HSBC Asset Management

The Importance of Manager Selection

March 2024

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The importance of manager selection

Across private markets, there is optimism and some positivity as we progress through 2024. After a period in which rates were increased at their fastest pace in decades[1], it is likely that we will see rates begin to fall this year. As at the end of March, the Fed were still predicting there would be three rate cuts during 2024[2]. While there is still some uncertainty as to when cuts will begin[3], due to inflation remaining stubbornly high and growth remaining solid, a clearer picture is emerging.

As we have said before, investors like clarity[4]. In our view, 2024 could be a year where investors get the clarity they need to make investment decisions. We are likely to see greater clarity around the macro-outlook and this could provide conditions for recent fund vintages to potentially be good performers. Should it evolve this way, investors might be able to take advantage of lower asset prices in some markets, balance sheet restructuring and discounts in secondary markets. Already, there are signs that activity could be bottoming out in some markets and accelerating in others.

Solid fundraising in 2023

After hitting a peak in 2021, fundraising markets weakened in 2022. This was then followed by a mixed performance across fundraising markets in 2023. However, when we look at private equity specifically, the amount of capital raised was down just 1.1%, compared to 2022. During 2023, private equity funds raised $554bn, compared to $560.7bn in 2022. These figures are likely to increase quite significantly over time, as more data is added. To provide an indication of how much initial data can change, at this time last year Pitchbook reported that private capital fundraising in 2022 was at $1.16tn. Now they show a fundraising total of $1.5tn – a 27% increase for 2022[5].

Because fund closings for established managers are more likely to show up immediately in public sources, the largest funds are usually in the initial pull of data. Meanwhile, smaller funds take longer to surface. A similar pattern emerges in the number of funds closed, with the 2022 number more than doubling over time, as more data was collected.

Assuming the 2023 numbers grow similarly that witnessed in previous years, across private capital markets, we could expect the actual 2023 total fundraising figure to reach around $1.5tn, or roughly the same as 2022's total. Despite all this, we are still unlikely to challenge 2021 in the short-term. These important nuances in the data point to why initial figures tend to understate the real level of activity within fundraising markets, giving up cause for some optimism that the market is still relatively healthy.

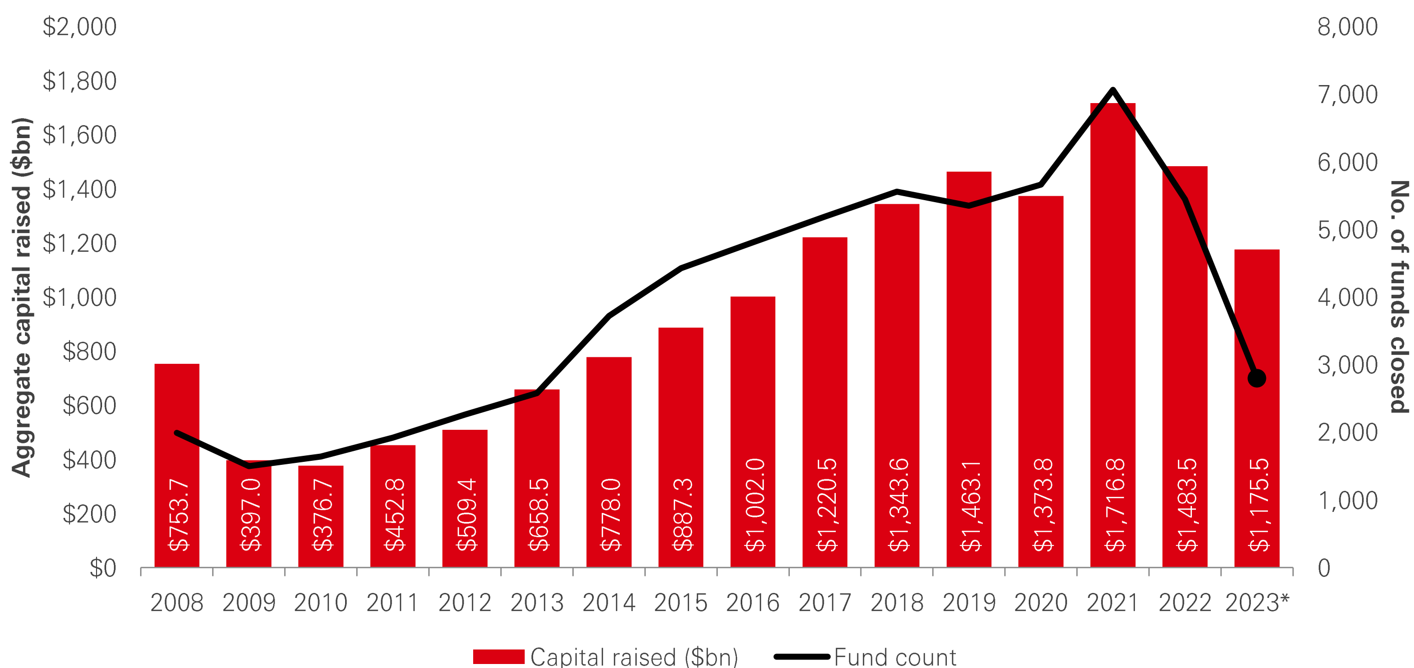
Any forecast, projection or target when provided is indicative only and is not guaranteed in any way.

