCE THE 90s, PARTICULARLY IN THE US. CHINA IS THE OBVIOUS EXCEPTION.



Source: World Bank, CFA Institute analysis.

THIS IS BEING DRIVEN BOTH BY A DECLINE IN IPOS IN DEVELOPED MARKETS…



Source: PwC, Jay Ritter, FESE, LSE Group, WFE, CFA Institute analysis.

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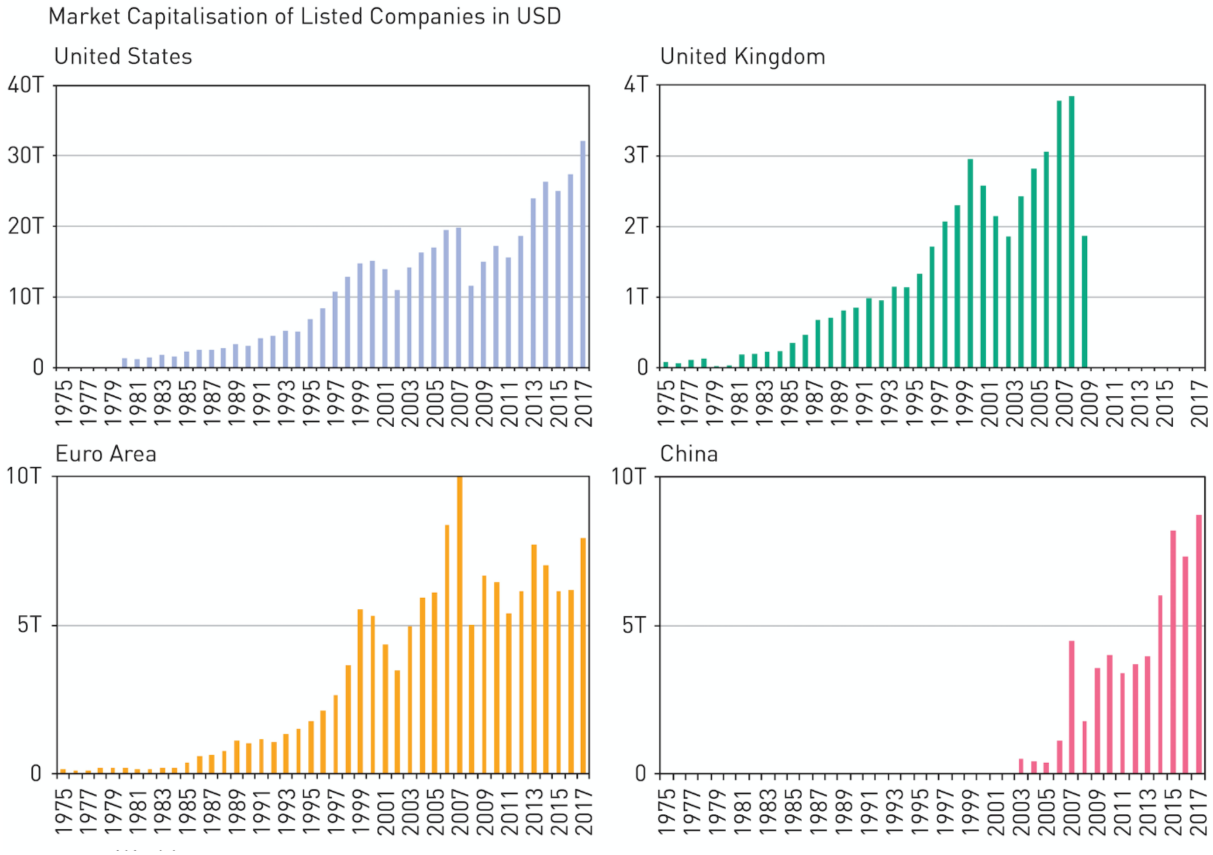
…AS WELL AS M&A ACTIVITY CAUSING REMAINING PUBLICLY LISTED FIRMS TO GROW LARGER…



Source: World Bank, CFA Institute analysis.

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THE DECLINE OF PUBLIC MARKETS?

Why? Should we care?

THE DECLINE IN IPOS IS MAY BE CONCERNING FOR A NUMBER OF REASONS.

Relevance of equity markets

- Listed markets could become overexposed to older industries and underexposed to growth industries. This may affect their usefulness as a benchmark for determining risk premia.

