

Top considerations for private markets in 2022



Introduction

Welcome to our annual examination of key considerations across the various private markets asset classes and geographies. In identifying the topics for these pieces, we used our extensive knowledge of our clients and their portfolios as well as our in-depth coverage of alternatives fund managers to capture what we believe to be the top concerns from the perspectives of both limited partners (LPs) and general partners (GPs).

In leaving 2021 behind, we had very much hoped to be largely done with the ramifications of COVID-19. However, the emergence of additional variants of the virus has continued to roil economies and financial markets as well as perpetuate elevated levels of uncertainty. Despite the persistence of these high levels, many investors continue to be very active across alternatives markets. This is particularly true in venture capital, which is often considered to be at the upper end of the alternatives risk continuum. This has been driven in part by the receptivity of the IPO market and the increasing usage of special purpose acquisition companies (SPACs) as a viable exit path for venture and growth capital funds. The capital inflows to these markets offer evidence that, despite the unrelenting uncertainty, investors are ready and willing to deploy capital into risky assets when they can develop a reasonable belief that they may receive a commensurate return.

In this year's *Top Considerations*, we cover the following topics:

- **The 60/40 portfolio.** The first section starts at the top as we look at the broad issue of overall portfolio allocation. We present some interesting performance results for a traditional 60/40 portfolio of US public equities and US bonds over various 10-year periods. We also describe what the addition of alternative investments within a portfolio could offer investors.
- **Private equity.** In the second section, we present a general description of how several characteristics of private equity portfolios differ markedly from many other asset classes. Moreover, these differences have important implications for portfolio construction, manager selection and governance.
- **European private equity.** The next section covers Europe and notes that as activity has picked up in the second half of the year, investors are facing the challenge of high prices in many sectors, including tech and healthcare. Further, many LPs are dealing with the conundrum of good fund managers significantly increasing their fund sizes, and this has made many LPs nervous.
- **Asian private equity.** The Asian section provides some insightful background on the processes that led to the recent regulatory changes in China. We continue by describing the impact on and implications for private equity and venture capital markets both in the near term and over the longer timeframe.
- **Venture capital.** The venture capital section offers a provocative overview of the many new types of investors entering the rapidly evolving world of venture capital markets. We argue that this could be a sign of a market top, especially for late-stage venture capital markets, and we suggest LPs be very discerning with their investment decisions.
- **Natural resources.** The reemergence of inflation is the primary focus of the natural resources section. We make the point that natural resource commodities have a high correlation to inflation and could be considered a tactical or strategic allocation for those concerned that inflation is not as transitory as it has been represented.
- **Infrastructure.** The infrastructure section delineates the increasing prevalence of open-ended fund structures and the impact of both the various climate change initiatives and recently passed US legislation.
- **Private debt.** As with some previous sections, inflationary pressure is paramount in the private debt section. We explain that the floating-rate nature of private debt as well as several other attractive characteristics may offer investors a means to mitigate inflation risk.
- **Real estate.** Next, we illustrate how investors are increasing their allocations to real estate, driven in part by the desire to achieve cash yields while also seeking some inflation protection. Interestingly, many investors are actively over- or underweighting real estate sectors based on demographic trends and the continuing economic alterations propagated by the pandemic.

Newsflash: Diversifying into alternative investments may not be worth the effort...

What's the point of investing in alternatives?

We would argue that there are three main reasons, as follows:

1. **Return enhancement**
2. **Inflation protection**
3. **Diversification benefits**

Most types of alternative investments offer some combination of these three desirable attributes.

What has happened over the past 10 years?

Over the 10-year period ending on September 30, 2021, you could have achieved all the goals outlined here by simply maintaining a strategy of investing in a simple 60/40 mix of US public equities and US bonds. Here are some statistics for this 10-year period:¹

- The 60/40 mix outperformed cash by 10.5% per annum over the 10-year period as a whole. That provided plenty of return enhancement and was way ahead of inflation, no matter how you choose to measure it.
- The worst cumulative drawdown the 60/40 portfolio experienced relative to cash during the 10-year period was the 7.8% drawdown experienced in Q1 2020. But even that drawdown didn't last long and was recovered by the end of the following quarter. In fact, the 60/40 portfolio did not have any drawdowns during that 10-year period that lasted longer than 12 months. Mixing equities with bonds provided all the diversification necessary.

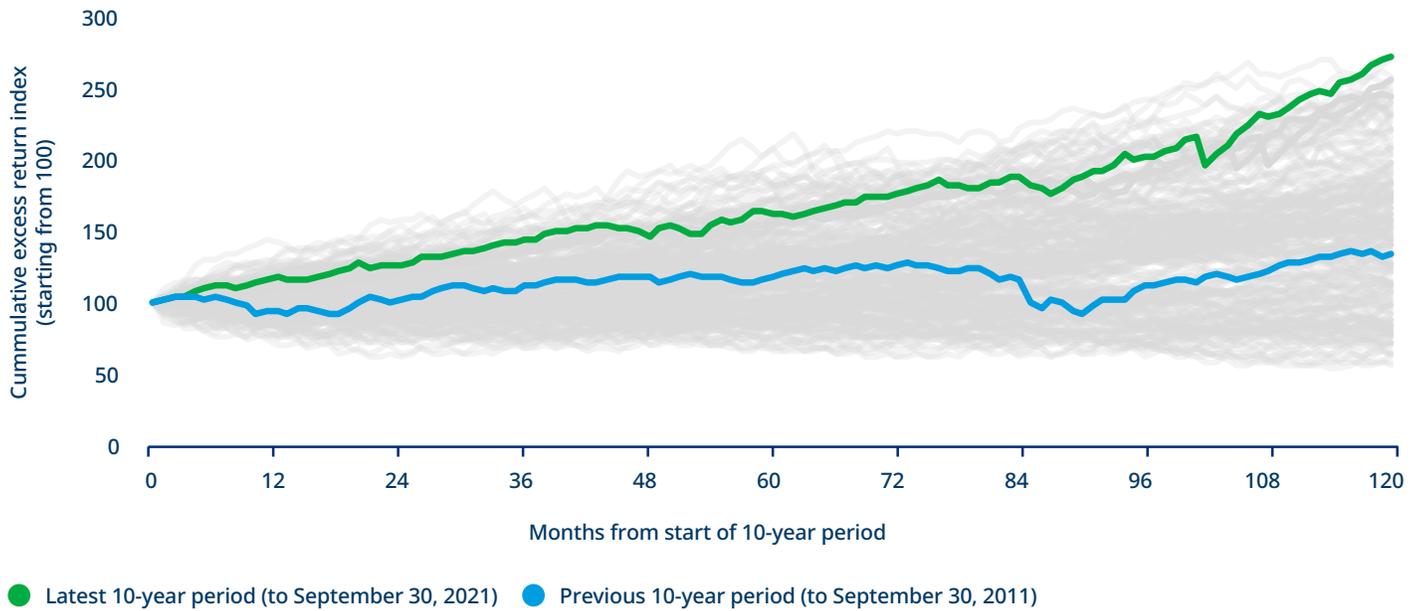
These statistics demonstrate conclusively that diversifying out of equities and bonds into alternative investments isn't worth the effort. Or do they?

Longer-term history

To put the past 10 years into perspective, it is worth looking at the longer-term data. Each line in the chart below plots the cumulative excess return over cash for a 60/40 mix of US public equities and US bonds over a 10-year period. There are 229 lines shown in the chart, covering overlapping 10-year periods with start dates running at quarterly intervals from July 1, 1954 (which is as far back as our data allows us to go), through October 1, 2011 (the most recent 10-year period described above).

¹ Mercer, November 2021.

**Figure 1. 10-year excess return over cash of a 60/40 portfolio
(for 229 overlapping 10-year periods between Q3 1954 and Q4 2011)**



Source: Mercer, November 2021.

The green line shows the cumulative excess return for the most recent 10-year period. And guess what? At the end of the period, that one is the highest of all 229! When investors look back over the past 10 years, they are seeing the best period in recorded history in terms of the performance of a 60/40 mix of US public equities and US bonds relative to cash. Moreover, this means they are also looking back at the worst period ever for diversifying out of the 60/40 mix into alternatives.

