First time buyers of Private Equity/Credit, BEWARE!

In working with high-level professionals, retired senior business executives and wealthy families over the years, we have learnt that capital preservation is the most important investment criteria for our clients. Having gone through many financial crises, the Global Financial Crisis and COVID to mention just two and the internet bubble in the late 90's, we always guide our clients away from risks we don't understand.

The race currently on to sell unlisted (private) assets to wealthy individual investors demands reflection. Increasingly banks are announcing tie-ups with alternative asset managers and making plans to make it easier to offer their clients a number of products from private equity, private debt and infrastructure firms. Many of these offerings are untested in volatile markets and many investors don't understand them.

A few years back we wrote a two-part article addressing Alternative Investments as it was a growing asset class available to investors. In Part 1 and Part 2, our goal was to ensure that our clients were well-informed and had a broad understanding of various alternative investment options, including private equity, private credit, infrastructure, and hedge funds.

We noticed last year that the private equity industry has begun transitioning its primary performance benchmark from Internal Rate of Return (IRR) to Distributions to Paid-In Capital (DPI). This shift reflects growing investor demand for tangible cash returns over projected future gains. The change comes as annualized IRRs dropped below 10% by March 2024—well below the historical 25% target.

DPI figures have also been underwhelming. According to Goldman Sachs, funds launched between 2019 and 2022 returned only about 15 cents per dollar invested, compared to earlier vintages that returned over 50 cents. In response, private equity firms are under increasing pressure to generate liquidity, often by reducing asset prices to facilitate exits and meet investor expectations for near-term cash flow.

In the spring this year we read reports of private equity assets under management (AUM) declined for the first time in decades, according to Bain & Company. AUM fell 2% year-over-year from June 2023, driven by investor hesitation amid a $3 trillion backlog of aging and unsold deals. This capital overhang has led many investors to pause new commitments.

The report also highlights a continued deterioration in liquidity. The proportion of net asset value returned to investors as cash—measured by Distributions to Paid-In Capital (DPI)—has dropped to roughly half its historical average. In 2024, DPI fell to just 11%, marking its lowest level in over a decade.

Bain & Company projects that these challenges are unlikely to ease before 2028, signaling a prolonged period of constrained returns and limited exits.

Back in December Donald Trump nominated cryptocurrency advocate Paul Atkins to chair the US Securities and Futures Commission (SEC). Earlier this month, he withdrew 14 rules that had not been finalized by the time the previous chairman left the office. These included rules that limited how investment advisors used technology to put their own financial interest ahead of their clients, reduced investor protection and would have required investment advisers to adopt cybersecurity policies and reporting to the SEC. It is reasonable to expect that new SEC policies will be more favorable for financial institutions and advisors than to investor protection. Yet another reason for caution.

When combined with considerable economic uncertainty, multi-layers of leverage in the financial system and the rapid development of various speculative digital offerings, we believe requires extra caution. We appreciate that returns have been good, even stellar, for short periods for some of these assets, but our clients' investment objectives tend to be long term and always have capital preservation at the fore.

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