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The importance of vintage diversification

Private markets

Authors: Laeticia Friedemann, CFA, Alternative Investments Strategist, UBS AG Singapore Branch; Karim Cherif, Head Alternative Investments, UBS Switzerland AG

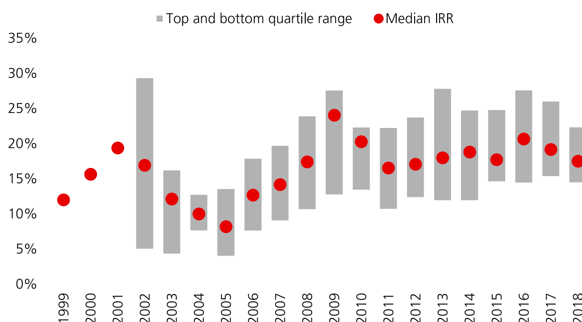
- Market timing in private markets is difficult to execute, given the long investment cycle and illiquid nature of the asset class.
- Vintage diversification can be a powerful tool to navigate economic cycles, mitigate return and cash-flow volatility, as well as to build and maintain robust self-funding portfolios—as long as investors can tolerate the asset class' associated risks.
- To systematically achieve vintage diversification, investors should design and commit to a road map, allocate capital across successive vintage programs, or invest in secondaries or perpetual funds.

Source: UBS

The importance of vintage years in private markets
In private markets, a vintage is the year in which a company is acquired or the year in which a traditional closed-ended fund makes its first investment. As companies are held for three to five years on average and funds typically span over ten years or more, they are influenced by varying macroeconomic conditions and their vintage year is often an important driver of performance.

Vintage years are an important performance driver, but predicting which will perform best isn't easy

IRR since inception per vintage year



Note: US Buyouts. Net to Limited Partners. Data as of December 31, 2023. Source: Cambridge Associates, UBS.

But predicting which vintage will perform best and avoiding those that won't is no easy task. In fact, over the twenty years leading to 2018, the median internal rate of return (IRR) since inception across US buyouts fluctuated between 10% and 20% per vintages, with pre-crisis vintages in 2005–07 recording historical lows and post-crisis vintages setting historical highs.

Don't time the market, time your commitments
Two overlapping dynamics typically impact the performance of private market investments: the cycle of a traditional closed-ended fund (i.e., deploying capital over an investment period of about five years, and realizing assets over a >10-year fund life), and the economic cycle. Investors cannot control the pace at which capital will be deployed or returned, nor can they predict the economic environment under which such capital calls and distributions are executed. They can, however, time their commitment to new funds and thus influence when a new private market investment cycle starts.

If you time the market, better invest in a downturn
While it is difficult to time the market and it is natural to be more cautious in times of uncertainty, downturns are typically among the best times to invest, as they offer more

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attractive entry points. Indeed, valuations tend to be lower at the trough of a business cycle, due to depressed EBITDA levels and bleak expectations about future profitability. Further, when it is time for managers to sell assets three to five years later, market conditions tend to have recovered, resulting in more favorable valuations. In other words, investing during a downturn generally allows investors to buy low and sell high.

That said, investors should still look to pace their investments across the economic cycle. Even during frothy market conditions, some managers benefit from a competitive advantage that enables them to be disciplined in the valuations they pay. Others have robust value-creation playbooks that allow them to capture upside despite eventual multiple contraction in an unfavorable exit environment. Managers also have the option to wait for more opportune times to realize assets. When comparing private versus public returns in periods of stress, we find that the relative advantage of private investments over listed ones continues to hold.