So what did the previous 10-year period look like? The blue line shows the 10-year period ending on September 30, 2011 — immediately before the start of the most recent 10-year period shown by the green line. The 60/40 mix also outperformed cash over that period but only by 3.0% per annum. The drawdowns were much worse. The excess returns over cash for the 10-year period started with a drawdown that peaked at 22.8% in Q1 2003 and was not fully recovered until Q4 2006. Then came the massive drawdown that started in Q4 2007 and peaked at 28.2% in Q1 2009, and it did not fully recover until Q4 2010. Diversifying out of the 60/40 mix into an allocation to private markets would definitely have helped over those periods.

Is that as bad as it can get? No, it can get a lot worse. The worst 10-year period for the 60/40 portfolio relative to cash was the period running from Q3 1972 to Q2 1982. The 60/40 portfolio *underperformed* cash by 5.6% per annum over that period. Diversifying into anything other than public equities and bonds would have helped a great deal during that time.

Summary and key points

The key point to note from all this is that while many investors would have received everything they needed from a simple strategy of holding a 60/40 US public equity/US bond portfolio over the 10-year period that ended in September 2021, that period marked an extremity in the recent history of financial markets, and there is widespread concern that investors will not enjoy similar returns over the next 10 years. There have been numerous other periods in recent history when the 60/40 strategy didn't serve investors well and diversifying into alternatives would have helped a great deal. We believe investors seeking to assess the value of diversifying into alternatives should bear this in mind when developing their portfolio allocations.

Private equity

In an environment where future return expectations for most asset classes are much lower than recent returns, many investors are turning to private equity to boost expectations for future overall portfolio returns. As a result, we have seen investor allocations to private equity steadily increase in recent years. Many of these investors are making their first allocations to the asset class and can be prone to common portfolio construction mistakes that seasoned private equity investors have learned to avoid.

Building a private equity portfolio is very different from building a public equity or fixed income portfolio. Many of the portfolio management tools available in traditional asset classes are not readily available in private equity portfolio management. This is because private equity is illiquid, funds are generally not open continuously and access to the most sought-after managers is often constrained.

Building a private equity portfolio is a long-term process that requires an open mind and flexible governance. Those that bring a rigid portfolio construction approach can be susceptible to common mistakes. Examples include:

- Short-term diversification.** As previously stated, private equity portfolio construction is a multiyear process. A new bespoke private equity program typically takes six or more years of consistent construction before it reaches a steady state and approaches the target allocation. Implementing a private equity program is not linear, in the sense that investors cannot effectively maintain a fixed diversification mix during the early years of portfolio construction — at least not without potentially sacrificing manager quality. Diversification is bound to vary widely relative to targets during portfolio construction. This should be expected, because the overriding goal ought to be selecting the highest-quality managers possible across the target strategies, regardless of when funds they sponsor become open and available. Investors have no control over the timing of target fund launches, and they need to remain flexible with an eye on the ultimate goal — building to a steady-state portfolio comprising the *highest-quality managers* that also deliver the desired target diversification mix.
- Inability to rebalance.** Private equity investment vehicles are illiquid, and investors are unable to actively rebalance exposures in the same manner as they could in traditional asset classes. Aside from exploring the secondaries market, private equity investors really only control the selection of managers and the size of commitments they make to private equity funds. This can be challenging when managers currently held in a portfolio alter their expected capital call schedule or accelerate the frequency with which they raise new funds. Investors with fixed annual commitment budgets may struggle to allocate budgets across planned new and re-up commitments. A near-term decision to pass on a re-up opportunity with an existing manager, usually in an effort to manage near-term diversification, may be shortsighted. If access to a manager is constrained and an investor declines to re-up, the investor is unlikely to regain access to that manager when they later want to increase exposure to the strategy and/or geography. A better approach may be to maintain access and exposure to the manager via a smaller commitment size.
- Rigid-commitment-pacing plans.** Some investors have a fixed annual budget for new private equity commitments, above which they may be prohibited from making new commitments. Commitment pacing is a valid tool for managing vintage year diversification, but a rigid budget can be counterproductive. Investors have limited visibility into and no control over when target managers will launch and close new fund offerings. If an investor is surprised by an unexpected fund launch or even a delayed fund launch, they may find themselves either without enough budget or with an excess budget. When subject to rigid-commitment budget constraints, an investor may miss out on attractive opportunities. Potentially even worse, an investor may allocate to a lower-quality manager simply to deploy their full annual budget. Neither of these outcomes is optimal. Investors may be better served by taking an extended view on a long-term asset class. Investors should consider looking at a multiyear commitment budget and sizing commitments flexibly rather than allowing short-term constraints to influence long-term investment decisions.

We have learned many lessons from working with clients of various types and sizes. In our experience, investors improve their probability of success in private equity by adopting a long-term view, not only on portfolio construction but also on the policies and constraints they impose on themselves from a governance perspective. Certainly, investment policies and governance are necessary and good. However, they need to be aligned with the investment objectives and time horizons of the subject portfolios while also incorporating an awareness of the dynamics of private equity markets.

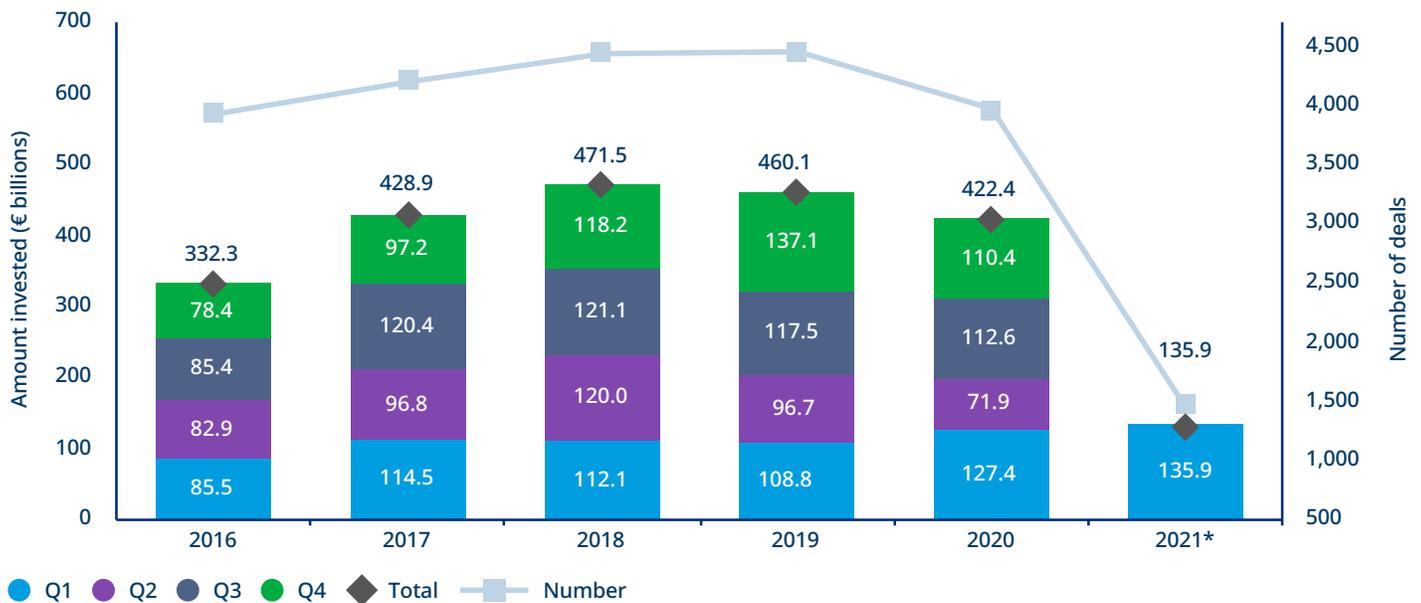


European private equity

After a decline in activity in 2020 associated with COVID-19, activity has strongly rebounded in Europe, particularly in the small-to-midmarket space. This has resulted in a flurry of new investments by GPs as well as a number of divestments, enabling GPs to send cash back to their investors. Looking closely at the investments being made, it is apparent that some sectors are more popular than others. Technology and healthcare are clear favorites, and it is not surprising that companies in these sectors are trading at lofty multiples. To justify the high prices, GPs need to have a clear reason

for making an acquisition, whether that is pursuit of a buy-and-build strategy or having expertise in the sector and very clear growth plans that justify paying the high multiple. Indeed, according to PitchBook (as of July 2, 2021), 71% of the deals in Europe in Q1 2021 were add-ons, indicating that buy-and-build strategies are central to sponsors' investment strategies. This means the higher prices are easier to justify as the buyer is essentially a trade buyer who should be able to extract synergistic benefits.

