2024 Investment Outlook

CAPRICORN
PRIVATE INVESTMENTS

EXECUTIVE SUMMARY

2023 was a year of twists and turns although it ended up being a good one for our portfolios with solid absolute returns and, critically, portfolios are now above their previous high-water marks. There were good contributions from listed equities, private and liquid credit and smaller positive contributions from absolute return. Private equity was broadly flat in aggregate with opportunistic and real estate strategies offsetting losses in early-stage venture capital investments.

We believe we are now in a new regime with higher interest rates than before the pandemic, with the era of low/zero/negative rates over. This adjustment means good risk reward is available in areas of secured lending and opportunistic credit strategies. Dispersion is also higher, leading to more relative value opportunities for active management. Pricing readjustment in the private equity sector is leading to better risk-adjusted opportunities across all areas, with secondaries a current sweet spot.

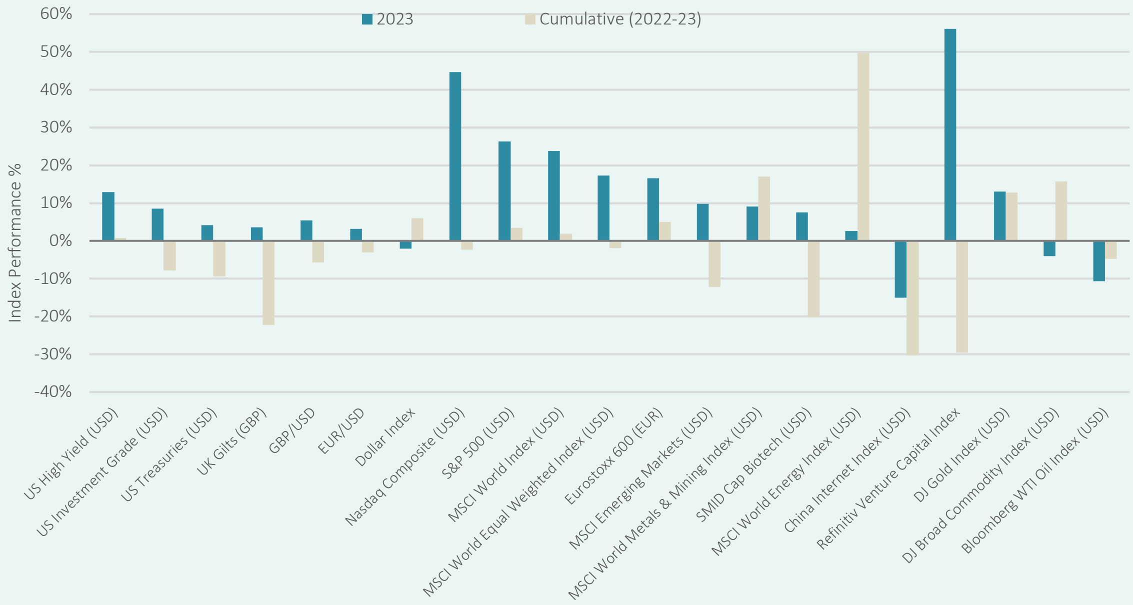
As a firm we continued to grow, hiring two new senior members of the team with considerable experience of working with entrepreneurs and their families. Our assets are now c.£1B across 17 clients. We continue to strive to be a partner of choice for entrepreneurs and their families who are of scale, but do not wish to set up their own family office teams or structures. We believe that our core tenets of having a long-term mindset and blending best-in-class active management in less efficient markets with cheaper passive options is a winning strategy.

We thank you for your continued support.

REVIEW OF 2023

In contrast to 2022 where most asset classes delivered a negative return, 2023 saw a positive outcome for most liquid markets. However, we think it is right to look at assets over the period from January 2022, which is when central banks began the current tightening cycle. In this case most asset classes were still in negative territory at the end of 2023.

Fig 1: Returns by asset class for 2023 and 2022-23 combined – there are only handful of assets with material positive return over the 24-month period, most notably energy equities and commodities



Source: Refinitiv, Deutsche Bank

We entered the year cautiously, expecting that the fastest rate-rising cycle in recent history across all major developed markets would slow economies sufficiently that the risk of recession seemed high and, it seemed to us, not discounted sufficiently within risk assets such as equities or high-yield bonds. We believed it would be challenging, (and certainly without any previous historical precedent) to achieve the so-called 'soft landing', where inflation gently declined back towards the 2% target, without a material rise in unemployment (thereby allowing the central banks to start cutting rates).

Through 2023, inflation has come down without unemployment rising significantly (yet). As we write, it does look like a 'soft landing' is on track and markets repriced significantly late in the fourth quarter to reflect this expected outcome for 2024.

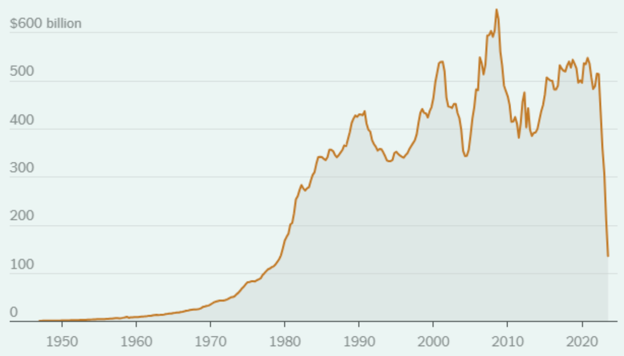
Stepping back, why was this the case?

We know that policy rate changes operate with a long and variable lag. The terming-out of borrowings during the low-rate pandemic period meant many households and corporates became more immune to the subsequent rate rises. As an example, the current rate on US 30-year residential mortgages is 7%, versus the average of 3.7% actually being paid today[1]. Corporations,

[1] Source: Apollo

which were sitting on excess cash accumulated during the pandemic, were now earning material interest on these balances for the first time in more than a decade. As Fig 2 below shows, in 2023 overall corporate debt interest payments in nominal terms hit a 40-year low. That this debt was termed out was a known factor by most market participants, but the resilience was perhaps greater than expected.