Savers shut out of growth

- Average savers, who depend on investment returns for retirement savings, may be disadvantaged because only large funds and entities can efficiently invest in illiquid sectors such as private equity or infrastructure.

Opaque investments

- The information asymmetry outside of public markets may cause investors to be locked into poorly performing assets over extended periods, without a liquid secondary market that could be used for price discovery.

To explore this issue further, we organized member and practitioner workshops to solicit further input – Hong Kong, Abu Dhabi, Dubai, London, New York, and Washington DC.

THERE ARE SEVERAL FACTORS IMPACTING THE HEALTH OF CAPITAL FORMATION ON PUBLIC MARKETS.

New business models: asset light, intangibles heavy

- Industrial design and product manufacturing can increasingly be outsourced.
- Back-office functions can increasingly be outsourced.
- The key assets become intellectual property.
- As a result, bulk capital is not a prerequisite for growth to the same extent as before.
- Public markets are not perfectly suited to correctly-value intangible assets.

Public market structure discourages small IPOs

- Reg NMS MiFID, algorithmic trading, online brokering have resulted in cheaper and faster trading for investors… as long as the underlying is liquid.
- Increasing focus on fees and value for money drives growth in passive investment indexing, which reduces interest in small IPOs.
- Retreat of investment banks from market making + large scale of modern active managers makes small IPOs unattractive for market intermediaries.

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THERE ARE SEVERAL FACTORS IMPACTING THE HEALTH OF CAPITAL FORMATION ON PUBLIC MARKETS.

Regulatory changes

- Common complaint that regulations are driving away IPOs do not seem to be true. Delistings mainly caused by mergers, firms do not typically delist to go private.
- Special regimes for small firms (e.g. SO exemptions JOBS Act) seem to have no effect.
- It would be easier if regulations were the problem!
- Rather, deregulation of private markets appears to have jump-started the trend away from public markets.

Private funding options have increased.

- Private markets have become deeper in the post-crisis, low-interest rate environment.
- Institutional investors are searching for higher yields, with the illiquidity premium and information asymmetry in private markets suggesting higher expected returns.
- This has given entrepreneurs more options when growing their firms, large amounts of capital can be raised without public markets.

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THERE ARE SEVERAL FACTORS IMPACTING THE HEALTH OF CAPITAL FORMATION ON PUBLIC MARKETS.

New business models:
asset light, intangibles heavy

Public market structure discourages small IPOs

The eclipse of the public corporation?

Regulatory changes

Private funding options have increased.