Figure 2. Europe private equity deal flow



Source: PitchBook (as of July 2, 2021).
*As of March 31, 2021.

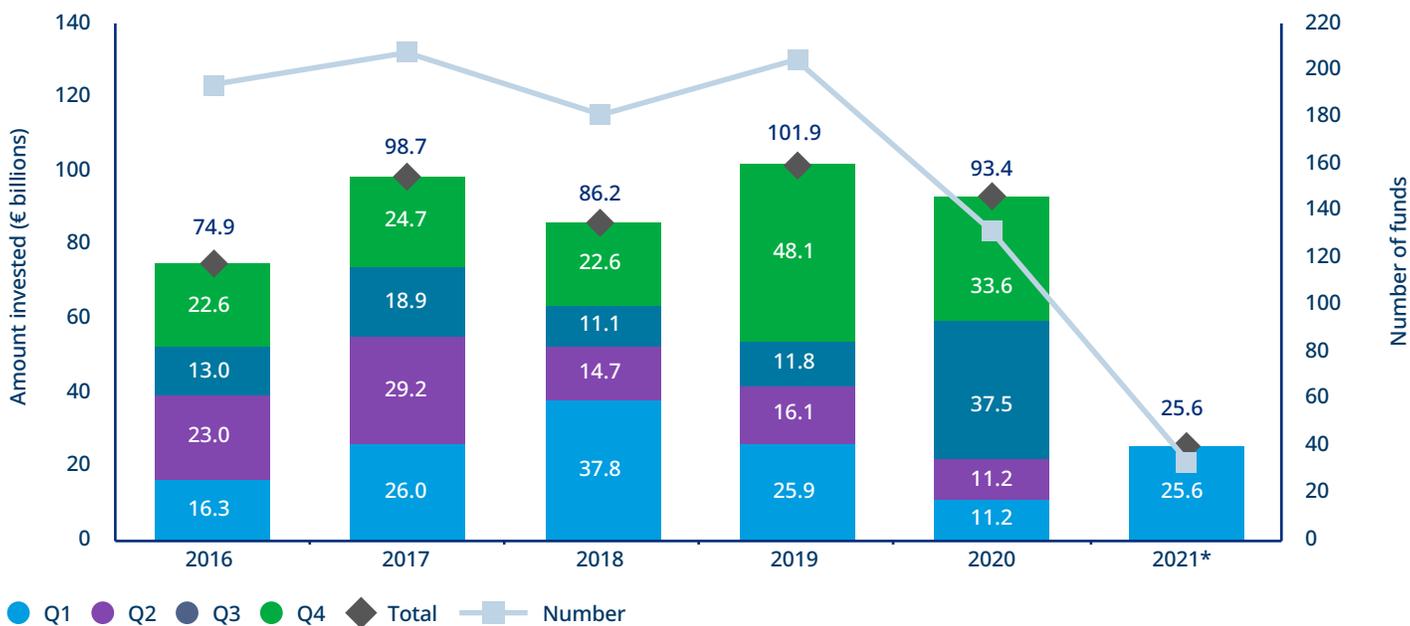
In terms of exits, Q1 2021 was the strongest since 2018. However, this may be explained by the COVID-19 catchup effect. Most GPs put exits on hold in 2020, both to allow COVID-19-impacted assets to recover and to ensure that they receive maximum prices for more resilient assets. Many of those delayed exits are now occurring, with sales largely to strategic buyers or other funds rather than by IPO. It is noteworthy that in Europe, unlike the US, there has not been a boom in exits to SPACs thus far.

Likewise, having been slow to deploy capital during the pandemic, many European GPs have rapidly invested over the past six months and consequently now look to bring forward their fundraising. With the advent of new funds, fund size becomes a question; inevitably, fund sizes are increasing and, frequently, quite dramatically. For example, a 50% increase seems quite conservative in many cases, with some GPs doubling the size of their last fund.

One of the key challenges for investors is determining how big is too big. And when do you say no to a re-up, particularly if the fund has historically performed very well and been access constrained? The argument often is that co-investment offered together with the last fund justifies a larger fund this time. But whether this is true remains to be seen. Does the GP not plan to offer co-investment to its LPs this time? With many of the fundraisings being moved up, the forward calendar over the next six months looks very crowded, creating a challenge for investors to review all the offerings available and for GPs to compete for airtime with investors.

There is also plenty of choice in terms of fund size. The smaller funds (between €500 million and €1 billion) were most abundant in the early part of 2021, but the larger funds are also coming back to market, which will add to the amount of dry powder going into H1 2022. Given the COVID-19 situation in Europe, “face-to-face” diligence will remain challenging, with many GPs now providing either a hybrid option or still conducting remote due diligence. With the limitations around travel still somewhat in place and given the uncertainty induced by the virus variants, it is likely that LPs will continue to focus on established existing managers they know well. This, in turn, provides those GPs with the opportunity to continue to substantially increase fund size.

Figure 3. Europe private equity fundraising



Source: PitchBook (as of July 2, 2021).
 * As of March 31, 2021.

Asian private equity

Is China PE/VC still investable?

Since July 2021, China's regulatory tightening in certain sectors and President Xi's "Common Prosperity" agenda have spooked many investors. Some interpreted these actions as representing an extension of the Chinese government's desire to reassert its dominance over the private sector, which has raised concerns as to whether China is still investable. To answer this question, it is crucial to understand the drivers behind these policy changes and the impact on the private equity and venture capital (PE/VC) markets.

What happened?

Since Q3 2020, a number of new policies have been enacted, underlining the potential significance of regulatory risk in some sectors. The list below summarizes some of the key areas that have been affected:

- **Real estate debt deleveraging.**² The crackdown on over-leveraged property developers such as Evergrande Group is part of a broader effort by policymakers to reduce economic vulnerabilities, such as reliance on the oversized property sector and financial leverage. Another key objective is to transition the economy to the next phase of development and direct more capital flow from less productive property to sectors more aligned with China's strategic objectives, such as high-tech manufacturing.³
- **Anti-monopoly.** A more stringent anti-monopoly law is being implemented to address allegedly unfair market competition by large tech giants in the hope of creating a more level playing field for small and midsize enterprises (SMEs). This is in line with similar efforts in developed markets over recent years.
- **Data security.** A new data security law requires any Chinese company that holds personal information on at least one million users to seek a government cybersecurity review before listing abroad. The most affected companies are those deemed to hold sensitive personal information or data on key infrastructure.
- **Education.** China imposed a far-reaching restriction on after-school tutoring that severely limits the role of private capital in the education sector.

Why is this happening now?

The recent policies target certain behaviors and industry practices that China's government deems inconsistent with its goals. After years of rapid growth for tech companies — which have been relatively unconstrained by regulations — policymakers are implementing regulations to tackle some of the perceived ills of growth, including anti-competitive practices, data security and various social issues.

The speed, overall number and severity of some of these regulations shocked many investors and raised fears about the potential for further regulatory actions affecting broader swathes of the private sector. Previous statements made by numerous government officials about policy priorities foreshadowed many of these regulatory developments. In some cases, there had already been related regulatory actions in the not-so-distant past.⁴ Nevertheless, some have argued that the communication and implementation of these latest reforms could have been managed in a more transparent way to reduce uncertainty and market impact.

Is China moving away from private enterprise, bottom-up innovation and capital markets?

The focus on Common Prosperity is perceived to be a significant philosophical shift, and it has led to concerns that the role of private enterprise will be reduced while a redistributive drive will punish success and reward mediocrity. However, President Xi has made it clear in subsequent speeches that the aim is not to create a "welfare" culture, as seen in some Western countries, but instead to ensure that a broader middle class can help reverse unfavorable demographic trends and facilitate the transition to a more diversified, consumption-based economy.

The 14th Five-Year Plan announced in March 2021 has a strong focus on innovation, particularly in digitalization across industries to increase productivity and become self-

² Property companies have been under pressure since August 2020, when the Chinese government announced its "three red lines," which target two leverage ratios and one liquidity ratio. The aim is to reduce the growth in property-related debt and slow the growth in land prices. Entities not meeting either of those criteria are not allowed to take on new debt.