Fig 2: Overall corporate debt payments plummeted to 40-year lows



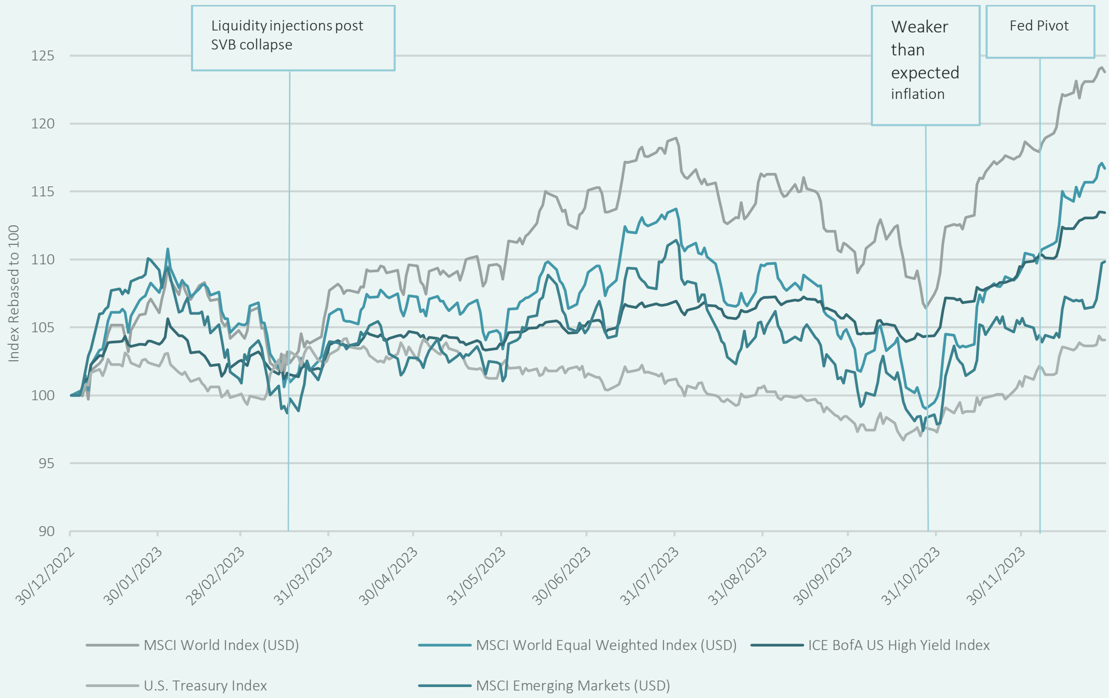
Source: NY Times

We wrote in our 2023 letter that when rates rise faster and by more than anticipated this "increases the risk of something severe occurring that no one expects". It didn't take long for this to occur, as illustrated by the failure of Silicon Valley Bank and other US regional banks due to losses on Treasuries and MBS depleting their equity. However, the actions of regulators, effectively back-stopping losses and forcing banks into sales/mergers, quelled these fears sufficiently to make them a non-event. The same could be said about the forced takeover of Credit Suisse, one of Europe's longest-standing financial institutions, by its arch-rival UBS.

In 2023 we anticipated that China's reopening would pose an upside risk to inflation as demand for raw materials and commodities would increase; however, this did not transpire. Brutal lockdown conditions further depressed an already cautious consumer with a high saving habit. Coupled with a highly indebted economy and ongoing property crunch, China's reopening disappointed leaving it as one of the few major stock markets to experience a material negative return (marking the third year in a row of price falls). If anything, China is exporting 'deflation' to the rest of the world with its much lower growth dynamic, exacerbated by very challenging demographics.

Up until October, there was significant uncertainty around the path of inflation, with the summer readings proving higher than estimated and forcing longer-term yields higher. 10-year yields briefly hit ~5% in the US and UK, putting further pressure on risky assets. For context, the S&P Equal Weight Index was down -4% at the end of October (versus +9% for the cap-weighted index) and US (5-10 year) Treasuries were down -1.3%. This outcome somewhat justified our cautious stance. However, a combination of softer economic data (a case of bad news is good news) and a lower-than-expected headline inflation print (by just 0.1%!) acted as a significant boost to risk assets. A subsequent further decline in inflation in December, along with a clearly communicated Fed pivot towards lower rates in 2024 was interpreted by the market as a green light to rally, with bond yields dropping back to where they had been at the beginning of the year (round tripping from just under 4% at the end of 2022 up to 5% then back to 4%) and equities rallying. The equal weight S&P climbed to an 11.5% return and the cap-weighed S&P 500 index to an 24.6% return by year-end.

Fig 3: Markets recovered substantially after softer inflation data and Fed pivot in early December



Source: Refinitiv

The other big story of the year was also in these numbers, with the dominance of the large-cap tech stocks once again coming to the fore. The so-called Magnificent 7 (Apple, Alphabet, Amazon, Meta, Microsoft, Netflix, Nvidia) rose approximately 100% in aggregate and generated almost 70% of the gains in the S&P500 in 2023 as investors assessed the potential impact of the increased uptake in the use of artificial intelligence. However, it is also true that these companies all experienced strong sales growth in 2023 with margins also rising as efficiency gains were implemented. The concentration of these names in the index (about 30%) makes top-down analysis of US equities more challenging, forcing one to separate this sub-set of names from the rest.

Against this backdrop, our USD denominated multi-asset portfolios delivered solid absolute returns of between 8-10%. In the context of limited drawdowns in 2022 (c.-5%), almost all client portfolios recovered their losses and are above their respective high-water marks, which is not the case for the majority of benchmarks or peer group[2]. Clients with greater exposure to liquid assets (equities, bonds and various forms of semi-liquid credit) performed best, whereas clients with greater exposure to private equity and venture experienced returns at the lower end of the range. Relative to benchmarks (which comprise investable ETFs of primarily developed and emerging market stocks, treasuries, investment grade and high-yield bonds), we had average outperformance last year of c.5% but were c.3% behind in 2023 mainly due to the strong rally in liquid assets toward the end of the year which outperformed our more diversified portfolios. The main driver of that difference was a lack of any material price appreciation in private equity investments, along with an underweight to the specific above-mentioned tech stocks within our equity allocations, which generally had more sectoral and geographic diversification. Our energy and commodity equities also lagged in 2023, as commodity markets underperformed off the back of a strong 2022 due to weak China demand and also strong energy production in the US.