1. Federal Funds Effective Rate (FEDFUNDS) | FRED | St. Louis Fed (stlouisfed.org) as of March 2024.
2. Fed Meeting March 2024: Key Takeaways From Rate Decision and Updated Forecasts– Bloomberg as of March 2024.
3. Fed to cut US rates in June, risks skewed towards later move: Reuters poll | Reuters as of February 2024.
4. Why alternatives are still relevant (hsbc.co.uk) as of February 2024.
5. Pitchbook, data as of March 2024

However, when breaking down the data among asset classes, it is clear that some experienced a tougher market than others. While private equity fundraising was solid, secondaries funds were in demand, raising 65.1% more capital in 2023 than in 2022. That said, this was from a fairly low base. The biggest losers were venture capital, which was off 47.3%, and real estate, which closed on 41.9% less capital. In reality, while fundraising markets are relatively solid overall, it is likely that we will head back towards the trajectory we were on pre-pandemic, with 2021 an outlier.

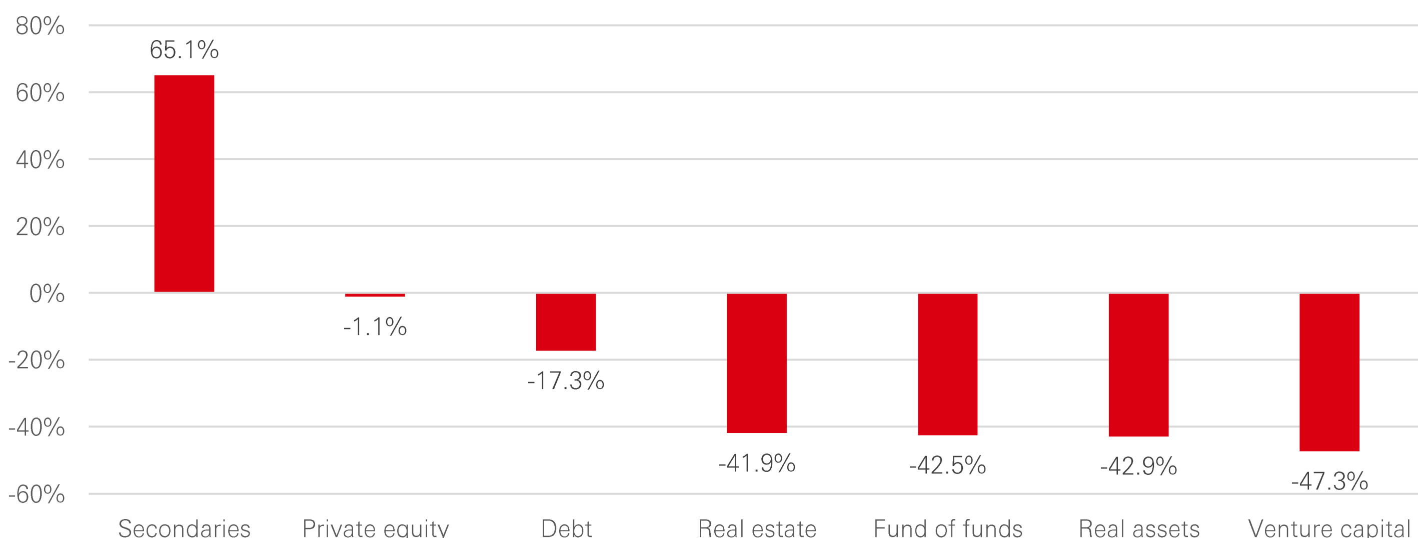
Capital concentration is a theme which has been discussed within private markets for some time. There was further evidence of this in 2023. The largest managers and funds continued to dominate. Within private equity markets, for example, the average size of global buyout funds topped $1.2bn – an increase of 83% on 2022 and a record high.