³ For example, policymakers would like to achieve a more balanced economy that is more resilient to external shocks. They look to reduce reliance on export-driven growth by promoting a large domestic consumption base and producing more strategically important goods at home so as not to rely too much on foreign suppliers and be vulnerable to sanctions.

⁴ Examples include slowing down leverage in the real estate market since 2015, regulating after-school tutoring and off-campus tutoring in 2018, restructuring the healthcare sector in 2018, and some anti-trust action in 2020, among others.

reliant in sectors deemed critical for national security and economic independence from other countries.

From a long-term perspective, the role of the private sector remains important to the achievement of China's strategic economic goals. The private sector contributes significantly to China's investment and its research and development (R&D) expenditures. This is a key feature of the Chinese economy compared to other developing economies, where private sector investment and R&D spend is far lower. In China, there is a rich ecosystem for innovation and development due to growth of a deep consumer market.

While investor interests were clearly not prioritized during the recent crackdown, there are no signs that China is moving away from market-based finance in the long term. In fact, President Xi announced the launch of the Beijing Stock Exchange (BSE) in September 2021 for listings of tech companies. The new exchange is expected to create a more comprehensive and tiered capital market structure and is a step forward in China's capital market reforms as part

of its effort to fund innovation and reduce the economy's reliance on bank lending. At the same time, a rising number of defaults, both in the state-owned and private sectors, suggests that China is serious about removing implicit credit guarantees to ensure that risk is priced by the market and capital is allocated more efficiently. Furthermore, dual circulation does not mean a shift toward autarky. International trade will continue to be a key force driving China's economy while it rebalances toward domestic demand and reduces reliance on imports in certain sectors that are perceived to be of national strategic importance.

Last but not least, in September 2021, China officially applied to join the 11-member Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).⁵ While this may be viewed as geopolitically motivated, it is considered a significant trade initiative as entry into the pact would require China to agree to further economic reforms, such as creating a level playing field for private enterprise relative to state-owned enterprises and improving property rights and the rule of law.



⁵ The CPTPP, signed in 2018, removes tariffs on an estimated 95% of goods traded between member countries, including Australia, Canada, New Zealand and Singapore.

How was the China PE/VC market impacted?

China's offshore equities listed in the US and Hong Kong, which were particularly exposed to some of the regulatory actions in 2021, experienced a significant correction as investors applied discounts due to the heightened regulatory risk.

Similarly, Q3 2021 has been an unsettling period for the China PE/VC market. Fundraising for the year through the end of September 2021 was down by 13% compared to the same period in 2020, driven by a 76% decline in Q3 2021 compared to Q3 2020. Investors refrained from making new commitments and instead focused on established partnerships.⁶

In contrast to fundraising, the pace of investment remained relatively stable in Q3 2021 compared to the previous quarter. However, Q4 is likely to see a more negative impact on drawdowns as fund managers moderate new investments until the dust settles and turn their focus to portfolio management to extract value from existing portfolio companies.

Divestments have slightly increased compared to the same period last year. The pace is likely to slow for the rest of 2021 as GPs will likely pause bringing companies to the market while sitting out the current negative sentiment and hoping for better valuations in the near future.

How should investors position themselves?

While the new policies will likely be a drag on growth in the short term, China's long-term outlook, which we believe will drive growth in both quality and quantity of China's PE/VC opportunity set, remains intact due to:

- Solid growth potential from what is already a large GDP base
- A sizeable population of millennials and a growing middle class that are key drivers of private consumption
- A strong focus on R&D and a large and growing talent pool (China has been establishing itself as an innovation center, and the current reforms are aiming to accelerate this)

In accordance with the central government's long-term national planning for 2021–2025, some of the key investment opportunities will revolve around the major themes of domestic demand, digitalization, technology localization, healthcare and clean tech. Investors should consider these long-term opportunities and navigate the evolving regulatory frameworks by engaging GPs with deep local knowledge and the ability to identify both potential opportunities and risks emanating from the current regulatory evolution as well as other developments.⁷

⁶ All fundraising, investment and exit data is from the AVCJ database.

⁷ For more details on opportunities in the China PE/VC market, as well as onshore and offshore public equities and Chinese onshore bonds, visit Mercer's China hub: www.mercer.com/our-thinking/wealth/investing-in-china.html.

Venture capital

The nontraditional investor indicator

History has shown that when nontraditional investors begin to flood the venture-backed investment market, bad things can follow. Two good examples of this phenomenon were the 2000 internet bubble and the 2009 global financial crisis (GFC). While the visiting investors during those two periods were slightly different in nature, both events provide support for the idea that LPs should view nontraditional investors entering the venture market in a nondiscriminatory way as a warning sign. Fast-forward to a post-pandemic world in which the VC market has had one of its best years in recent memory and has attracted a flood of nontraditional investors. It is in environments like this where LPs must be more disciplined and thoughtful with their investment decisions, especially in late-stage venture.

So what is a nontraditional investor? Market incumbents call them “nontraditional” or “tourists,” and they are investors that enter the VC market in droves by investing directly in venture-backed late-stage companies after the market has developed momentum. Examples of these investors include mutual funds, hedge funds, buyout firms, investment banks, corporate venture capitalists, sovereign wealth funds and even some LPs. A common characteristic of these investors is that their primary contribution is capital rather than other resources offered for the continued development of the company. Most nontraditional investors, although not all, rarely take active board seats, roll up their sleeves or have the venture company development experience to offer sage advice to the founders. Many of these investors show up when times are good and then quickly retreat when markets experience a downturn. Some of these nontraditional investors, such as corporate venture capitalists, have lower return thresholds and look for strategic value or technical knowledge instead of, or in addition to, financial returns.

By contrast, traditional VC investors take board seats, dig deep into the company’s strategy and operations, and contribute their company-building expertise to entrepreneurs. Traditional venture capitalists are mentors, sounding boards and team members for their entrepreneurs. Venture capitalists are looking around the

corner trying to address markets and, in many cases, trying to create markets — a skill set usually lacking in many nontraditional investors.

Per PitchBook (as of Q2 2021), we have seen a record level of nontraditional investors participating in venture-backed company financings in 2021, particularly in the later stages. Of all VC investments in the US, 34% were from nontraditional investors — a percentage that increases to 50% at the late rounds. For mega rounds (the very late and pre-IPO rounds), nontraditional investors represented a remarkable 88% of all participants.

We are not suggesting that investors avoid investing in venture capital or with these nontraditional investors; rather, we are recommending that investors be thoughtful about their selections. The unprecedented investment levels of nontraditional investors can be an indicator of a market top, and that warning should be factored into investment decisions. Assuredly, there is money to be made across multiple stages of many venture companies’ life cycles. With companies staying private longer, raising more capital and exiting at higher levels than in the past, there are varied investment approaches that can work. However, in frothy cycles, backing the right investor(s) could make the difference between hitting your target returns and falling short.

History has shown that some unprepared, inexperienced and unsophisticated investors will jump on the venture bandwagon at the wrong time. We see many of the same market characteristics today that proved problematic in prior downturns: high volumes of nontraditional investors, high valuations, weaker terms and conditions, and investors lacking experience in the craft of venture capital. If you are backing nontraditional managers, recognize that if there is a downturn, they most likely will be affected more severely due to their higher entry values than early-stage venture investors. There is a reason the phrase “the IPO is the new down round” was coined. It has yet to be seen how these nontraditional investors will navigate through a correction when they hold a minority position, do not have any board representation and/or invested under weak terms.

However, there are also positive aspects to the market. Some of these late-stage nontraditional investors are here to stay and have identified niches to navigate. Many are making significant money. Furthermore, exit values surpassed US\$500 billion for the first time in 2021.⁸ Additionally, exit values and counts are on pace to double even those of 2020. As long as the exit market stays healthy, late-stage nontraditional investors could continue to perform.

We have our picks in the market and know why we like them but are acutely aware of the risks in the later stages of the venture market. We advise investors to choose

wisely and look not only for the usual attributes — team stability, incentives, terms or LP alignment, consistent strategy overtime, and track record — but also determine whether the nontraditional investor has performed through a market correction. If so, what was its loss ratio? Many non-traditional investors only began investing in private markets post-GFC, and they may believe that markets always move up and to the right. As is common across private markets, manager selection is the most important decision LPs can make in venture capital, although asset allocation and vintage diversification can also help contribute to successfully managing over frothy market cycles.



⁸ PitchBook as of Q2 2021.