We are pleased our portfolios demonstrated resilience in 2023 against a volatile back drop with reasonable total returns. In the following pages we will discuss portfolio positioning and some of the underlying strategies which we believe will drive returns going forward.

[2] Referring to risk equivalent ARC benchmarks

OUTLOOK

It has been a long time since we have heard about so many ways of "landing" such that the word is in danger of losing its meaning. The data is quite mixed and could be used to support quite divergent outcomes. However, let's go through three possibilities:

1. The inflation battle is not won i.e. the so-called "no landing". The year-on-year comparisons in the energy, commodity and goods spaces have played out and the easy wins have been banked. The service sector (which is typically 80% of developed economies) continues to experience higher than historic inflation due to tight labour markets. This scenario would result in the 2% target not being reached, or perhaps it is reached but doesn't stay there. This leaves the central banks unable to reduce rates to the levels anticipated by the markets currently.

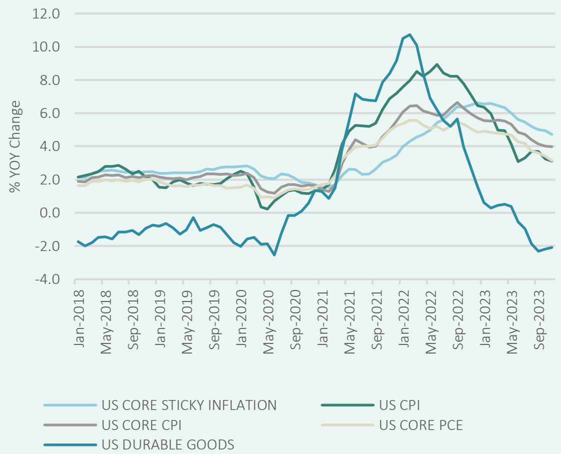
2. A "soft landing", where inflation falls to the 2% target within 6 to 12 months and then stays there. This occurs without any material economic slowdown or major pick-up in unemployment. Rates can be eased by 1.5% to 2% and cash could still offer a small real return. This is the current market pricing for bond and stock markets, especially in larger cap stocks.

3. A "hard landing", where the central banks have (only in hindsight) overtightened, and the economy experiences a material slowdown with sharp increases in unemployment. Usually, this scenario is sparked by an unexpected catalyst (several large bankruptcies, or a sectoral collapse of some kind). Interest rate cuts would be steeper than anticipated.

We do not have a strong view on the above outcomes. We view the global economy as on an edge – where the edge represents this soft landing. It is difficult to walk along this narrow edge and we could easily slip off into a scenario of either stubborn inflation or a recession. It is a reflection of the post-Covid economy that mixed signals abound. We are now seeing signs of weakening labour demand[3] and lower capex spending emerging, showing that the interest rate hikes are having an impact. We are also seeing signs of stickiness in some inflation measures at the same time. We believe the biggest risk is holding a "higher for longer" position as central bank credibility to achieve 2% targets remains a key objective (said another way, Fed Chair Powell will want to be remembered in the vein of Paul Volcker rather than Arthur Burns). The critical question is whether the central banks can successfully avert a hard landing by pre-emptively cutting rates without then sparking another round of inflation. We simply don't know, but we do know it will be difficult. So far so good.

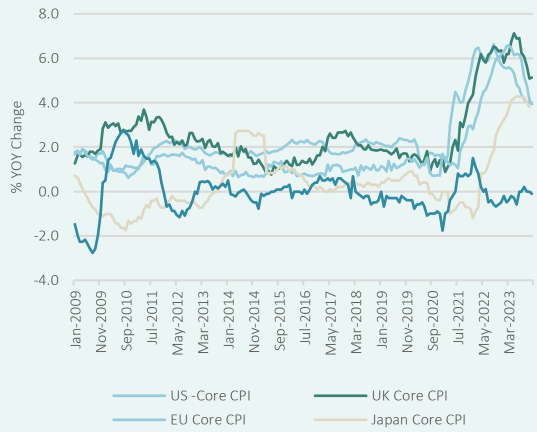
[3] Already in January 2024 we have seen profit warnings from Pagegroup, Robert Walters and Hays citing a weaker recruitment market

Fig 4: Measures of US Inflation show that goods inflation is now back to pre-pandemic levels. However, core sticky inflation, reflecting slower moving items, remains above 4%



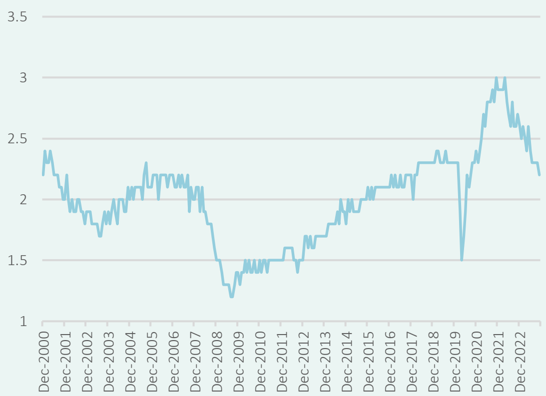
Source: LSEG Datastream

Fig 5: European and UK core inflation has been trending down and forecast to hit 2% in 2024. Japan core has also turned lower, but China continues to be in deflation



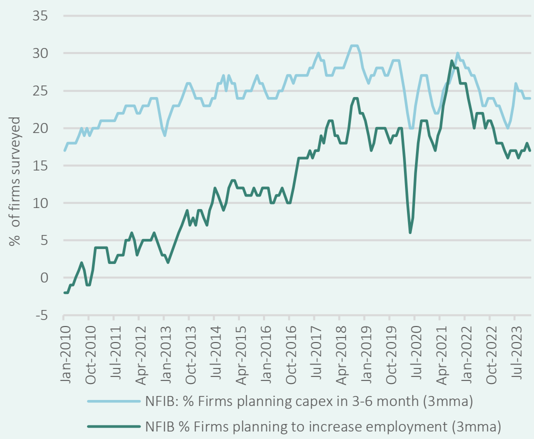
Source: LSEG Datastream

Fig 6: The US labour market is no longer as hot (% quitting jobs)