Annual private capital fundraising



Source: Pitchbook, data as of March 2024

Fundraising ($ capital raised): YoY change – 2023 vs 2022



Source: Pitchbook, data as of March 2024

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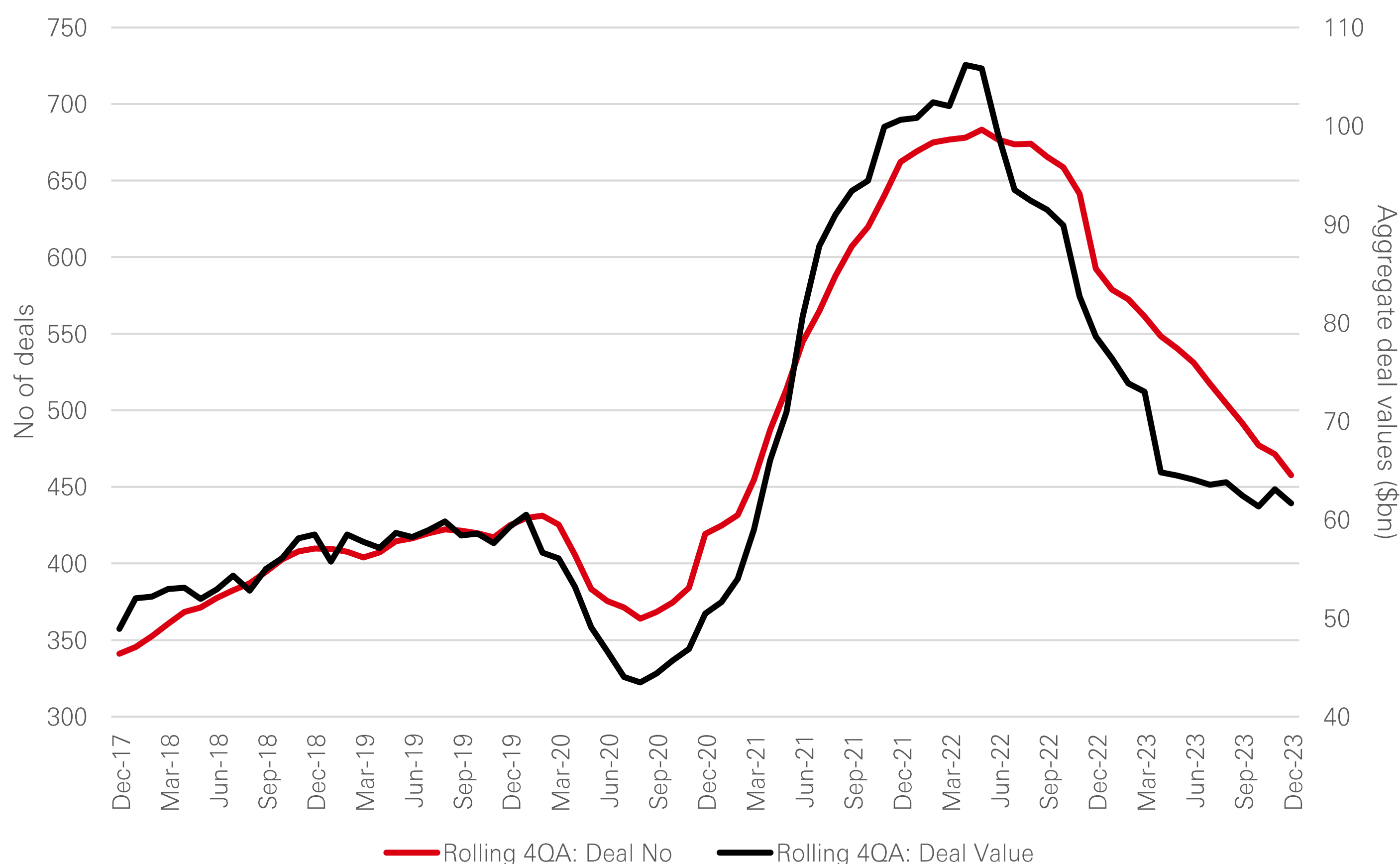
Private equity deal activity levelling off

