SARANAC
PARTNERS

Investment roadmap

DECEMBER 2023

AT A GLANCE

— This month's main feature is on **return compression** between equities and credit. Saranac has been expecting broadly similar returns between these asset classes, largely because higher yields have raised the attraction of fixed income as an asset class – not because there is an outright negative view on equities. This has translated into a higher exposure to corporate credit in multi-asset portfolios, and a lower than usual allocation to equities (although we raised the equity weight mid-year). How has this view worked out? Equity returns have generally been higher than credit this year, following the rally in recent weeks, but not by a very substantial magnitude for many investors. We expect equities to deliver slightly higher returns than credit over time, but by a much smaller amount than the historical average, and with higher volatility. We retain the pro-credit tilt in our multi-asset portfolios.

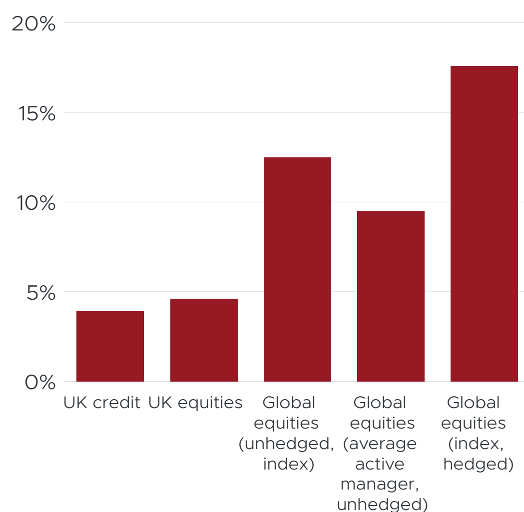
— We regard the **global economy** as stagnating rather than in recession, with significant regional dispersion: Europe and China are struggling to a greater extent than the US. Recession risk is material, but not inevitable. The possibility of a soft landing is higher than earlier in the year. Markets seem to be expecting bad news: economic surprises have been positive since mid-year, despite the weak underlying trend.

— **Long-term interest rates** have declined sharply in recent weeks. We attribute this to a more doveish Fed and position unwinding. The likelihood is that 2024 will see an easing cycle emerge, as markets now expect, but the scope for early and aggressive rate cuts is limited. We expect yield curves to steepen.

— **Equity valuations** are on average slightly higher than normal following the recent rally. However, the dispersion in valuations remains significant. US megacap valuations are extended, but perhaps some 25% of global sectors are still priced for economic distress. We regard the potential for weakness in corporate earnings as the main threat to global equities.

— We also take a closer look at the **NAV** loan market. These are loans completed by GPs that have been cross-collateralised against the underlying portfolio companies of a specific fund vehicle. They can offer a higher return for the providers of capital. However, we remain cautious of these structures, as there a number of technical factors that make them unattractive for LPs. Saranac has taken the decision not to invest in GPs that use these loans, and embed within legal documents a restrictive clause on GPs in this context once invested.

Chart 1: Asset class returns in 2023 (£, to 4th Dec)



Source: Saranac, Bloomberg

Equities or credit? Thinking strategically

Credit in multi-asset portfolios: return compression

One theme implemented across many Saranac multi-asset portfolios for much of this year has been a higher exposure than usual to corporate credit strategies and lower than usual exposure to equities. We regard this as a conservative investment stance, not a particularly bearish one.

There was a simple rationale for this tilt – the compression of returns between the two asset classes. The material rise in bond yields during 2022 offered much higher potential returns in fixed income than in any period since the 2008 crisis. This allowed for the implementation of a range of standalone fixed income strategies, depending on investor risk appetite, and also a more prominent role for fixed income exposure in multi-asset strategies. At the same time, while equity valuations on average were by no means extended earlier in the year, neither valuations nor earnings appeared sufficiently depressed to suggest that sustained strong returns associated with a rise in both components were very probable.