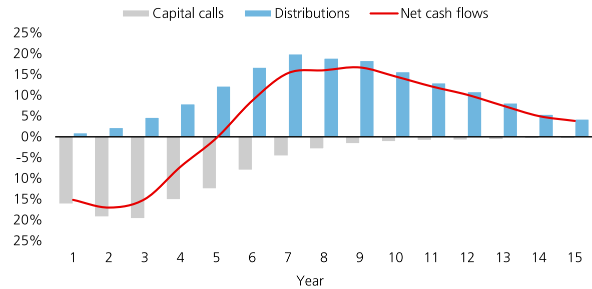
High opportunity cost of missing a vintage
In fact, trying to time economic cycles has a high opportunity cost. Based on data from Burgiss, an investor who made annual commitments to buyout funds between 1986–2010 would have delivered a 1.75x net multiple on invested capital. Had the investor avoided the worst three vintages over that period, the portfolio would have returned 1.81x, or 3.2% more than the base scenario just described. Had the investor missed out on the best three vintages, however, the portfolio would have delivered 1.65x, or 6.1% less than the first scenario. Therefore, missing out on the best vintages hurt performance twice as much as successfully avoiding the worst vintages.

Since it is difficult to predict how each vintage will fare, consistent annual commitments can ensure an investor captures outperformance from vintages, while mitigating the impact from lower-performing years and smoothing exposure across economic cycles.

Building robust portfolios requires discipline
Vintage diversification is equally crucial when considering private market cash-flow dynamics. Investors who allocate annually to each vintage should naturally achieve a self-funding portfolio over time when capital calls from younger funds are financed by recycling distributions from older funds.Skipping vintages may create a gap in distributions, increasing capital requirements and delaying the point when a portfolio becomes self-funding. In our case study, the portfolio excluding the best three vintages broke even six years after the base portfolio. Uneven allocations per year also make it more difficult to maintain a steady-state exposure, as measured by the net asset value (NAV), which is already sensitive to the economic cycle. In our case study, it took a decade for the portfolio excluding the worst three vintages to near the base-case NAV again.

Investors can time their commitment to new funds, thus influencing when a new private market investment cycle starts

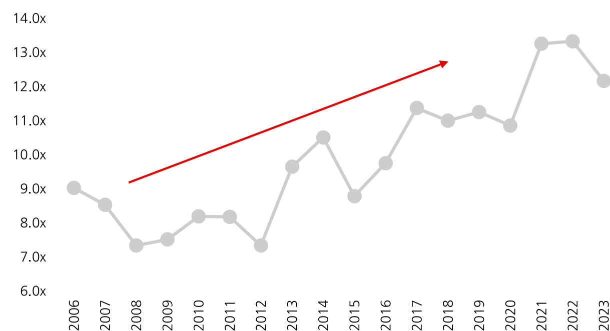
Average cash flow profile of a private equity fund, in percentage of fund size



Note: All data as of June 30, 2021. Source: Pitchbook, UBS.

Investing in a downturn can lead to 'buying low and selling high', as valuations tend to be lower at a business cycle's trough

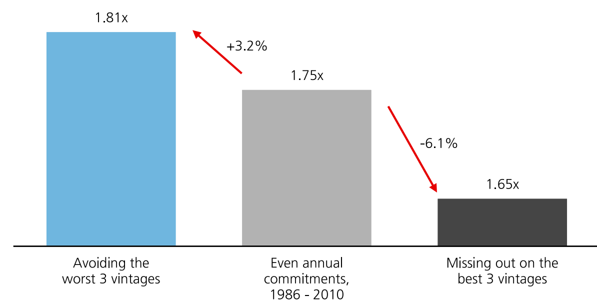
Median US Buyout EV/EBITDA multiple per vintage year



Note: Data for 2013 - 2023 as of March 31, 2024. Data for 2006 - 2012 as of June 30, 2015. Source: Pitchbook, UBS.

Missing out on the best vintages hurts performance twice as much as avoiding the worst vintages

Portfolio multiple of invested capital (MOIC)



Note: Historical buyout cashflows. Data as of September 30, 2023. Source: Burgiss, UBS.

Opportunity to get into hard-to-access funds

Investors who consistently allocate to private markets can take advantage of weaker fundraising environments to invest into otherwise hard-to-access funds. While demand for leading managers remains robust during a downturn, fundraising timelines generally extend, and competition also typically decreases as some investors pull back. This can create a strategic window of opportunity for investors to commit to sought-after funds. Once part of a manager's investor base, they become well-positioned to secure access to future fundraises, especially when supply of capital is high. Curtailing allocations during that time can have the opposite effect.