While headlines often focus on the decline in buyout deal numbers and values since 2022, levels are not vastly different to those prior to the onset of the pandemic. At that point, activity was solid and on an upward path. In our view, given the well-known headwinds to activity since interest rates began to increase, it's not surprising to see deal numbers and values have fallen. On a rolling four-quarter average basis, we can see deal values levelled off towards the end of 2023. While deal numbers continued to decline, this points to a smaller number of higher value deals. In our view, this shows that private equity firms are targeting more established companies, which may be able to provide some downside protection and upside potential.

One way to see the impacts of higher interest rates on private equity deal activity is through equity contributions to buyout deals. Data shows equity contributions rising to levels not seen in many years. GPs (fund managers) are making larger equity contributions, given the higher cost and reduced availability of debt financing. There are already some signs of debt availability increasing and costs falling but when interest rates begin to fall in earnest, we may see activity increase further[6].

US PE deal activity: rolling 4QA (monthly data)



Source: Pitchbook, data as of March 2024

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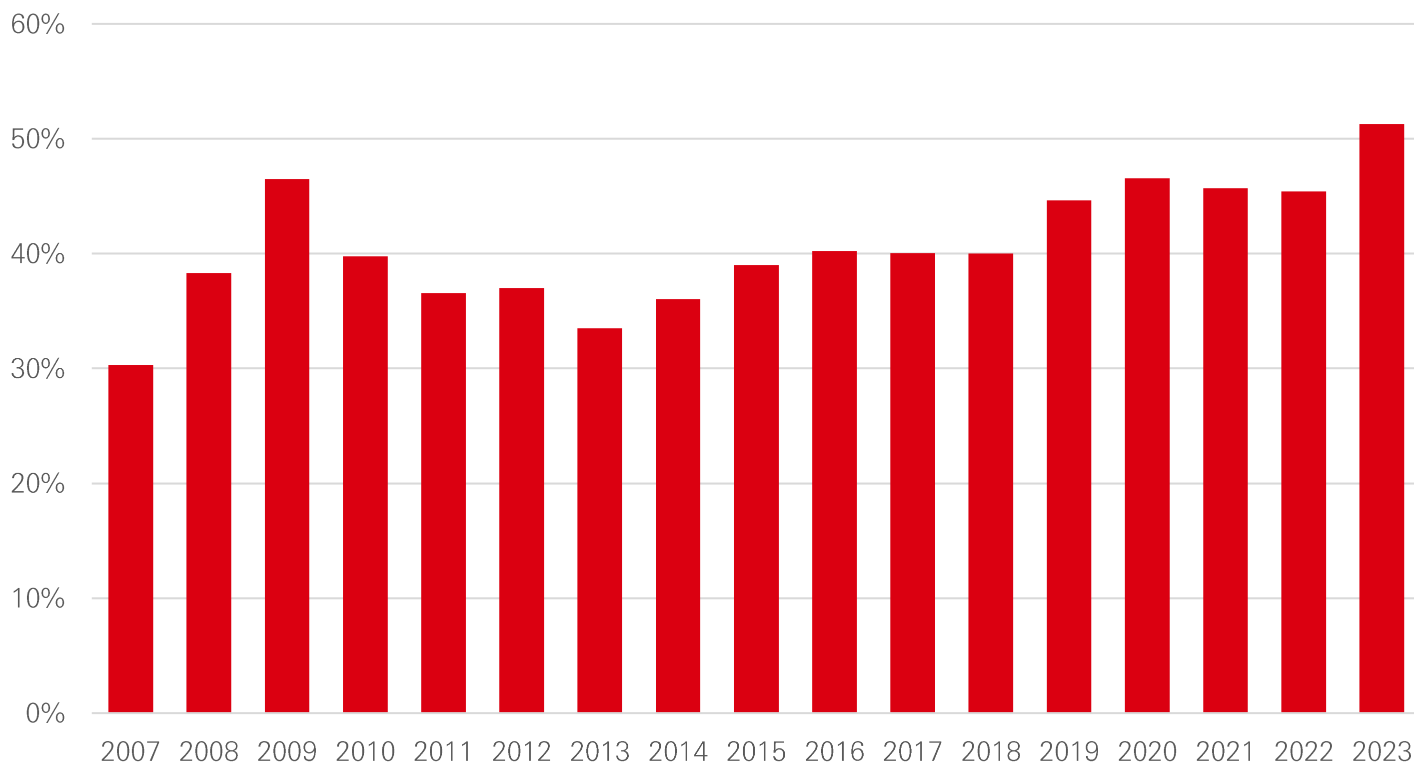
6. PitchBook as of March 2024.