Natural resources

Going into 2022, the resurgence of inflation is top of mind for many investors in natural resources.

Inflation is now regularly and ominously in the headlines. It has returned as a relevant topic for the first time in decades. Higher inflation is no longer a theoretical possibility. It's a reality facing investors — this year, right now.

According to the Organisation for Economic Co-operation and Development, inflation in its member countries surged in mid-2021 to the highest rate since 2008.⁹ In the US, a key measure of inflation hit a new 30-year high in 2021. The Personal Consumption Expenditures (PCE) price index — which tracks consumer spending — was up 4.3% over the 12 months ending in August, the fastest pace since 1991.¹⁰

As the *Wall Street Journal* recently reported, many investors are “woefully unprepared” for higher inflation.¹¹ Why? Until just recently, inflation was not on anyone's radar. Many investors simply hadn't given it much thought. And one of the reasons is that US investment professionals under the age of 50 have not seen a single calendar year with inflation

higher than 4.1% during their entire working careers. We find this fact to be amazing. Colleagues in the first half of their careers are as familiar with inflation as they are with disco or pet rocks.

How high will inflation go? How long will the inflation rate remain at or above today's elevated levels? These are important questions facing investors, with no conclusive answers. However, we agree with the majority of economists surveyed by the National Association of Business Economists who say that the risk of inflation is the highest it has been in two decades.¹²

If investors are convinced that today's higher inflation will be short lived, then they are unlikely to make any major changes to their portfolio allocations. But those investors that believe inflation will go higher and/or last longer than expected per conventional wisdom should seriously consider increasing their tactical (and maybe even strategic) allocations to natural resources. Why? Because natural resources have historically performed very well during times of high and rising inflation.

“Powell retires the word ‘transitory’ in describing inflation.”

Source: *Yahoo News*, November 30, 2021.

⁹ Riley C. “Global Inflation Hasn't Been This High Since 2008,” *CNN Business*, June 3, 2021, available at <https://www.cnn.com/2021/06/02/economy/inflation-oecd/index.html>.

¹⁰ Tappe A. “A Key Measure of Inflation Surged to a New 30-Year High,” *CNN Business*, October 1, 2021, available at <https://www.cnn.com/2021/10/01/economy/inflation-incomes-august/index.html>.

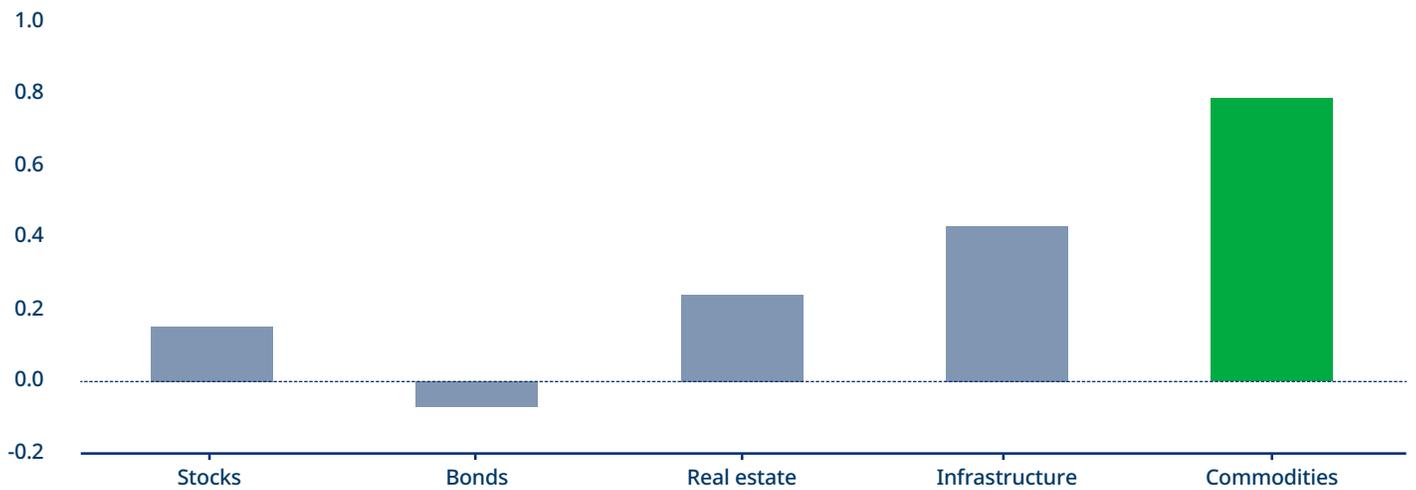
¹¹ Mackintosh J. “Everything Screams Inflation,” *The Wall Street Journal*, May 5, 2021, available at <https://www.wsj.com/articles/everything-screams-inflation-11620163599>.

¹² Fanzeres J. “U.S. Inflation Risks Mount Along With Debt Concern, Survey Shows,” *Bloomberg*, March 22, 2021, available at <https://www.bloomberg.com/news/articles/2021-03-22/u-s-inflation-risks-mount-along-with-debt-concern-survey-shows> © 2022 Mercer LLC. All rights reserved.

As shown in the two charts below, natural resource commodities have strong correlation to inflation. As a result, they have outperformed major asset classes during high-inflation environments. This is not surprising.

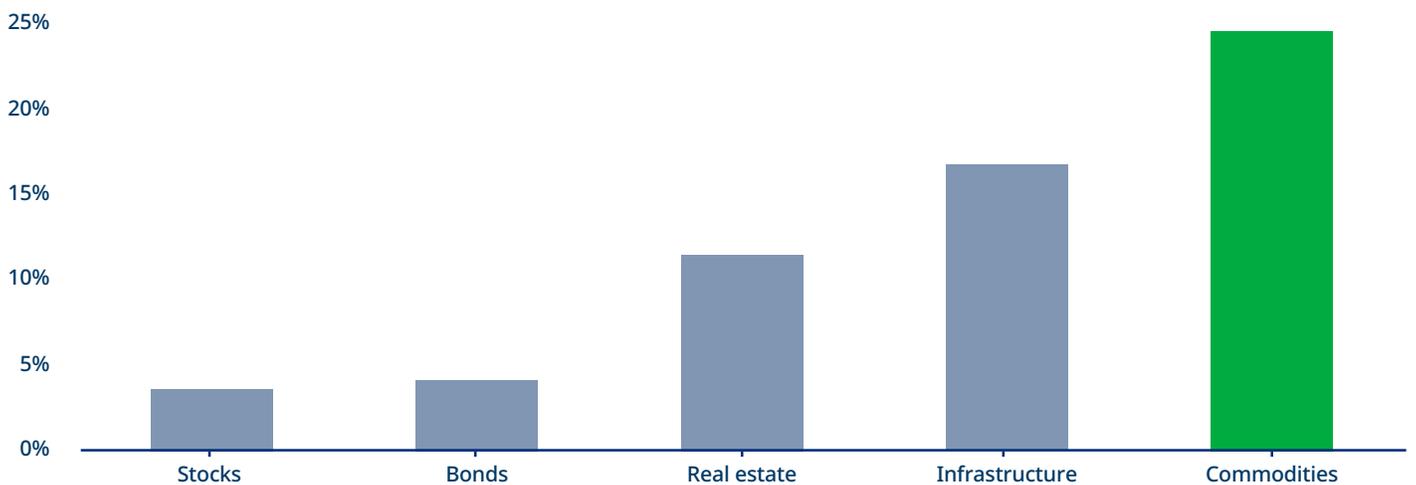
Natural resources, along with other real assets, have been considered inflation hedges. Most real assets performed very well during the high inflation of the 1970s and early 1980s.

Figure 4. Correlation to CPI — November 30, 2002, to April 30, 2021



Source: Aether Investment Partners.

Figure 5. Average asset class returns in high-inflation environments — November 30, 2002, to April 30, 2021



Source: Aether Investment Partners.

Since inflation can devastate the purchasing power of a portfolio, inflation protection should be an important consideration when building portfolios. Think of it as an insurance policy. As with other insurance policies, we certainly do not hope for, or even expect, any disasters. However, it is prudent to ensure that portfolios are prepared — and protected — in case the worst should happen.

Investors regularly ask which sector or subsector of natural resources or the broader real assets category will perform best during the next period of high inflation. This is certainly a reasonable question, but the unsatisfying answer is this: It is simply unknowable in advance which sector will be the best performer — and therefore the best inflation hedge — during future inflationary periods.