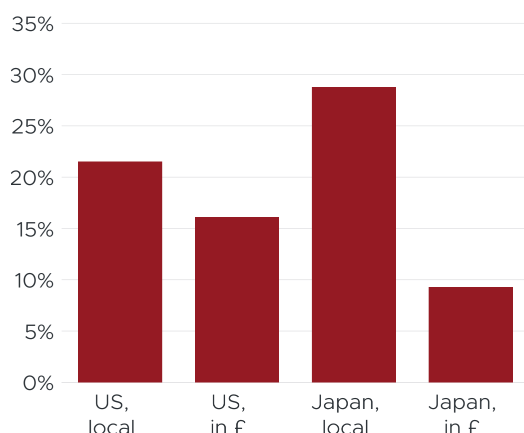
The high exposure to credit reflected a view that, given the respective pricing of each asset class, equity and credit returns were likely to be fairly similar over time, and very material equity outperformance was improbable. Nevertheless, the volatility in the latter asset class was likely to be materially lower, limiting the potential for large losses. Evaluating the risk/reward for each asset class suggested that a higher than usual exposure to credit was warranted. This did not reflect an outright bearish view on equities, as cash weights have been maintained at relatively low levels, particularly in recent months – rather a view that credit had in a relative sense become more attractive.

One theme implemented across many Saranac multi-asset portfolios for much of this year has been a higher exposure than usual to corporate credit strategies and lower than usual exposure to equities.

Evaluating the strategic tilt

How has this view worked out in practice? Obviously, the evaluation has varied as market conditions have changed during the year, but as the year is close to ending it's possible to have a clearer view. The easy part is that the volatility in equity returns has indeed exceeded credit returns – equities have been around twice as variable – but 'twas ever thus. What about the returns (chart 1)?

Chart 2: US and Japanese equity returns in 2023 (local currency and £, to 4th Dec)



Source: Saranac/Bloomberg

We present here returns for a sterling-based investor, but the results generalise to other currency bases. At the aggregate index level, UK credit returned ~4% to early December, broadly similar to cash returns. Some active managers have also delivered a moderate return over the index, particularly if there was some exposure to higher-risk areas of credit markets.

The equity return is, however, less straightforward to evaluate, because to a greater extent than usual investors' experience has been dependent on precisely which equities were held. For example, UK equities have risen slightly so far this year, delivering a return similar to credit. Since the volatility in equities was higher, the conservative Saranac stance could from this perspective be justified, even though the volatility in UK equities has also been relatively low.

However, if a global approach to equity exposure had been implemented, the calculation changes. The MSCI world equity index has risen by ~19% in local currency terms, albeit with much of this gain delivered in the past few weeks, as overseas markets on average outperformed UK equities significantly. Looking more broadly, investors in emerging market equities are likely to have experienced small losses, while those exposed to small cap companies are likely to have had a return closer to flat.

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The significant gains in developed market equities were not, however, directly achievable for UK investors, for whom the return in sterling is relevant. Allowance therefore needs to be made for exchange rate movements. Since sterling has appreciated this year, a global equity portfolio following an indexed strategy would have returned ~12%. This lower value reflects the strength in the pound against the dollar, and more particularly against the yen, which depressed these overseas equity returns on conversion to sterling (chart 2).

Of course, the non-sterling exposures could have been currency hedged, which would have delivered an aggregate global equity return of ~17%. However, it is unusual for many sterling investors to hedge a significant component of their non-UK equities

Table 1: Equity and credit pricing

	End 2022	Dec 2023
UK credit yield	5.9%	5.9%
Global equity PE multiple	15.6x	17.8x

(Saranac hedges 50% of its US and European equity exposures in multi asset portfolios, and we believe this hedge level to be higher than standard).

A further complication is that a material component of the rise in global equities this year came from a very small number of very large US companies, rising on average by some 75% (Nvidia's gain, for example, was 200%), compared with a gain of some 4% for the average company in the global index. Active managers who had material exposure to these outperforming large companies have delivered global equity returns of 20% plus, but many did not. A rough estimate would be that the average equity manager has underperformed the global index by ~3%. On an unhedged currency basis, this would imply a global equity return in sterling of ~9% for the average manager. This is still higher than the credit return, but by a modest rather than highly material amount – and at the cost of higher volatility.

Tilt towards credit still intact

Although we raised the equity weight in many Saranac portfolios mid-year, it is still somewhat below what we would regard as the probable average weight over longer periods of time. The credit weight, and the alternatives weight, are both somewhat higher than usual.

The rationale for the equity/credit positioning is still very much in line with that described above, but the quantification has shifted somewhat. The current sterling credit yield, which we regard as a starting point to evaluate forward-looking credit returns, is ~6%, similar to its level at the start of 2023. However, equity valuations are now somewhat more stretched – virtually all the rise in global equities this year has been the result of a rise in the PE multiple, not in corporate earnings. Higher multiples tend to be associated with lower equity returns, although we do not regard the valuation of global equities as being particularly stretched (table 1).