Buyout deals: equity contributions



Source: Pitchbook, data as of March 2024

Performance dispersion has been widening

Private equity performance in recent years has benefited from a number of tailwinds. Cheap and readily available debt, buoyant activity across sectors providing a liquid exit environment, and rising valuation multiples. For investors to make informed decisions when it comes to allocating capital to private market funds, one of the key things to understand is how past returns have been generated. They generally also consider whether those drivers of returns will be replicable in future.

Rising valuations have been a core component of return generation, according to Cepres/Bain analysis. It is clear that most managers, to a certain extent, have benefited from multiple expansion to drive a large proportion of returns. This may be more difficult to replicate in future. If managers are to continue driving returns, there will have to be more of a focus on both revenue growth and margin expansion – over multiple expansion. This is an important consideration, and in our view is likely to result in more of a focus on value creation skills and expertise. This is a theme HSBC Asset Management has been focusing on for some time when performing our own due diligence.

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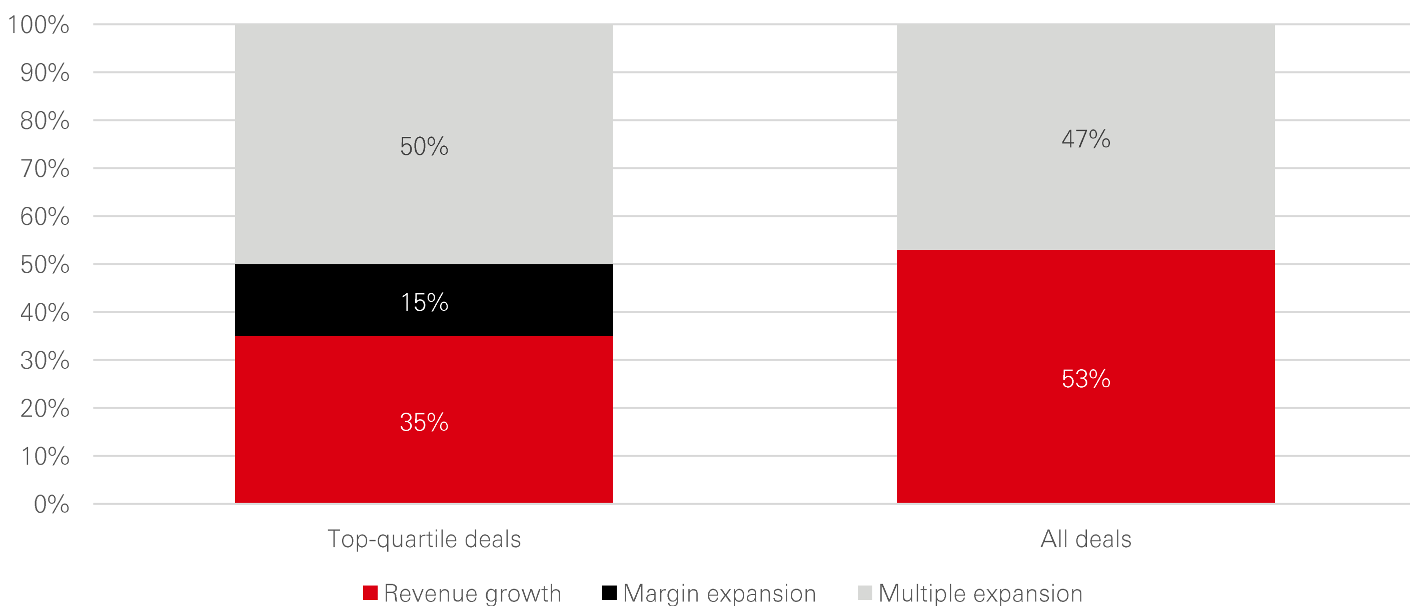
Median indexed value-creation drivers for global buyouts, by quartile performance (deal entry years 2013–23)