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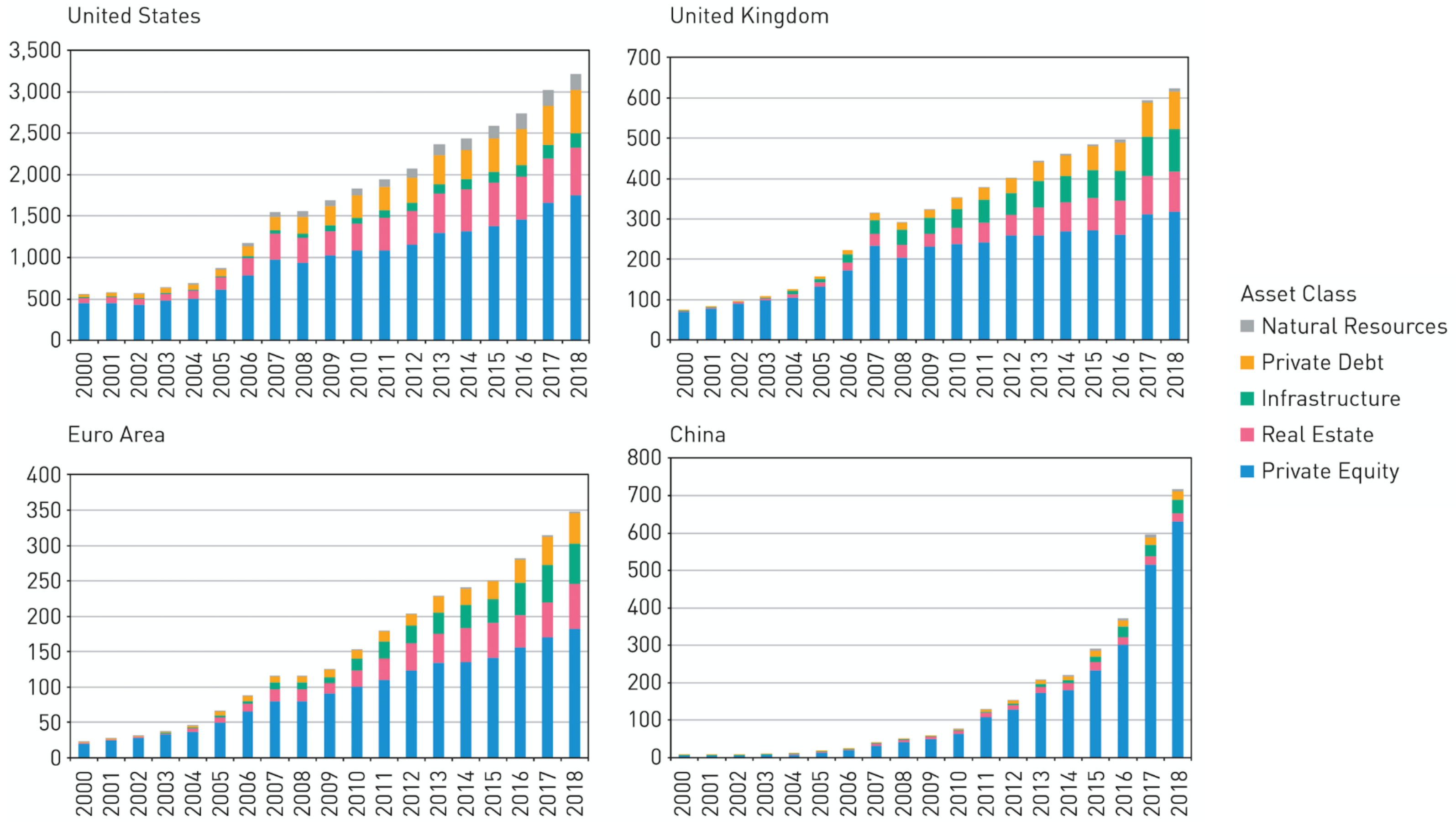
THE GROWTH OF PRIVATE MARKETS

A success story. For now?

PRIVATE MARKET AUM IS MOSTLY DEPLOYED INTO PRIVATE EQUITY AND REAL ESTATE INVESTMENTS…



Source: Preqin,
CFA Institute analysis.