Source: LSEG Datastream

Fig 7: The number of companies planning to invest is shrinking



Source: LSEG Datastream

Looking further ahead, we are mindful of the longer-term inflationary pressures discussed in our 2023 letter; we do not see those factors abating even if short-term investor attention has drifted elsewhere. We had previously written that four structural factors were likely to keep a longer-term elevated cost of capital, namely:

1. Investment into on/near/friend-shoring to create more resilient supply chains

2. Less global trade (which is a key driver of #1)

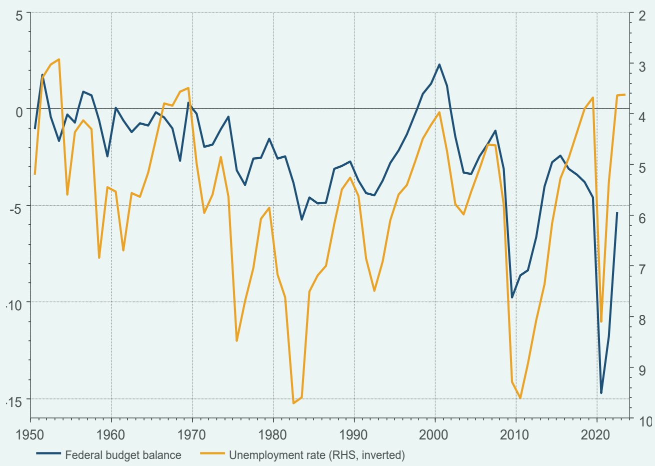
3. Funding the clean energy transition. There is enormous political pressure here and the sums required are in the trillions[4]. The size means government spending will have to form the bulk of the funding. This will put pressure on resources and keep deficits elevated.

4. The ageing of workers reducing the pool of available labour (perhaps to be offset by the deflationary impact of AI…)

These underlying inflationary factors should act as a brake on how low medium-to-longer-term yields can reasonably go. At the moment, government bond yield curves are inverted, pricing in declining short-term interest rates. Interest rate curves will eventually normalise (probably this year), and short-term rates will come down provided inflation trends lower, but we are less bullish on medium to longer term (5 years and out) rates declining meaningfully.

What is the clearing price for US Treasuries when US debt:GDP shows no signs of reducing particularly in an era of close to full employment (Fig 8)? Much of this supply will have to be taken up by private investors of various kinds (HNWI, retail investors, corporates, pension funds etc.). We suspect that at least a 4-5% yield will be required to draw in the demand (assuming inflation reverts and stays at the 2-2.5% level). This kind of yield will likely have implications for other asset classes in time as "crowding out" risks rise.

Fig 8: US budget balance and unemployment rate (% of GDP)

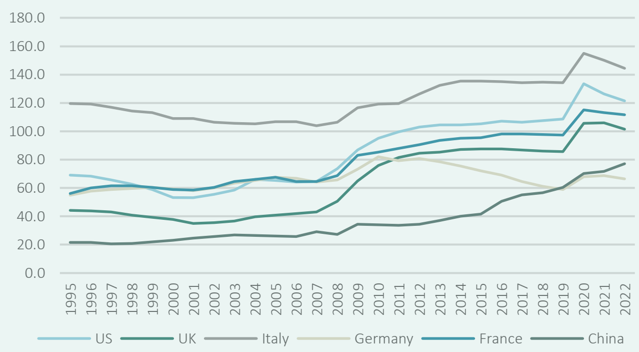


The US deficit is at 6%, yet unemployment is c.4% and at the lowest levels since post war. Usually this would result in budget surplus, but the deficits have only been worse in the post war period in Covid and aftermath of the GFC.

Source: LSEG Datastream

[4] Cap Gemini report, World Energy Markets Observatory 2023 estimated $5-7Tr a year to decarbonise by 2050. Barclays report "Costing the earth" quotes annual investment from $4-9Tr per year from different sources.

Fig 9: Government debt as a % of GDP



Source: IMF Global Database

Government debt continues to climb though it is slightly below the Covid high as GDP recovery causes a reduction in the ratio. With significant spending requirements on medical care for ageing populations, infrastructure and green transition, the likelihood is that this increases unless productivity growth occurs and / or (unpopular) higher taxes are levied.

We cannot finish the outlook without some further reflection on what is likely to be another year of heightened geopolitical risk. The current environment is one of the most fraught since the days of the Cold War. China / US tension, the ongoing conflicts in Ukraine and the Middle East, plus upcoming elections in both the US and the UK create a shifting and unstable backdrop. Ultimately these risks are likely to prove inflationary and restrictive on global trade. However, recent experience suggests that while these tensions rightly attract a lot of interest and comment, their impact on financial markets is generally quite minimal. We would expect the war in the Middle East to cause particular issues for supply chains and contribute to inflation. The US elections and the potential for a second Trump administration will create a lot of noise, but may ultimately prove a positive for risk assets, as was the case post his 2016 victory. The UK is also likely to have a change of government in the second half of 2024. However, we have viewed the UK as a relatively unattractive jurisdiction to deploy capital since the 2016 Brexit vote, so our portfolios are not exposed to any material downside risk here.

PORTFOLIO POSITIONING

Given our long-term time horizon, and our view that we are entering an era of more "normal" interest rates, our asset allocation will generally be geared to quality, growth-orientated equity assets selected on a bottom-up basis, complemented by an allocation to less-directional strategies which should perform in a range of differing environments.

If we experience strong growth and stubborn inflation with fewer rate cuts than anticipated, then we would expect our short duration fixed income and private credit strategies to perform similarly to the high single-digit returns we saw in 2023. In equities, performance will be more challenging as interest rate cuts get priced out. The larger-cap, highly cash-generative stocks will likely continue outperforming other equities. A fairly muted year for performance (-5% to +5%) would be the likely outcome absent stronger than expected earnings growth.

Under the scenario of a soft landing, we would expect to see positive momentum shift from larger-cap equities to smaller-cap equities which generally benefit more from a lower rate environment. We would also anticipate some catch-up from lower-valued non-US stocks, but only if the soft-landing scenario should also play out in their respective economies. Fixed income should perform positively as rates decline or remain stable. If we see a broadening of performance in public equities this would then act as a catalyst for a renewed opening of IPO markets and a rebound in M&A activity later in the year.