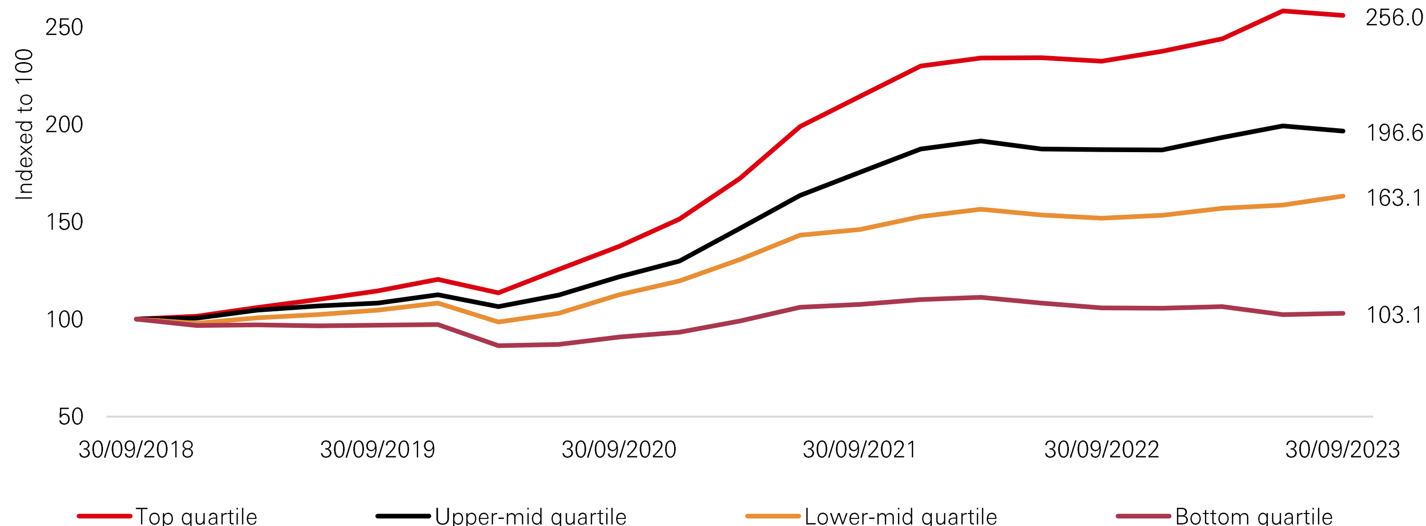


Source: DealEdge powered by CEPRES data; Bain analysis, data as of March 2024

Another way to look at performance is through a lens where funds are split into quartiles, based upon their performance. Looking at the data this way highlights a wide divergence between the winners and losers. It is clear that private equity funds have outperformed the broader private capital market. Given the points that we have made previously, it's probably not surprising that the gap between winners and losers is widening – some managers have been better placed to maximise returns, with a range of value creation strategies.

We believe investors should focus closely on the drivers of performance and form a view as to how markets may evolve, favouring managers which should be able to deliver solid returns in the current market environment. In our view, this is a key consideration because if you are an investor making a marginal allocation to private equity, it's arguably more important than ever to select winning managers. The difference in performance is clear. As an investor, if you are not able to separate the best performing from the worst through the due diligence you perform, you are likely to be disappointed with the performance of your private equity allocations.