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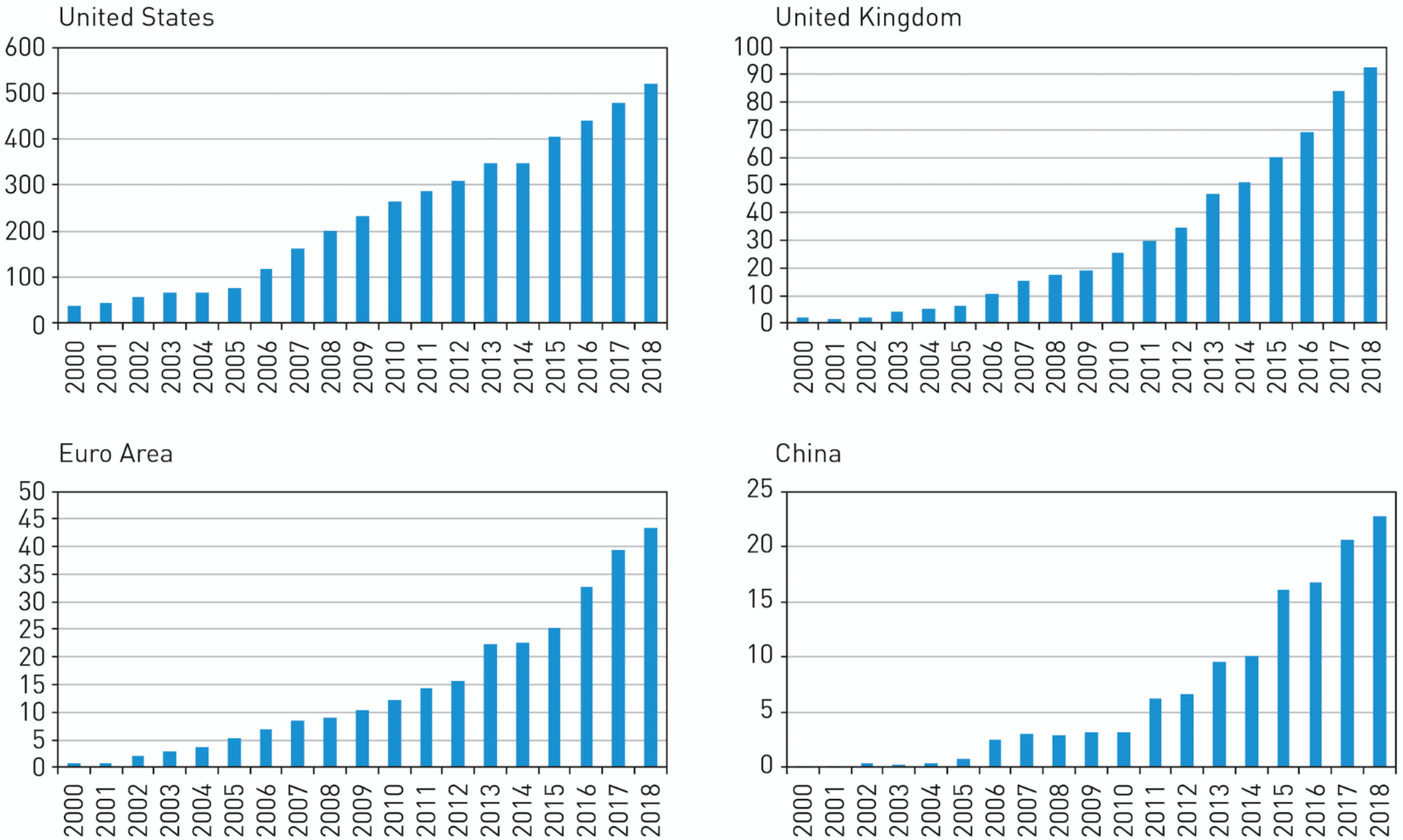
…ALTHOUGH PRIVATE DEBT MARKETS ARE GROWING RAPIDLY AS BANKS EXIT CORPORATE LENDING POST-CRISIS.



Source: Preqin,