The expected returns from equities and credit over time are still, unusually, in the same ballpark (mid to high single digits), and we believe that this warrants the maintenance of the current strategic tilt towards credit in multi-asset portfolios.

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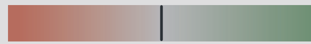
To reiterate: this is not a bearish view on equities per se, and we expect both asset class returns to be ahead of cash. Moreover, we expect slight outperformance of equities over credit – sufficient for equities to remain the asset class of choice for investors seeking to maximise return, and fixed income still more appropriate for more risk-averse investors. In addition, we continue to see an opportunity to balance more efficiently risk and return opportunities for multi-asset investors by maintaining, for now, a relatively high exposure to credit opportunities.

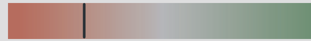
Public markets

EQUITIES

Valuation



Earnings



Positive
Energy; Healthcare; Japan

Negative
IT; Financials; Emerging Markets

Market background
Equity markets reversed the weak price trends of the past few months by surging almost 5%.The rally was driven higher by reduced inflation anxiety and initial signs of a softening US labour market. The market shifted focus from whether we are at or near peak rates to when and by how much the Fed might cut rates in 2024. Following the quarterly earnings announcements, more analysts have revised down their earnings number than up. This is due to cautious guidance from management teams. However, forecasts still factor a growth in earnings through 2024.

Targeted exposure
We are most cautious on IT and financials in terms of sectors, preferring the more defensive characteristics of healthcare. In addition, we expect the oil price to be supportive of cash generation in the energy sector. We are sceptical of the potential for emerging markets, despite superficially attractive valuations.

GOVERNMENT BONDS

Short maturity

Long maturity

Targeted exposure
5–10Y sovereign bond exposures

Positive
10Y US TIPS,
10Y Australian government bonds,
5–10Y nominal Gilts

Negative
>5 year European sovereign bonds,
Japanese government bonds

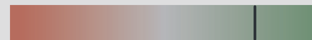
Market background
We now think that the major global central banks have reached the end of their tightening cycle (excluding the BoJ perhaps) and are likely to start cutting interest rates in the first half of 2024. This is on the basis that the disinflationary process remains on track and that cracks are starting to appear in the job market and at the consumer level. The market has been quick to adjust, with overnight futures pricing between 125bp and 150bp of cuts by the end of 2024 in the US and in Europe.

Targeted exposure
We are not pushing back strongly against market pricing and therefore we have not reduced portfolio duration meaningfully, despite the strong bond market rally. As we head into 2024, we expect sovereign yield curve to bull steepen as central banks cut rate and long-dated yields are pulled down. As such, we expect duration risk to do well in 2024–25.

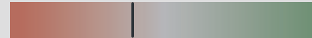
Public markets

CORPORATE AND EMERGING MARKET DEBT

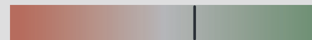
Investment grade credit



High yield



EM debt



Positive
IG credit with a preference for £IG, short-dated subordinated bonds, AAA/A securitisation, US Agency MBS

Negative
US B/CCC junk bonds

Market background
Credit spreads tightened strongly in November, with $IG spreads compressing 21bp to 113bp, below our fair value target of 120bp. $HY spreads sank by 50bp to ~400bp, as lower bond yields alleviated fears around the 2024–25 maturity wall. The bull flattening of the US Treasury curve drove the outperformance of (i) USD IG over EUR and GBP IG and (ii) outperformance of long-duration $IG compared to shorter $ bonds. Subordinated bank debt and corporate hybrids continued to perform strongly, as a consequence of elevated carry and further spread compression.

Targeted exposure
We remain constructive on corporate credit fundamentals but credit spreads at their tightest levels since early 2022, they see limited room for further compression and excess returns. Our core view remains for a deceleration in macro momentum as we head into 2024, which could lead to lower sovereign yields and wider credit spreads, particularly in High Yield, potentially benefiting a defensive fixed income positioning. We find best value in £IG, based on our constructive UK rates outlook and a spread pick-up over $IG. We maintain exposures to 3–7y $IG and 0–5Y €IG, which offer attractive yield for a limited duration risk. We maintain a defensive stance in High Yield as we expect (i) HY spreads to widen as we near the 2025 maturity wall and (ii) as credit defaults to pick-up from current low levels. Similarly, we maintain an IG bias in EM corporate and sovereign debt.