In the hard-landing scenario, risk assets would underperform, with equities and high-yield bonds vulnerable to a price correction and a performance outcome similar to that experienced in 2022. Further stress in private equity, venture capital and some of the weaker vintage private credit funds would be inevitable as liquidity remains absent – write downs would be likely. Our less directional and uncorrelated investments should hold up here and we hold tail risk positions which ought to perform positively in this outcome. This would give us firepower to buy stressed assets in this situation.

Consolidating the above view, our positioning is not materially different to last year. We are broadly neutral on equities, and mindful of not being too underweight the US markets. We have continued to rotate out of absolute return into publicly traded and private credit strategies; we believe there is a higher probability of a similar high single-digit return with very low or negligible risk of loss in the strategies we are pursuing. In private equity the focus has been almost entirely on opportunistic strategies to exploit stress in real estate, over-levered corporates and secondaries.

Portfolio Strategic Asset Allocation for 2024

Asset Class	Beginning 2023 Asset Allocation	Beginning 2024 Asset Allocation	Change
Cash	2%	2%	-
Government Bonds	0%	0%	-
Credit (Liquid)	6%	8%	+2%
Credit (Private)	10%	12%	+2%
Absolute Return	18%	14%	-4%
Long-Short Equity	5%	5%	-
Equities	34%	34%	-
PE/VC	15%	15%	-
Real Estate	5%	5%	-
Tail Risk	5%	5%	-
Total	**100%**	**100%**	

INVESTMENT STRATEGY AND THEMES

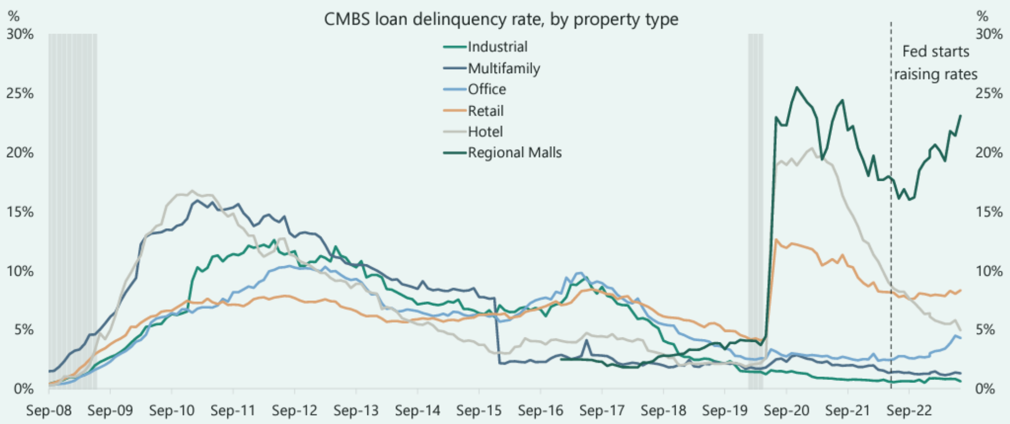
Liquid fixed income:

Within fixed income we have been positioned with a very short overall duration. Portfolios have an exposure to floating rate bonds which delivered a very good risk-adjusted return in 2023. However, we will now be moving to short duration fixed-rate bonds as rates have peaked and are most likely to decline. In the event of a recession, floating-rate bonds would likely underperform as the bonds would experience the twin negative of wider credit spreads and loss of yield as policy rates reduced. Fixed-rate bonds would, on the other hand, benefit from a drop in underlying interest rates. We have also kept the position in European Bank AT1s (despite the well-publicised bump in the road with the Credit Suisse collapse in March) with yields still an attractive 8-10%. The majority of banks are very well-capitalised and printing strong profits from higher net interest margins and modest credit losses.

Opportunistic Credit:

The area which occupied a lot of our research time in 2023 was opportunistic credit. This is backing external specialist managers capable of providing dynamic and flexible funding solutions to companies and assets. While, broadly speaking, most economies performed fine in 2023, there were plenty of sectors in stress. Most notably the commercial real estate (CRE) sector – which has been one of the first to feel the pain of rate rises and lower demand in some specific sub-sectors (office being the main pandemic victim).

Fig 10: CMBS loan delinquency rates have been raising since the Fed started raising rates



Source: Apollo

There is a significant wall of debt maturities within the CRE space coming in 2024 and 2025. With bank retrenchment expected to continue from the space (and likely losses needing to be taken) we believe this area will be a rich opportunity for multi-disciplined opportunistic credit funds.

Fig 11: CRE maturities are elevated across core real estate in the next 5 years

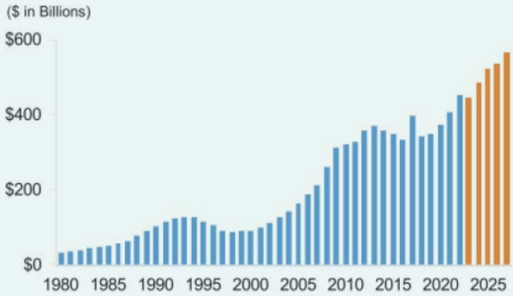
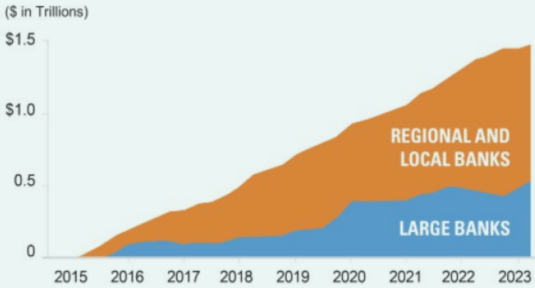