CFA Institute analysis.

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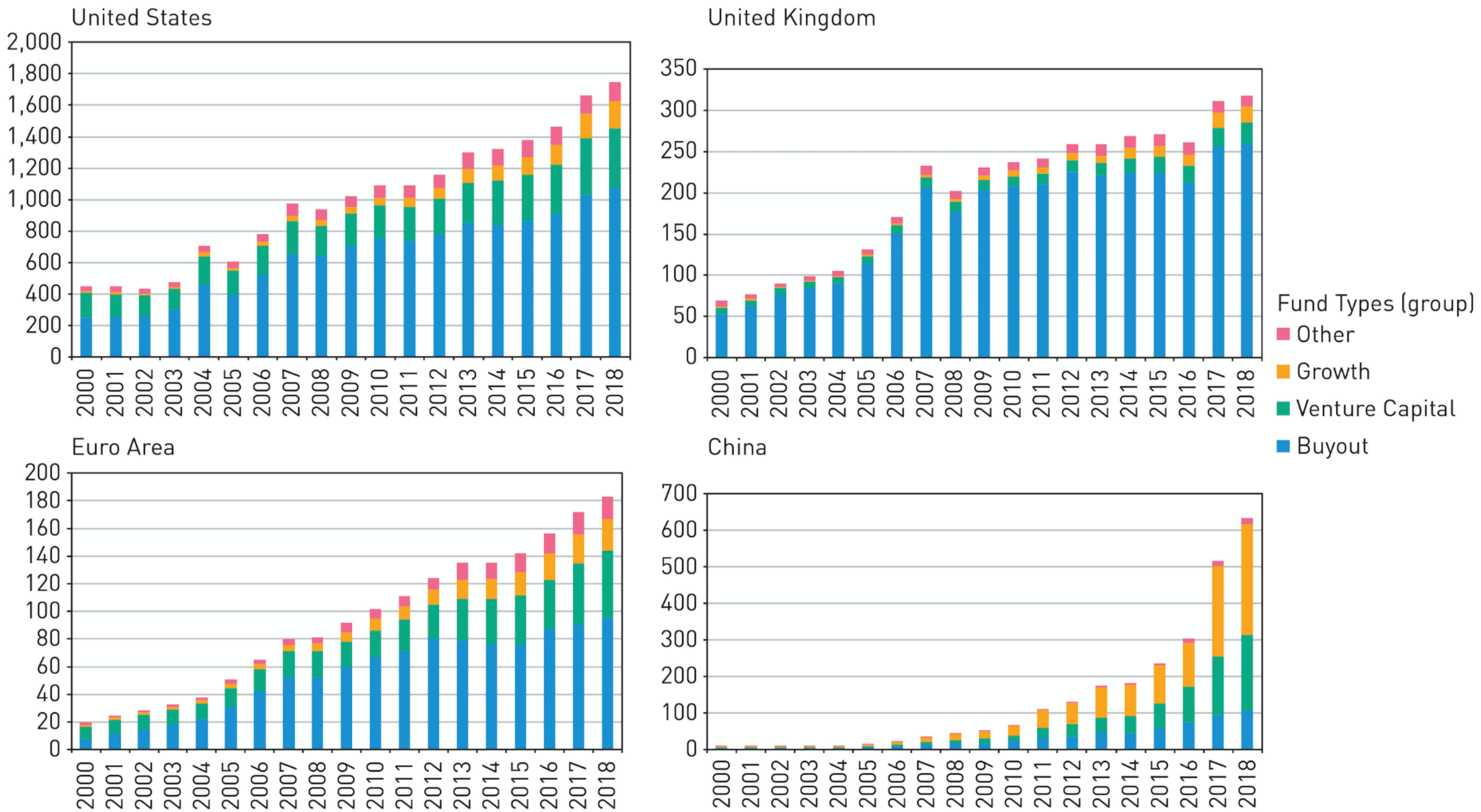
WITHIN PRIVATE EQUITY, MOST AUM IS DEPLOYED INTO BUYOUT AND VENTURE CAPITAL FUNDS.