Those seeking to increase their allocations to natural resources will encounter additional challenges. Natural resources encompasses multiple sectors and multiple subsectors, all with their own distinct risk and return profiles, characteristics, strategies, managers and required expertise.

To compound the problem, good and accurate data on private natural resources are hard to find. Investors accustomed to being able to quickly and easily access quality data, relevant benchmarks, robust manager universes and comparable indices for traditional asset classes or even private equity will likely get frustrated when attempting to do the same for energy, timber, mining, agriculture or water.

In addition, major economic disruptions are taking place. One example is the energy transition the world is going through. How quickly will it take place? What are its ramifications? What resources are needed to support the transition? Which are in conflict with it?

Investors must wrestle with all these questions when building — and maintaining — a natural resources portfolio.

The steps to implement or expand a natural resources allocation include sourcing, analyzing and gaining access to great managers that can successfully navigate the distinct industry cycles. This process is a prerequisite to success. How is this done? It helps to have extensive sector experience and good relationships developed with top managers over many years. Rigorous due diligence is also a must. Finally, it is important to develop diversification by manager, strategy, geography, sector, subsector and vintage year.

These keys to success are simple to outline but require substantial work and expertise to execute well.

Natural resources and other real assets can be an integral part of a well-managed portfolio. With the reality of higher inflation now clearly upon us, they are even more important today than they have been in recent decades. We do not know how long this inflationary period will last or how high inflation will go, but we do know that the prudent thing to do is to hedge against it. Part of the solution can be to incorporate a quality real assets component in a prudently designed portfolio.

Infrastructure

As 2021 comes to an end, it is natural to reflect on the year that was and contemplate the year that is yet to come. The popularity of infrastructure as an asset class has continued to grow, in part, due to its attractive characteristics in relation to managing inflation risks. The total capital raised this year by infrastructure funds could even exceed the pre-pandemic 2019 record of US\$128.8 billion, with several US\$15 billion+ funds expected to reach final close in Q4.¹³ To date in 2021, infrastructure has generally managed to weather the “kryptonite effect” of the global COVID-19 pandemic, but the “asset class of steel” will always remain vulnerable to this type of villainous exposure. The longer-term threat to (but also opportunity for) infrastructure is the climate crisis; will this prove to be the Doomsday for the asset class or instead the dawning of a new Golden Age? We will explore this further in a future thought-piece but highlight below an access route to unlisted infrastructure that is gaining in popularity.

In 2021, there has been a real acceleration in the revival of open-ended infrastructure funds as a means to invest in the asset class, as there have been a number of high-profile new fund launches or new fund announcements. Interestingly, the majority of these new fund launches have been from high-quality infrastructure managers more typically focused on closed-ended structures and with a more core-plus/value-add+ strategy. In contrast, although there is not a perfect correlation between structure and strategy, open-ended infrastructure funds have tended to follow a core/core-plus buy-and-hold approach. Also, asset managers currently without an infrastructure capability are seeing this as a way to enter the otherwise competitive closed-ended funds market.

Recently launched open-ended funds appear to have been well supported by investors, as reflected by their multibillion-dollar initial closes. This support has come from a mix of new LPs and those that are broadening their relationships with particular GPs from previous closed-ended fund commitments. We view this as being reflective of continued, specific demand for core/core-plus infrastructure and more immediate cash yield from a certain subset of investors. In particular, these investors are placing greater emphasis on income and the perception of liquidity from open-ended infrastructure than on the greater total return and diversification that a more holistic approach can provide.

So what does this mean? Catering to specific demand and increased fund choice is likely to accelerate the adoption of infrastructure as an asset class within portfolios, particularly from investors that may have liquidity constraints. That said, it remains to be seen whether the liquidity requirements of these investors and the structures devised by GPs actually fully align. On the supply side, we expect infrastructure managers to continue to launch new products, attracted by the AUM potential and the diversification of their business models and LP bases. From a market perspective, however, the competition for core/core-plus assets is only likely to intensify, and these assets are likely to remain out of the market for many years once acquired given the buy-and-hold approaches being followed.

If the consequences of the major 2016 events (primarily the US presidential election and Brexit) have taught us anything, it is to expect the unexpected. We have already seen a global pandemic, so where might a black swan appear next, particularly in an infrastructure context? The recently completed Conference of the Parties (COP26) in Glasgow, Scotland, was viewed in some quarters as the last opportunity to avert irreversible damage to the planet due to climate change. Whether politicians can agree and then commit to the actions needed to avoid potential disaster is another question. Interestingly, only in four of the G20 countries do more than half the people have trust in their respective governments more generally.¹⁴ Yet in a separate survey related to COP26, globally, more than half of respondents wanted their respective governments to play a leadership role on climate change.¹⁵

So what does this mean? If the risks and opportunities associated with climate change were two sides of the same coin, infrastructure would be that coin. Damnation comes from the carbon emissions associated with traditional power generation and transportation but salvation through renewable energy, energy transition and resilient urban infrastructure, which either removes or offsets these emissions and their negative effects and will lead us to a more sustainable future. Recently (and finally), the US Senate and House of Representatives passed the Infrastructure Investment and Jobs Act (IIJA), an approximately US\$1.2 trillion legislative bill that includes approximately US\$550 billion of incremental infrastructure spending. This is a positive and much-needed shock to the system, although, as always, it remains to be seen

¹³ Alves B. “Q1–Q3 Hints at Record Year for Infra Fundraising,” *Infrastructure Investor*, October 27, 2021, available at <https://www.infrastructureinvestor.com/download-q1-q3-hints-at-record-year-for-infra-fundraising/>.

¹⁴ OECD. “Trust in Government,” available at <https://data.oecd.org/gga/trust-in-government.htm>, accessed July 9, 2021.

¹⁵ Ibid.

how the IJA plays out in terms of accessible, investable opportunities for private sector investors.

Climate change means infrastructure is exposed to both positive and negative climate-change-related shocks; these could be political, regulatory or operational in nature. The IJA represents one of the most high-profile political shocks to date, but there have already been several other global impacts (such as planned phase-outs of coal-fired power generation and the production of hydrocarbon-based vehicles but also support packages for renewable energy

and de-carbonization). Thus, although they are inherently unpredictable, they paradoxically should continue to be expected. For investors, this means being more aware of climate change as it relates to the potential impact on current and future infrastructure investments, as we have seen the impacts extending across subsectors within the asset class to varying degrees. If the past five years (and the associated politicians) are anything to go by, there is genuinely no such thing as a silly question when considering potential risks and opportunities.



Private debt

The last time inflation was an issue for private markets was in the late 1980s, when junk bonds and leveraged buyouts dominated the financial headlines. Since the 1980s, declining inflation and interest rates have proved a tailwind for private markets, lowering financing costs and pushing valuation multiples higher. As we look to 2022, there is a growing concern that inflation could become a more

permanent factor as opposed to a transitory spike in the post-COVID-19 environment. Many market participants view inflation as the major risk today and see it as a potentially longer-term challenge. It is therefore pertinent to consider whether private debt can provide some protection against inflation and rising rates.

Figure 6. US Inflation (CPI) versus US 10-year yield



Source: Bloomberg, November 2021.