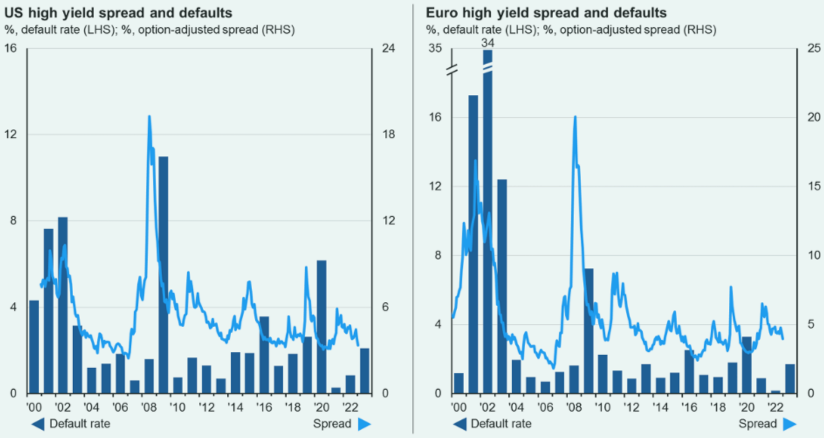
Fig 12: Cumulative change in CRE exposure since March 2015 – losses on existing portfolios will put regional banks under stress



Source: Fortress

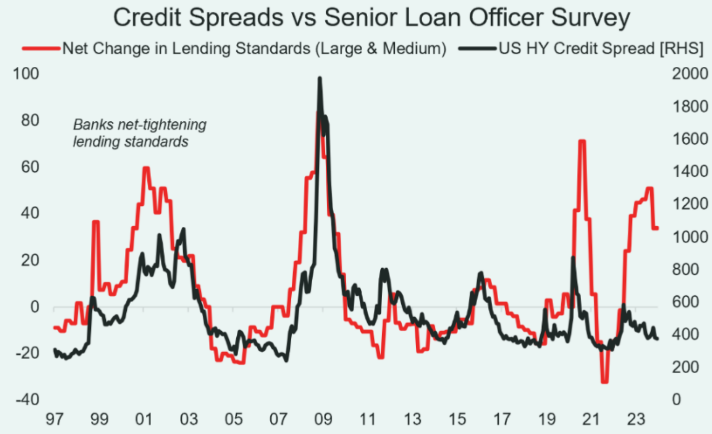
Similarly, there is likely to be stress in the private equity leveraged buyout space. Many deals were struck when interest rates were at their lowest points in decades and the rapid change in interest rates will have a detrimental impact on the ability of private equity firms to hold onto assets without significant capital injection. As one (distressed/opportunistic) manager put it to us, “our opportunity set is every PE deal struck between 2018 – 2021”. There may be some hyperbole here, but the huge deals struck at high multiples, high level of leverage and low cost of debt relative to today will force restructurings and/or changes of ownership resulting in eventual value transfer. We are excited that there are a number of businesses which simply carry too much debt (something seen in every cycle) that could offer great returns to the active investor should those businesses struggle to refinance.

Fig 13: Defaults are starting to rise as interest rate rises begin to bite, but the absolute levels are still low



Source: JPM

Fig 14: One of the interesting charts that defied history was the absence of an increase in credit spreads despite tighter credit conditions – if credit conditions remain tight, we'd expect that spreads would go higher



Source: TopDown charts

Private Credit

Private credit has been one of the buzz words in investing in 2023. Every large private equity firm now has a private credit division. Sovereign Wealth Funds and family offices are piling in. Here's a quote from Blackstone CEO Steve Schwarzmann last September:

"If you can earn a 12% return for lending to companies, what else do you want to do in life? If you are living in a no growth economy and somebody can give you 12 or 13% with almost no prospect of loss, that's about the best thing you can do."

We do not for one minute believe that a business paying 12-13% interest rates is going to do so in a close to risk free manner, but the sales talk is very compelling. The significant flows heading into the space (various estimates put the private credit asset class to reach $2Tr at the end of 2024, roughly doubling in 4 years) make us cautious on some of the deeper areas of private credit such as large cap direct lending. These loans are used mainly to fund private equity LBOs and they have taken the place of publicly traded loans and high-yield bonds. They are likely to experience some stress in 2024-2025 if rates do not moderate. The newer vintages make more sense, with better protections and less leverage, but the returns are never quite what they seem. Once fees and losses are taken into account, the returns are more likely to be in the high single digits - still attractive, but short of the headline numbers.

We have preferred to focus on smaller, niche areas of private credit – targeting specifically underserved but credit worthy borrowers with low leverage and high asset coverage and extremely low or zero losses. We also favour strategies where yield can be earned immediately. Our analysis (which we are happy to share) on private credit suggested that annualised returns needed to be 4-5% higher in private credit drawdown funds to account for cash drag and the absence of compounding relative to making an investment into a more liquid fund with a lower yield, but one that could be earned immediately. Our private credit line-up of funds will typically yield 8-12% with senior security usually in the form of an asset rather than secured over cash flows and the majority have some form of interim liquidity. The LTV is on average around 50-60% which gives us significant headroom to take any losses. They also have the benefit of being immediately investable to pick up the yield on day one. Where we have invested in private credit funds with a drawdown structure, the returns have been augmented by equity upside participation (usually via warrants) to generate the higher returns.

Absolute Return

We have reduced our allocations here given favourable risk/reward in credit. Most of our exposure lies in arbitrage strategies designed to generate a high single-digit return whilst still allowing investors to have some near-term liquidity. The returns were lower than we would expect in 2023 but were still ahead of almost every other investment when we combine returns across 2022 and 2023. Absolute return contained one of our best performers in 2023 – catastrophe bonds. These are bonds which reinsurers sell to remove risk from their balance sheets and place into the hands of investors. The bonds had experienced some muted returns in prior years after a series of hurricanes eroded returns resulting in spreads reaching record highs at the end of 2022. This gave us an opportunity to invest at attractive levels and earn a return close to 20% in 2023. The prospective returns still look attractive and remains a hold in our portfolios.