STRUCTURED PRODUCTS

Equity volatility collapsed towards five-year lows in November – with the VIX falling to around its pre-Covid lows in the ~12 region, at a time where global interest rate volatility remains at multi-decade highs. We looked to capitalise on this buy adding long volatility exposure in simple listed option format via the SPY (S&P 500) index puts. Away from this we continue to view the environment for adding capital protected products as attractive, with rates at the front end still in attractive territory from a funding perspective and equity volatility at these lows. We view the autocallable environment as particularly poor at present and consider the risk premium gained from underwriting risk at these volatility levels as unattractive.

Public markets

HEDGE FUNDS

The magnitude of credit maturities coming due, mostly in 2025–26, coupled with higher rates for longer will likely lead to a transfer of value from equity to credit investors. We expect material dispersion, with some companies having more difficulty operating on the other side of the maturity wall than others. This creates an attractive environment for **Long/Short Credit** funds with flexible and patient capital, as they are being paid to wait for fat pitches to come around and/or a full Distressed cycle to emerge. **Convertible Arbitrage** remains attractive given the robust new issue market, as well as funds engaging with issuers around corporate liability management activities. **Structured Credit** is attractive but given the economic uncertainty and potential for larger tail events we believe exposure is best managed through a diversified, lower duration and higher credit quality expression.

CURRENCIES

Dollar

Sterling

Euro

Yen

Market background
The US dollar came under pressure in November, declining 3% on a trade-weighted basis. The British Pound and Australian Dollar gained ~4% against the USD in November, the best performers across developed markets FX, the Brazilian real gained a further 2.4% and has now appreciated 7.5% against the dollar this year. The US dollar's pullback was driven by bets that the Fed have not only hiked for the last time, but are not far from embarking on as much as 100 basis points of rate cuts in 2024. US macro data has decelerated in November and the narrative of US exceptionalism versus other DM economies is waning – despite Europe's own macro data remaining very challenged.

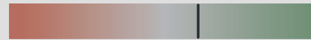
Targeted exposure
One currency that looks to be gaining some early momentum is the Japanese yen, appreciating 2.4% in November. With inflation running north of 3% since August 2022 and price pressures broadening, Japan is one central bank that will likely be tightening policy as others are easing into 2024, we continue to like long JPY exposure in portfolios.

Public markets

COMMODITIES

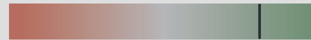
Gold

Energy



Industrial metals

Softs



Market background
Commodities
Despite the furious rally across equities and fixed income, November was a challenging month for commodities at a headline level, with energy driving the Bloomberg Commodities Index to a ~3.5% loss. Dispersion in the space has been pronounced, with precious metals rallying sharply as real rates tumbled lower and geopolitical tensions remained high. Central bank buying of gold remains strong, at exceptional levels compared to the long-term trend.

Targeted exposure
We retain direct gold exposure and also higher beta exposure via the substantial gold/silver miners weighting within the Baker Steel fund. Away from this we retain our medium-term conviction in the soft commodities trade and have exposure to the space in a lower correlated expression via the commodities carry implemented using capital protected notes.

Private markets

NAV Loans

In Q2 2023, we published a research paper that highlighted our findings on the fund-raising environment, specifically showing how the dynamics had shifted in the last five years relative to previous decades. The key message was ultimately how since 2017 GPs (General Partners) had become net capital callers, and how this change had created a liquidity squeeze for many LPs (Limited Partners), ultimately restricting their ability to reinvest in the market.

This shift in liquidity profile has brought a spotlight to what was a very niche area of the private markets' universe – NAV (Net Asset Value) loans. NAV loans have been a part of the market for many years. However, until very recently it was a small, niche strategy that not many market participants were paying too much attention to. However, as LPs have applied more pressure on GPs to return liquidity, NAV loans have very much come to the forefront of private markets.