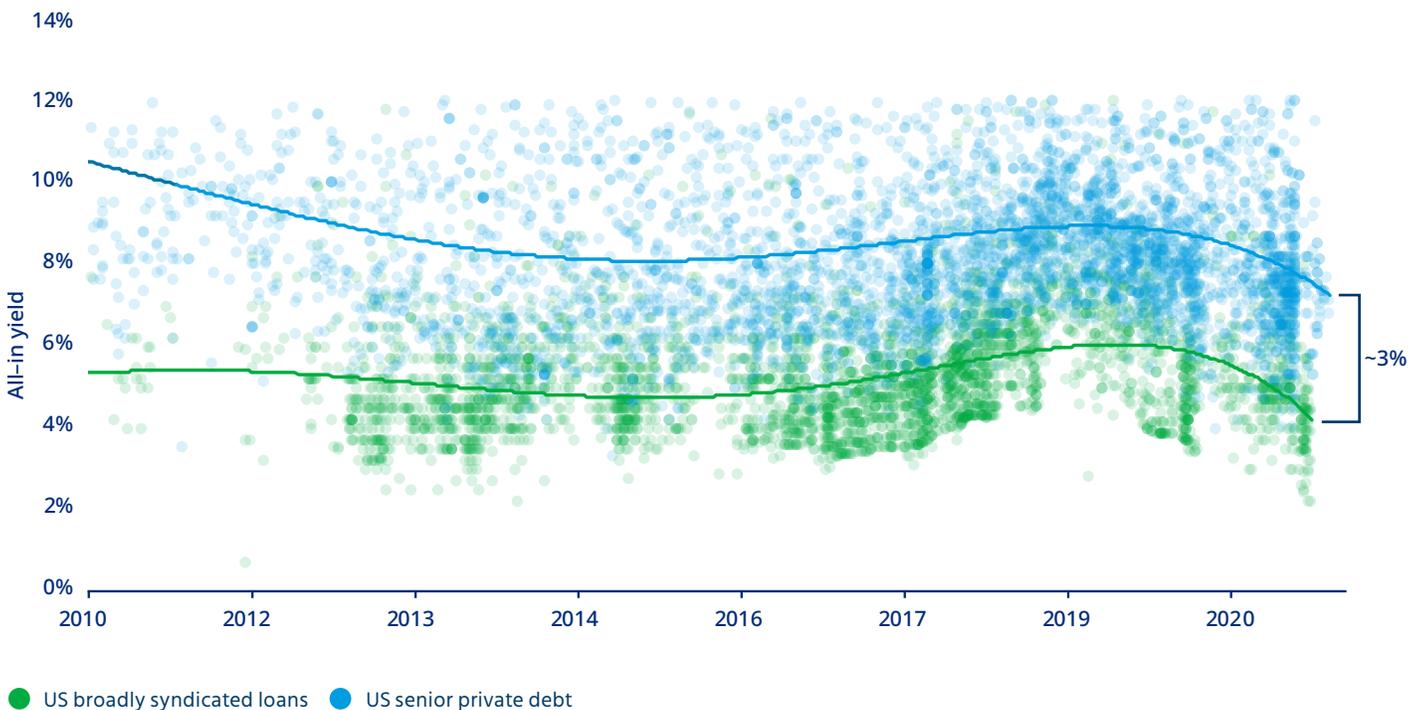
Facing inflation

Inflationary pressure has been increasing globally. This is most evident in the US, where the post-COVID-19 economic rebound is driving a surge in consumer prices. Pent-up demand, a surplus of monetary stimulus and the impact of supply chain bottlenecks have pushed prices higher for goods and services. Moreover, a confluence of changes in the labor market have pushed wages higher, causing prices to rise in order to protect corporate profit margins. Furthermore, and extending outside the US, long-term secular forces such as globalization seem less assured.

While the prospect for an inflationary cycle poses a significant risk for the market as a whole, private debt provides a useful option to help investors mitigate this risk within their broader portfolios. Private debt offers certain protections against inflation:

- Private debt returns are generated from interest that is based on a floating rate. The floating-rate nature of these loans means that, to the extent that inflation causes short-term interest rates to rise, investors can be protected. Floating-rate loans are highly likely to outperform fixed-rate bond allocations in a rising rate environment.
- Private debt as an asset class has proved its ability to deliver a durable premium to investors through the economic shock caused by the pandemic as well as other dislocations over the past 10 years. Yields attainable in the private debt markets have ranged from 270 to 300 basis points above those available in the high-yield and leveraged loan markets over the past 10 years. This provides a significant spread cushion to absorb both idiosyncratic company risks and broader market turbulence, which could result during an “inflation scare.”

Figure 7. All-in yield at entry — US senior private debt versus US broadly syndicated loans

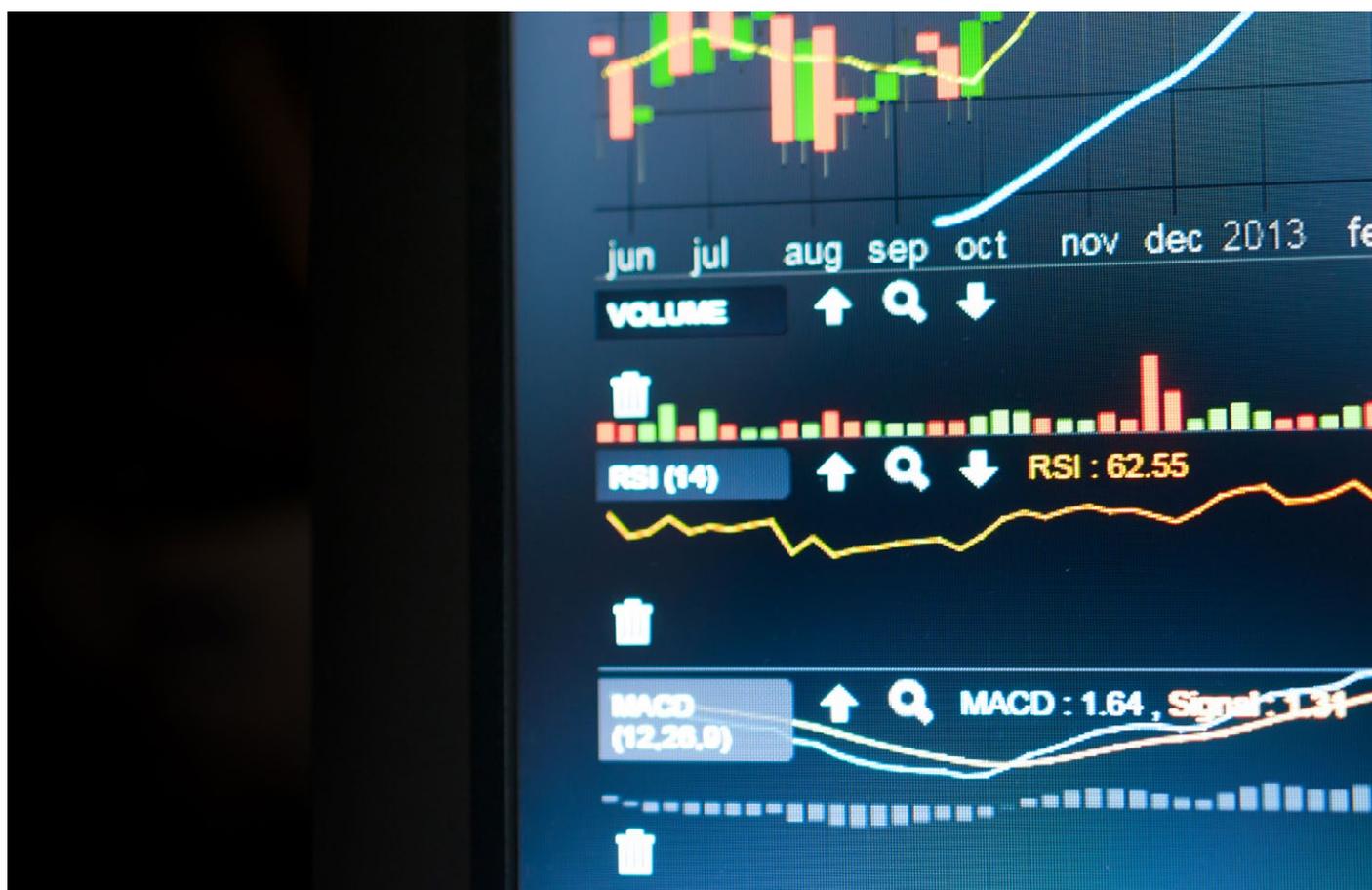


Note: For illustration and educational purposes only. Source: US senior private debt, Mercer proprietary dataset of ~5,000 anonymized direct loans. All-in-yield for US senior debt is calculated, per loan, as the spread at the point of entry, plus the original issue discount recognized over an assumed weighted average life of three years and the higher of three-month USD Libor or Libor floor. This analysis excludes any fund-level leverage level that might be employed to enhance the returns of the underlying loans. US broadly syndicated loans sourced from S&P LCD (as at June 2021) with all-in-yield calculated, per loan, as the original spread of first-lien loans within the S&P Leverage Loan Index, in addition to an assumed original issue discount of 0.5% and weighted average life of three years and the higher of three-month USD Libor or Libor floor. Past performance may not be indicative of future results. There can be no assurances that any fund or investment objectives will be achieved.