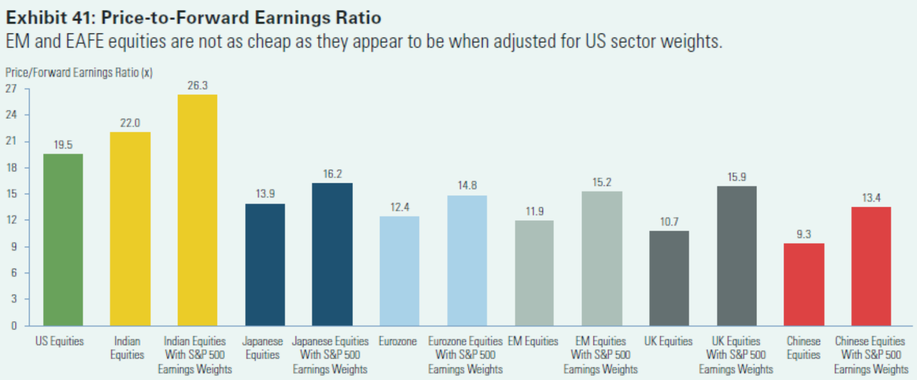
Equities

Historically our equities allocation has had the following biases:

1. A large cap skew with, until last year, a US overweight
2. Our active managers skewed to “quality” or defensive types of stocks
3. Off-benchmark exposures in biotech

The US overweight was reduced in 2023, as we exited passive, index exposure in US ETFs for global ETFs. While the global stock ETFs still have a heavy US weighting (65%) we felt it appropriate to moderate this risk given the valuation discrepancies. Clearly, the cutting back on the large cap US technology names took away a small amount of performance. However, revisiting this there is an interesting piece from Goldman Sachs comparing valuations once one adjusts each country’s equity market for the tech component; the premium is not as high as first impressions might suggest.

Fig 15: Once adjusted for sector weights US is not so expensive relative to other markets. The US is a tech play and other developed markets are more non-tech.



Source: Goldman Sachs

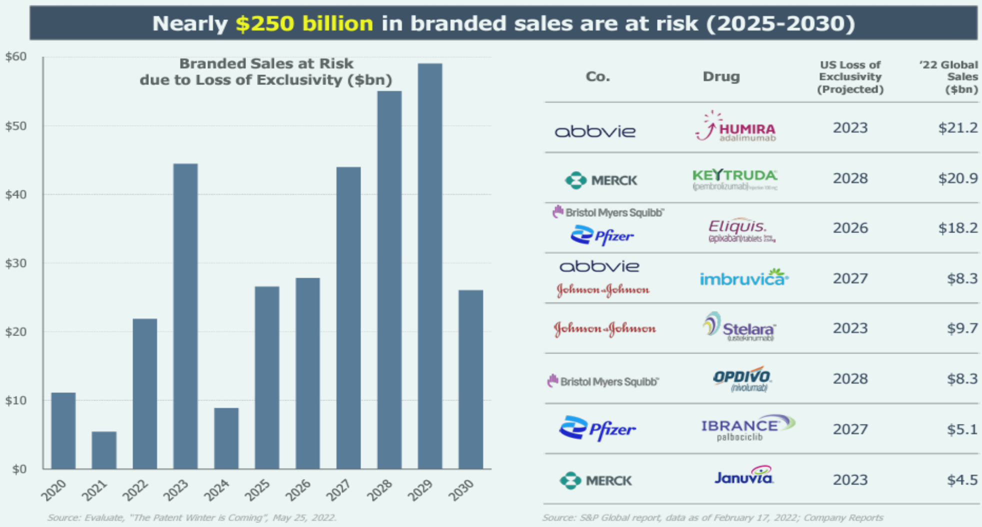
Historically technology only grows as a proportion of GDP. The advent of AI is likely to strengthen this trend still further. It is, therefore, very difficult to bet against these exceptional technology companies operating in the world’s friendliest capital markets and benefitting from the world’s reserve currency. We have consistently cautioned against underweighting US stocks and will continue to hold this approach and while we appreciate that non-US stocks may trade at lower valuation multiples, their growth is less certain and the macro overhang less favourable.

Areas of ongoing research are emerging markets, which should start to feel the benefit of a peak in US rates. And if past cycles are anything to go by, they should do well in a US rate cutting cycle, particularly assuming that involves a softening US dollar. The main caution here is China, which is experiencing outright deflation, and policy is not prioritising economic growth at the moment.

Biotechnology

Biotech is a sector we have discussed in prior letters. Last year we wrote that the M&A cycle had turned and this proved to be the case. Large cap pharma with excess profits from Covid started to put these dollars to work in 2023. There is also a new source of liquidity in the sector from the GLP-1 weight loss drugs which have the potential to be the biggest selling drugs of all time. These investments are necessary as previous blockbuster drug patents expire (Fig 16). Despite the return of M&A, the sector was extremely volatile and sentiment was broadly negative due to persistent fears over the interest rate cycle being worse than expected. This fear peaked in October 2023, but quickly reversed out in November and December to leave a strongly positive year for our funds after two years of declines. We are still optimistic about the space as valuations remain depressed and there are ample opportunities for specialists. The emergence of the 'soft landing' narrative will most likely be supportive and drive further outperformance.

Fig 16: Nearly $250B of branded drug sales are at risk (2025-2030)



Source: Biotech Growth Trust, Interim Report 30/09/23

Energy and Commodity Equities

In late 2021/early 2022 we built a small position in energy and material/mining related equities. Our research in 2021 concluded that these investments had, over time, provided the greatest upside potential in periods of high inflation. As it happens, periods of high inflation often follow large changes in energy prices (which then filters into everything else) and so this acts as a hedge to other parts of the portfolio which do well in less inflationary environments. In 2022 this was one of our most profitable positions. We continue to hold the position despite recent weakness.

We also own mining shares on a long-term basis given that critical materials will be needed to build out the decarbonised future. However, the position underperformed due to a high correlation to China and the sector has yet to decouple from Chinese growth. We presume that this will happen eventually, but we are revisiting this particular position for 2024.

Fig 17: Energy sector relative percentile rankings (versus S&P 1500). Energy is still cheap and offers very good cash flow.