Source: Preqin,
CFA Institute analysis.

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PRIVATE MARKET PERFORMANCE IS NOT GUARANTEED

Buyout

- US buyout funds have outperformed public equities in almost all vintage years before 2006, usually by about 3% to 4% annually.
- Between 2006 and 2014, their performance has been roughly equal to public markets in the United States, although it should be noted that this is during a long-running US bull market in equities.

Venture capital

- Venture capital funds of 1990s vintage did well, those of 2000s vintage have generally underperformed, while a rebound in outperformance can be observed in the most recent vintages.
- However, venture capital fund returns exhibit a high concentration of performance in a relatively few winners—having top-quartile fund exposure is critical.

BUYOUT FUNDS AND VC HAVE OUTPERFORMED THEIR BENCHMARKS BUT PERFORMANCE OF VC FUNDS IS DEPENDENT ON MANAGER ABILITY. PERSISTENCE IN BOTH TYPES OF FUNDS IS LOW.

Source: Preqin, CFA Institute analysis.

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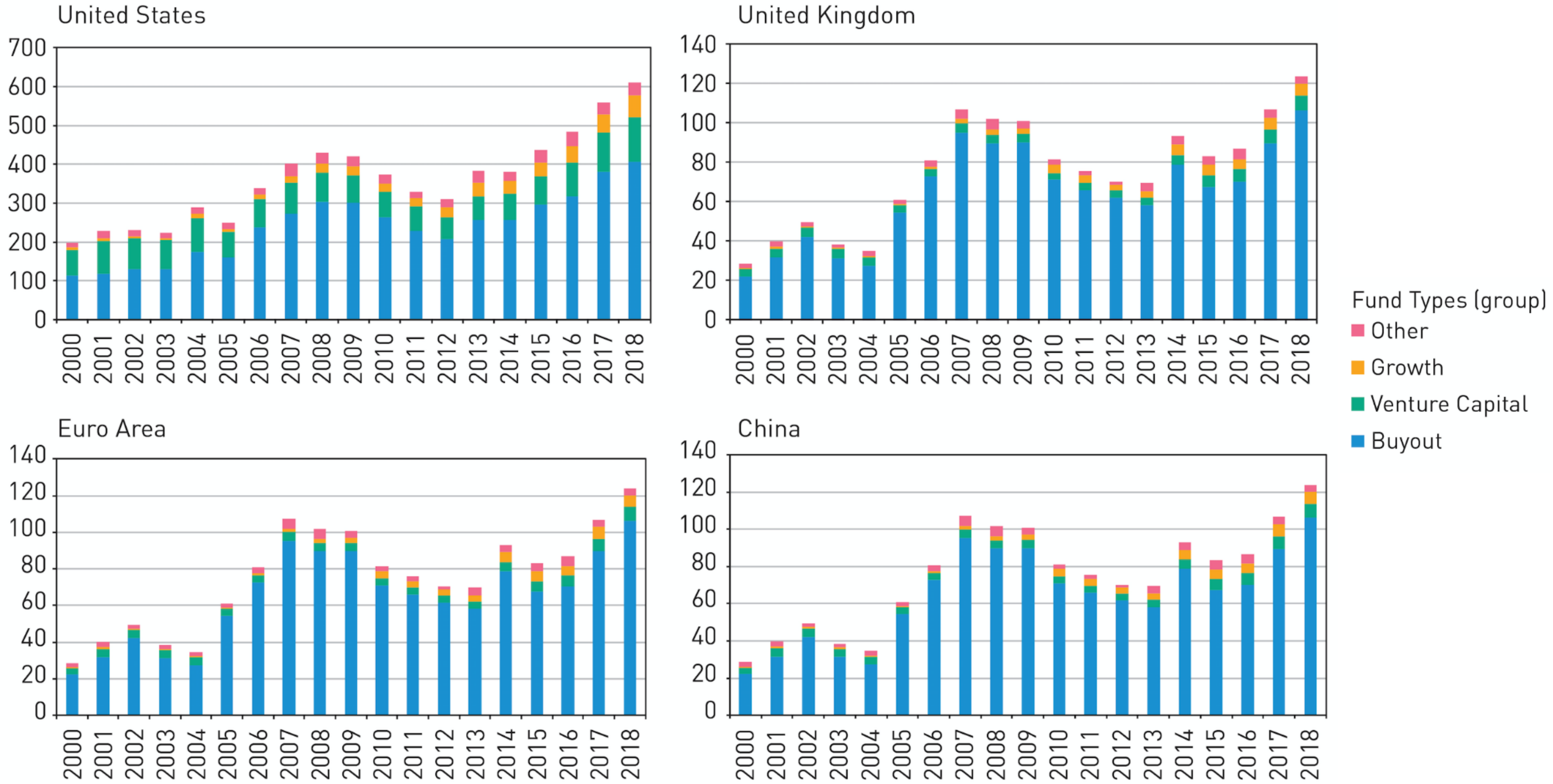
A SIGNIFICANT ISSUE FACED BY PE FUNDS IS THE DIFFICULTY OF DEPLOYING COMMITTED CAPITAL – DRY POWDER HAS BEEN RISING IN THE INDUSTRY AND DEAL VALUATIONS ARE FOLLOWING.



Source: Preqin,
CFA Institute analysis.

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POLICY RECOMMENDATIONS

Avoid a race to the bottom

- Regulators should avoid lowering disclosure standards and investor protections in a bid to encourage IPOs, these are unlikely to be causing the decline in the number of publicly listed firms.

Systemic implications

- We propose that bodies such as the FSOC examine the systemic implications of growing private market exposure among politically-sensitive institutional investors such as pension funds.

Improve access to private markets

- A responsible and professional approach to giving savers access to private market investments should help to maintain broad-based support for capital markets.

TO MINIMISE UNINTENDED CONSEQUENCES, SOME THINGS TO CONSIDER BEFORE JUMPING INTO PRIVATE MARKETS.

Daily liquidity is not a right

- Although daily liquidity is not a legal requirement, this norm has developed to process contributions transfers promptly.
- Expectations of daily liquidity should be discouraged in private market investments.

Illiquidity premium no more?

- Diversification and the illiquidity premium are typically presented as motives for investing in private markets.
- But the illiquidity premium can, and possibly has been, bid-away by excess demand for investments.

You get what you pay for

- Regulator push for ‘value for money’ typically means lower costs - little faith that the product offering can be improved?
- A more positive attitude is necessary for savers to have access to private markets.

Private markets are here to stay. Retirement savers can and should participate, but there needs to be a different mindset on behalf of all stakeholders compared to listed securities.

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THANK YOU

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