PitchBook Private Capital Index by fund quartile 5-year return



Source: Pitchbook, data as of January 2024

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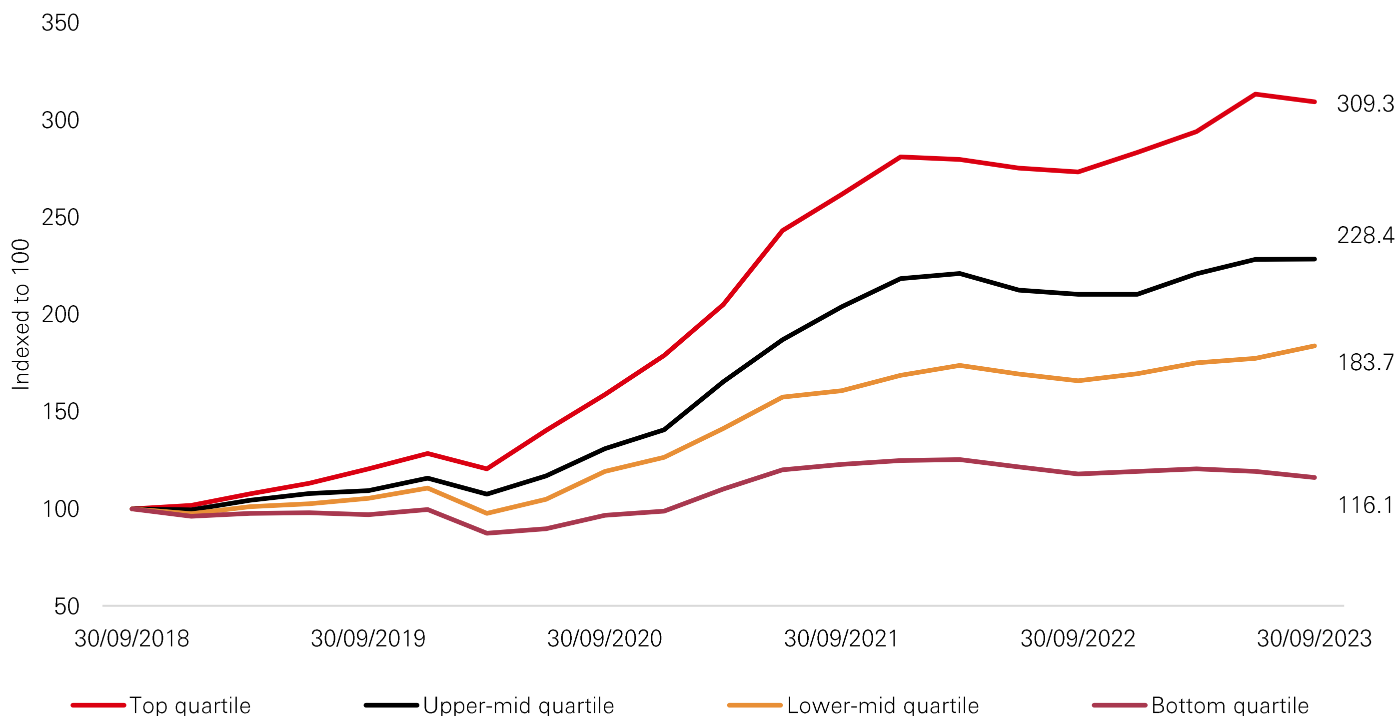
PitchBook Private Equity Index by fund quartile 5-year return



Source: Pitchbook, data as of January 2024

Regardless of the magnitude of the gap between the best and the poorest performing funds, there has always been and will likely always be winners and losers. It is important for investors to understand the drivers of performance for both managers and the funds they raise. We believe that detailed due diligence will help to identify whether previous performance is likely to be replicable in future – particularly as the macro environment evolves. In our view, while this due diligence work can be long-term and complex, it should not be avoided.

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Key Risks

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested. Past performance does not predict future returns. The return and costs may increase or decrease as a result of currency fluctuations.

- **Liquidity Risk** - Investors may be unable to dispose of an investment quickly and at a price that's closely related to recent similar transactions. There is no guarantee of distributions and no established secondary market
- **Event Risk** - A significant event may cause a substantial decline in the market value of all securities
- **Long-term Horizon** - Investors should expect to be locked-in for the full term of the investment, which is subject to extensions
- **No Capital Protection** - Investors may lose the entirety of invested capital
- **Unpredictable Cashflows** - Capital may be called and distributed at short notice
- **Economic Conditions** - Ability to realise/divest from existing investments depends on market conditions and the regulatory environment
- **Risk of Forfeiture** - Failure to make call payments could result in forfeiture of commitment, including invested capital, without compensation
- **Default Risk** - in the event of default investors risk losing their entire remaining interest in the vehicle and may be subject to legal proceedings to recover unfunded commitments
- **Reliance on Third-party Management Teams** - Underlying investments will be managed by various third-party management teams that will in aggregate determine the eventual returns for the investor

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