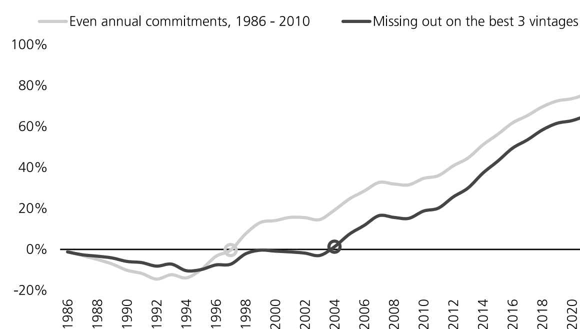
Achieving systematic vintage diversification

Vintage diversification is relevant to all investors, regardless of their target return, risk appetite, time horizon, liquidity profile, or portfolio size. Compared to other dimensions of diversification (e.g., instruments, strategies, geographies, sectors, segments and managers), achieving vintage diversification requires the most discipline, in our view. Nonetheless, investors can systematically diversify across vintages in four ways:

1. **Design and stick to a commitment roadmap:** Investors with greater resources can develop an annual commitment roadmap and put proper governance mechanisms in place to ensure it is respected.
2. **Invest in successive vintage programs** or fund structures investing into several primary funds within a single year. By allocating to a vintage program annually, an investor automatically builds a portfolio that is diversified across vintages, but also managers and sectors, often at lower investment minimums. Investors may also choose to allocate to multi-vintage programs, which invest over a pre-defined number of years (typically two or three). With such an approach, investors no longer need to commit every year, but instead adjust their commitment cadence to that of the multi-vintage program.
3. **Invest in secondary funds:** In traditional secondaries, investors sell their stake in private market funds to a secondary buyer, typically at a discount. Sellers seek liquidity out of distress or for portfolio management purposes. By investing in a secondary fund, investors can gain exposure to a diversified portfolio of funds that began investing several years ago, sometimes as long as >10 years. Secondary funds offer additional benefits, given that the underlying funds in their portfolio have started to invest, such as: an accelerated exposure build-up, a reduced blind-pool risk, and a mitigated net cash flow curve. Returns tend to be lower than that of other private equity strategies, however, as secondary funds gain exposure to companies later in their value-creation process.
4. **Invest in perpetual funds:** Perpetual funds are private market investment vehicles with no finite life. Unlike traditional closed-ended funds, which call capital from investors and distribute back proceeds from realized assets, perpetual funds draw down once and re-invest proceeds into new opportunities. Investors get into a perpetual fund at the latest NAV, allowing them to build their exposure from day one. Effectively, they buy a "slice" of the perpetual fund's portfolio upon commitment, which is already diversified across vintages as the fund has been active for several years. Investors naturally achieve vintage diversification as long as they remain invested in the perpetual fund. A manager's capacity to deploy generally depends on the capital inflows and redemption requests it receives, however, which may result in a performance drag.

Skipping vintages may create a gap in distributions, delaying the point when a portfolio becomes self-funding

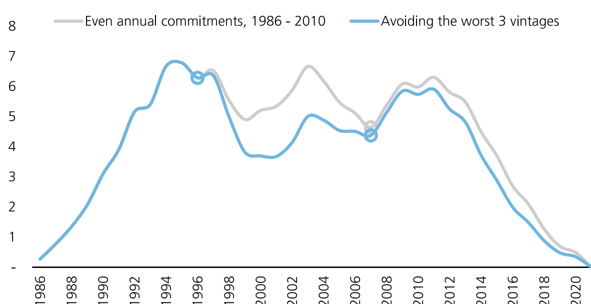
Net cumulative cashflows, in percent of portfolio size



Note: Historical buyout cashflows. Data as of September 30, 2023. Source: Burgiss, UBS.

Uneven allocations per year make it difficult to maintain steady-state exposure, which is already sensitive to the economic cycle

Net asset value, in USD million



Note: NAV inferred from the historical cash flows and IRR. Data as of September 30, 2023. Source: Burgiss, UBS.