- Moreover, private debt loans are not traded. Therefore, valuation methodologies can look through market volatility, focusing on fundamentals and expected future cash flows. This results in a typically smoother return profile to the underlying investor.
- Private debt has also exhibited lower defaults and higher recovery rates than other high-yield fixed income investments. This is due to covenants, governance protections and priority of claims that private debt loans enjoy relative to other asset classes.

Conclusion

Investors should be proactive in reviewing their portfolios against inflation and rising rates. While an inflationary cycle could pose a range of challenges for financial markets, private debt might be better suited for a rising-rate environment due to its floating-rate nature. The current economic backdrop appears to provide a solid foundation for credit performance, especially with both monetary and fiscal stimulus providing fuel to the economies. Default rates have been decreasing, and rating agencies continue to lower expectations for future defaults.¹⁶ For investors looking to dampen the inflation risk inherent in their fixed-rate bond allocations or seeking higher-yield and diversifying investments away from other growth asset classes, private debt should be seriously considered in the context of the current market environment.



¹⁶See, for example, FitchRatings. “Fitch Ratings Lowers HY Default Rate Forecast to 2% for 2021, 2.5%–3.5% for 2022.”

Real estate

The magnitude of investors seeking to increase real estate allocations continues to grow. Fueled by market recoveries, the amount of capital-seeking real estate investments has outpaced the deployment of capital by investment firms. Other factors, such as rising populations, a broad global focus on increasing access to quality housing, and a need for access to current technology and healthcare and related services, are highlighting the benefits of investing in real estate. However, the abundance of capital in some real estate sectors has driven pricing and valuations to all-time highs and yields to historic lows, albeit still attractive relative to yields that most other asset classes provide. While there are sectors that are still recovering and will continue to evolve, either positively or negatively, the overriding theme has been that adding real estate to portfolios can provide access to cash yields and provide a measure of protection against rising inflation.

In addition, an increasingly employed portfolio management practice has been to deliberately over- or underweight particular property sectors within a real estate allocation. Logistics, housing, life science, and other healthcare-, demographic- and technology-related sectors have shown resilience over recent market cycles, and those sectors have exhibited greater demand from tenants, thereby becoming increasingly attractive to investors. The growth in sector-specific investing continues to increase, with significant new investors entering the market.

Even with some uncertainty in global markets, real estate capital markets remain liquid. Most property types are experiencing improving fundamentals; however, performance is likely to remain bifurcated across geographies and property sectors. Structural changes in how and where individuals live, work and consume goods have begun, and the opportunity to seize outsized gains on demographic- and technology-led investment decisions is underway. These secular trends are providing extended tailwinds for sectors such as life science, data centers, medical offices, creative offices, and housing sectors needed in terms of advancements in technology and an expanding, aging population. Additionally, with a rising population, a global focus on increasing quality and affordable housing, and strong resilient returns from the residential sector, we expect a continuation of investments in residential globally. Opportunities for investment in real estate will persist in 2022 and over the next several years because of these secular trends.

Below is additional detail on specific property sectors that will continue to provide investment opportunities within real estate:

- **Residential.** The sector remains attractive as strong fundamentals underpin it. Housing shortages persist, driving unprecedented demand in the space. Historical long-term underdevelopment as well as new household formations and demographic shifts have fueled demand in this sector.
- **Affordable housing.** This affordable housing theme has come to the forefront recently as rents have recovered robustly. Government stimulus and a push to eradicate the divide in suitable housing across income levels has supported the sector. The lack of affordable housing supply, overwhelming demand and resilient income from the sector offer an attractive investment opportunity.
- **Logistics.** Strong demand and performance continue in this sector, driven by the heightened focus on storing and delivering goods with rapid speed. Although e-commerce sales are forecast to normalize following the pandemic highs, the sector is expected to expand over the next two decades as it continues to gain market share from brick-and-mortar stores. Logistics users are hedging future disruption by moving from a “just-in-time” to a “just-in-case” business strategy, adding to demand pressures.
- **Health-related and life science facilities.** A rapid rise in R&D funding, as well as an aging population and rising healthcare spending, have driven the demand. Private markets, with their recession-resistant qualities and generally lower volatility, continues to benefit from strong economic, secular and demographic tailwinds.
- **North America.** Vaccination progress has been key to the reopening of the US economy and alleviating the pressure on most real estate property sectors. However, despite a steady resurgence, vaccine hesitancy persists among a consequential portion of the population. Employment has rebounded, but widespread hiring challenges in certain industries, as well as workers reevaluating life priorities, have

added to labor pressures and resulted in wage spikes. Consumer demand has rebounded faster than anticipated, catching retailers, suppliers and distributors by surprise. Further, with disruptions in the supply chain leading to increased supply shortages, inflation has spiked to the highest level relative to the recent past. While rents have rebounded in most sectors, so have valuations. An important factor to watch is the supply/demand balance as new construction adds to the available supply across several property types. Additionally, rents continue to increase, which is positive from an investment perspective. However, what magnitude of rental increases, particularly within the residential sector, can tenants absorb?

- **Europe.** Shifts in monetary policy, ongoing digitalization and a growing focus on ESG will be three core themes affecting European real estate markets in 2022. If interest rates remain low, investors in Europe will continue to seek income-producing real estate. Germany and the Nordics will continue to be safe havens for real estate capital in 2022; however, southern parts of Europe are emerging as targets of riskier and higher returning capital. With increasing inflation, we expect to see growing interest in real estate as a means to protect real returns. As the digital economy grows, e-commerce and data-driven sectors will become an even larger force for demand in several parts of Europe, particularly for urban logistics and data

centers. Additionally, following on from the COP26 summit, we expect European real estate markets to be at the forefront of real estate ESG integration. Legacy real estate strategies must grapple with a step change in regulatory reporting and disclosure requirements while investors place increasing demands on managers to deliver their goals regarding the de-carbonization of their portfolios and seek clarity on pathways to net zero. In relation to this, we expect to see heightened demand for ESG-orientated real estate strategies that can deliver genuine social impact and/or will have greater focus on environmental performance.

- **Asia-Pacific.** Despite an extended lockdown, the Australian market continues to exhibit robust occupier fundamentals. We anticipate a continued focus on high-quality, modernized offices; certain retail subsectors; and interesting opportunities through the institutionalization of sectors such as residential and healthcare. In Asia, key economies are leading in containing the virus, which bodes well for these countries' recoveries. Valuations in Asia have been relatively slow to rebound, but opportunities exist in certain markets, such as China and Japan, where supply and demand dynamics remain favorable. Across the region, data centers and logistics are attractive as the quick adoption of e-commerce during the pandemic has prompted a spike in industrial and data demand.

Closing comments

Economic uncertainty created by the COVID-19 pandemic and the inflation generated by the various governmental attempts to mitigate its impacts were the two major reoccurring themes in this year's *Top Considerations*. This is not particularly surprising given the pervasive and ongoing reverberations induced by the pandemic across so many aspects of our daily lives. Within the alternatives space, two important characteristics specific to private markets funds are that fund managers often have extensive experience across a wide range of market conditions and they also have a vested incentive to maximize the value creation in their portfolio companies, even across periods of large and unexpected exogenous shocks such as this pandemic. Furthermore, that most private markets funds are closed-ended with long but limited lifespans creates the conditions in which difficult but necessary decisions can be made more quickly to adjust to a "new normal."

A good illustration of this essential ability to adapt to changing market conditions occurred recently in one of our venture fund portfolio companies. The company offered consumer services that were anticipated to suffer a severe negative impact from the work-at-home requirements adopted in 2020. The fund manager drew from their dot-com experience and immediately decreased staffing by 40% rather than continuing to maintain a high burn rate while hoping for a "V" recovery as they had done 20 years ago. This was certainly a difficult decision, and it had profound effects on the company's employees. However, it also allowed the company to reposition itself and adjust its offering to reflect the new reality of consumers' daily lives. Due to the success of these changes, the company was able to go public in 2021. Obviously, not all private companies are likely to enjoy such a quick and extensive recovery, but it does demonstrate how the knowledge and experience of private markets fund managers can be a valuable resource when companies are dealing with severe and unexpected circumstances.

We hope you found this year's *Top Considerations* to be informative and at times, perhaps, provocative. For 2022, we look forward to continuing to work with our clients and our private markets fund managers in helping them navigate these unprecedented market conditions. And we especially hope to see a recovery from the challenges we all have endured during this period of acute turbulence.

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