However, before jumping into our views on the space, it's probably important that we outline what NAV loans actually are. At a high level, they are loans completed by GPs that have been cross collateralised against the underlying portfolio companies of a specific fund vehicle. These loans typically carry a high rate of interest (10–15%) and low loan to value levels (20–50%), and hence are highly attractive structures for those providing the capital. Nevertheless, in our view, these facilities can become very problematic for LPs. To date, most of these financing structures have been taken out by GPs to provide liquidity back to LPs. The use of these NAV loans has been a clever way for GPs to increase their DPI and hopefully land new commitments in their latest fund vintages. This is highly advantageous to GPs, but we have identified a number of problems for LPs. The three key issues we have with these facilities are:

1. The cost of capital and repayment of the facility is ultimately paid when underlying portfolio companies are sold. Hence, the cost of gaining liquidity ultimately comes as at a cost to the LP, not the GP. Therefore, gross to net spreads would be much wider than we expect from a standard 2% /20% fee structure.
2. GPs have typically structured the facility as part of the funds' operating expenses, and therefore when GPs calculate their carried interest on the fund performance, they are doing it on a **gross** basis. This means that GPs are taking their carried interest share before taking into account the cost of capital they have incurred by taking out a NAV facility. This further adds to the gross to net spread effect we would see in funds that have utilised a NAV facility.
3. Finally, and probably the most structural issue we see with these facilities, is the fact that the distributions that LPs receive from the proceeds of a NAV loan are recallable. This means that whilst GPs are able to provide capital back to LPs, artificially boosting DPI and IRR metrics, if GPs fail to exit portfolio companies (an issue we expect to occur for many) within the tenure of the NAV facility, GPs can call the capital back from LPs in order to repay down the loan. This dynamic would effectively render NAV facilities as ineffective for the LPs, and depending on how many of their GPs did this, could create future liquidity issues if the proceeds are used to commit to new investments.

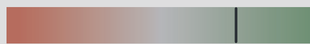
Given the above, we are highly sceptical regarding the use of NAV loans as a liquidity solution and believe that all private market investors should be cautious when investing in new managers/ funds. As a house, we have taken the view to not invest in any funds/GPs that use NAV loans and are embedding within our legal documents a restrictive clause on GPs that we work with to use NAV loans once we are invested.

It is important to note that the above are just, what we believe, are the most important considerations to note about NAV loans. However, there are a number of wider implications that investors should take into account when reviewing the use of these facilities by their GPs.

Private markets

ALTERNATIVE SOURCES OF RETURN

Secondaries



Record levels of secondary volume as investors seek to rebalance portfolios has resulted in a very attractive pricing environment

Special situations

Favourable market environment given the likely stress corporates will face in a higher rate environment

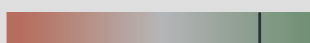
Venture capital

Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

Infrastructure

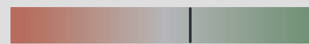
More attractive given supply chain issues and geopolitical uncertainties

Real estate



Pricing is unattractive given the narrow spread (in some cases negative) between cap rates and the risk-free

GP stakes and financing



Opportunity of higher yield and greater downside protection as a result of attractive secondary pricing dynamics

Real assets

At risk from weak growth environment

Private debt

A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

Leveraged buyouts

EBITDA multiples have begun softening and hence in time valuations could again become attractive

Mid-market growth

A prolonged period of weak/negative earnings growth as a result of a weak economic environment and increased cost of capital will see valuations struggle in the short term

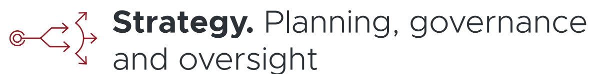
ABOUT SARANAC PARTNERS

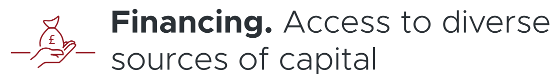
We founded Saranac Partners to do things differently. To create a community based around like-minded people, shared wisdom and collective learning. To work as partners, creating compelling opportunities and effective solutions. To offer unfailing support, honest challenge and thoughtful inspiration.

Our business combines the personal touch of a private office with the capability and breadth of a large institution. Our firm has strategic shareholders, outstanding technology, broad capabilities and the highest standards of corporate governance. Saranac Partners is a signatory to the United Nations Principles of Responsible Investing (UNPRI).

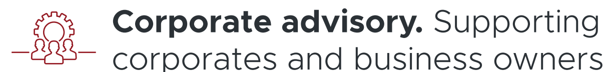
OUR SERVICES

We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.


Strategy. Planning, governance and oversight


Financing. Access to diverse sources of capital

Investments. Allocation and deployment of capital


Corporate advisory. Supporting corporates and business owners

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