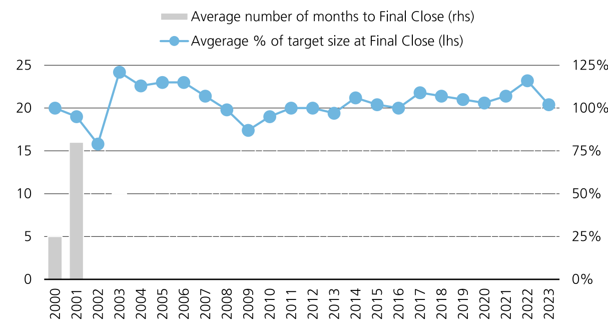
Conclusion

We recommend investors to diversify their vintage exposure by making annual commitments to private markets. Doing so provides four key benefits, as investors can:

1. Smooth out their exposure across economic cycles and fluctuations in valuations;
2. Enhance their returns by capturing the outperformance of select vintages while mitigating the impact from lower-performing years;
3. Build out robust self-funding portfolios by reducing both cash-flow and exposure volatility;
4. Invest into otherwise hard-to-access funds.

Investors can systematically achieve vintage diversification by designing and sticking to a commitment roadmap. They may also choose to successively invest in a diversified single-vintage or multi-vintage program. Those who would like to build their exposure to past vintages may do so by investing in secondaries. Finally, perpetual funds allow investors to achieve continuous vintage diversification by outsourcing the re-investment decision to the perpetual fund manager.

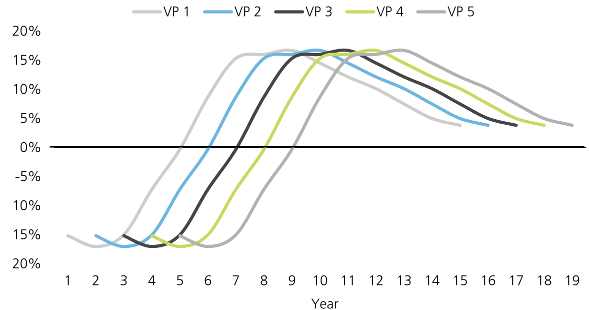
Leverage weaker fundraising environments to invest into hard-to-access funds as fundraising timelines extend and competition decrease



Note: Select Private Equity strategies (Balanced, Buyout, Growth, Hybrid, Secondaries and Turnaround). Accessed June 27, 2024. Source: Preqin, UBS.

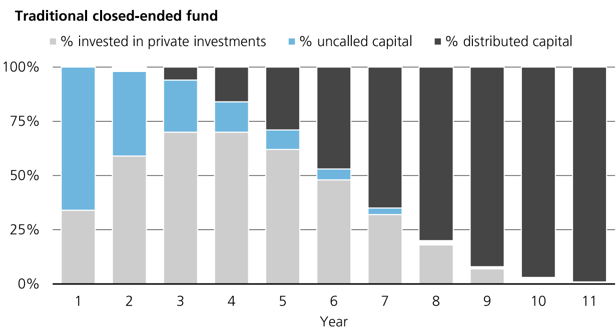
Automatically build a portfolio diversified across vintages, managers and sectors by allocating to a vintage program annually

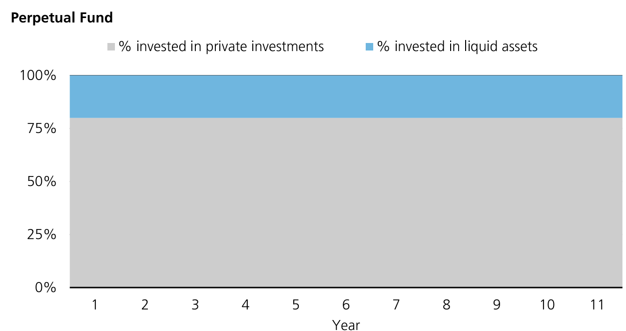
Average net cash flow profile of a private equity fund, in percentage of fund size



Note: VP = Vintage Program. For illustrative purposes only. All data as of June 30, 2021. Source: Pitchbook, UBS.

Investors can achieve continuous vintage diversification by outsourcing the re-investment decision to perpetual fund managers





Note: As of October 27, 2023. Source: Burgiss, UBS.

Appendix

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