COMMENT

Fear of missing out vs fear of capital loss

Capstone associate partner Lucien Cipollone assesses the response of private investors and managers to Covid-19 in comparison to the GFC.

As we entered 2020, the fear and market chaos associated with the GFC may have seemed a distant memory. Then came the shock of a global pandemic roiling economies and scrambling investment priorities for investors in the public and the private markets. With the benefit of a year to look back on the private market response to the Covid-19 crisis, one might ask how LPs navigated the crisis. Both periods were driven by fear; in the aftermath of the GFC, fear kept investors out of the market, and in the Covid-19 market, fear kept them in.

The GFC response

Coming out of the GFC, fear seemed to dominate all aspects of the private markets sector. A depressed public market created a denominator effect that suddenly had LPs over-allocated to alternatives. Investor programmes that had made aggressive forward commitments, suddenly lacked liquidity from anticipated fund distributions. Fear of capital call defaults haunted both GPs and LPs.

On the deal side, all but the most distressed sellers were reluctant to seek liquidity during a crisis and buyers in the early days of the crisis shied away from deals that had not repriced to the uncertainty of the moment. At least for a time, the volume of commitments an LP had made pre-GFC had come to a halt. In 2009, fear had paralysed much of the typical LP commitment activity.

In the years that followed the GFC, LPs learned from this period of paralysis. With the benefit of stabilised markets, it became clear that those LPs who maintained (or accelerated) their commitment pace in the 2009-2010 period enjoyed the fruits of some of the industry's most rewarding vintage years. GPs that were able to commit through the cycle balanced troubled deals that required work out with new deals where returns were built on the buy.

The Covid-19 response

In March 2020, the world was at a similar precipice. For a short time, public and private markets both experienced similar chaotic rides. Fear was certainly in the air. However, fear of capital loss was quickly overcome by fear of missing out. Perhaps partially informed by the missed opportunities of the post-GFC era, LPs, almost in unison, took the months of April and May to triage their existing portfolios, part of June to re-evaluate forward priorities, and by late June/early July, most were back actively and, in many cases, aggressively deploying capital. This commitment activity may have been redirected to more opportunistic strategies, but our observation was that the fear of missing out dramatically outweighed the fear of capital loss.

However, in order to make commitments to new GP relationships, LPs had to adapt their diligence to account for the travel ban that was in place throughout most of the world. Zoom meetings became commonplace and most LPs completed full diligence (including first meetings through "on-site" and operational due diligence meetings) by video meetings. The time savings from the reduced (or no) travel allowed LPs to dig deeper in diligence or even to meet with more GPs. It also allowed for more reference calls to be completed, which was critical when the LP was unable to meet the GP in person.

Today, deal activity continues to be strong, with GPs systematically transacting new deals and exiting current investments. This has all resulted in a compression of fundraising cycles for GPs, with bigger fund sizes fuelled by the great performance of their past funds and a healthy stream of distributions to their LPs. With all this activity, there are greater amounts of capital available to allocate to the private markets; however, there is less time for LPs to assess fund offerings from GPs with whom they are less familiar.

Challenges & opportunities

So where does that leave the challenge/opportunity for both GPs and LPs? On the GP side, it means adapting to the trend of being constantly in a state of relationship building, especially during the period between active fundraisings. Spending time with LPs over multiple touchpoints helps them to get familiar with a GP's USPs and differentiators, as well as crucially building trust. This is beneficial to both sides: for the GPs entering a fundraising period, they get a much better sense of those LPs' conviction for their fund through the quantity and quality of interactions they have had to date.

For the LPs, actively tracking a GP means there is often a 12-18 month signalling of an upcoming fundraise, allowing the investor to plan their forward pipeline of commitments and workflow more effectively.

For LPs, the opportunity lies around taking the same approach to refining their investment programme and capitalising on the best opportunities in the market today as they did post GFC: balancing the familiarity of committing to a re-up with GPs with whom they already have a relationship vs the risk of missing out in getting exposure to the best new fund managers.

To ensure that they capture the most attractive fund opportunities, many LPs are proactively adapting their investment processes, either by compressing their underwriting processes or by tweaking the constraints of virtually underwriting a fund without an in-person meeting.