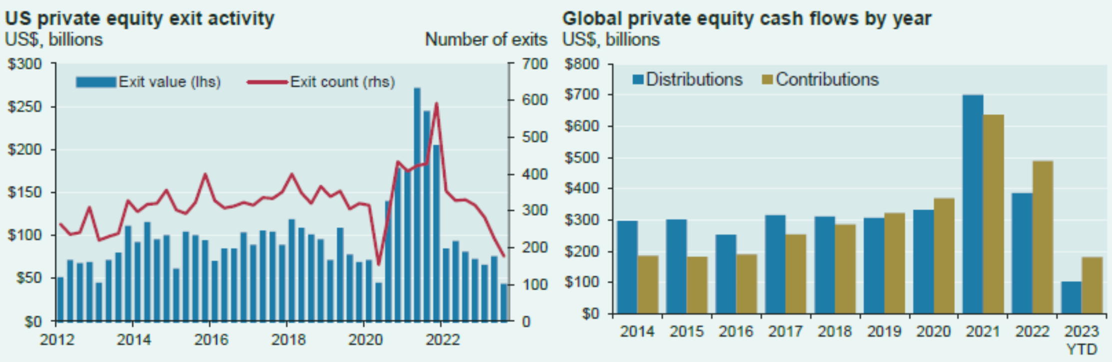
	Enterprise Value to EBITDA	Free Cash Flow Yield
Oil and Gas Drilling	2	94
O&G Services	2	91
Integrated O&G	3	86
O&G Production & Exploration	7	88
O&G Marketing and Refining	9	95
Energy	4	87

Source: JPM EOTM, Dec 2023

Private Equity

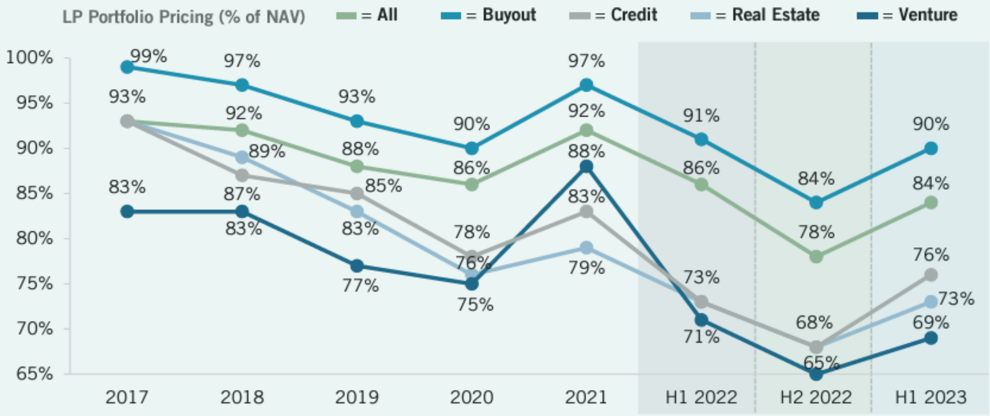
As mentioned earlier, the lack of exits from PE is now becoming a concern for LPs. Unless return of capital improves, we think the fundraising market for GPs will be very challenged. We took advantage of this by deploying into the secondary market given the attractive discounts on offer and think this will continue to be a theme in 2024. However, deal flow was lower than expected as sellers continued to hold out. We believe this should be a great opportunity for secondaries and likely to be one of the better vintages once public markets fully reopen to new listings and liquidity returns. There has also been a welcome decrease in leverage in new private equity deals – with gearing declining to 6x and average equity contribution to deals at 50% which indicate substantial de-risking for those investing today.

Fig 18: PE activity continued to trend lower in 2023, and the amount of capital returned was the lowest in a decade. This has improved the environment for secondary deals and also the pricing for new PE deals



Source: JPM EOTM, December 2023

Fig 19: Average discounts on private assets shrank slightly in 2023 from the lows in 2022, but the continued lack of exits in H2 2023 would lead us to believe these discounts are likely to have widened again



Source : Jefferies, H1 2023 Global Secondaries Report

Venture Capital

In the VC space, we continue to hold our positions across four different strategies that we allocated to in recent years. Clearly there have been some markdowns as excess has gradually been removed from sections of this market, but we remain optimistic that the power law (of finding a small number of outliers) remains and that provided one can access top decile funds then the long-term return from VC justifies a small allocation within our portfolios. To give just a few examples of companies within our VC funds we remain excited about – the opportunity to digitize and automate medical diagnosis and treatment remains vast; the arena of personalized medicine is still quite nascent; ditto blockchain technology and the infrastructure that will allow digital assets to develop in a sustainable and regulated manner. We also believe the opportunity to provide secondary or follow on capital to good companies on attractive terms will continue to be the case if broader liquidity is scarce.

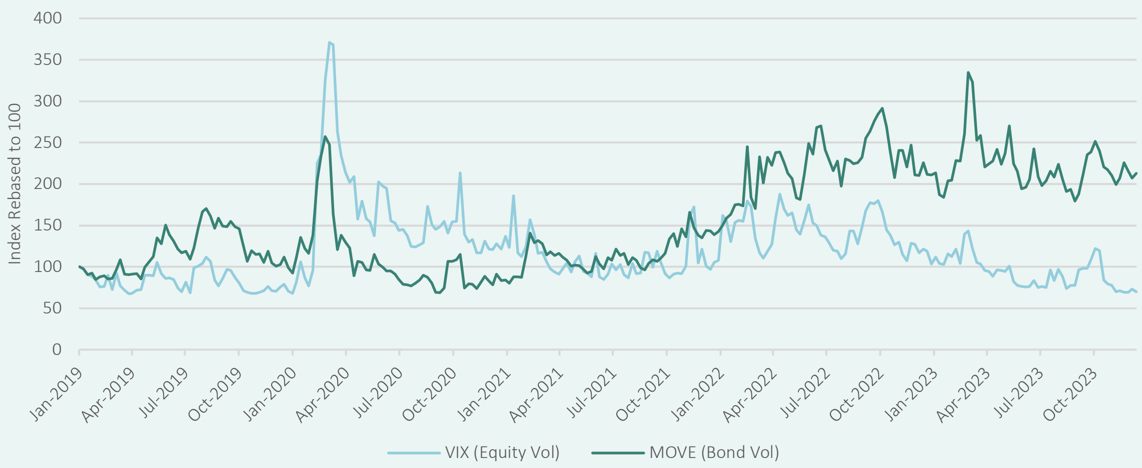
Real Assets - Data Centres

We continue to see positive momentum from our data centres investments. We see this as an attractive hybrid asset class – with a real estate underpin plus strong structural tailwinds from the growth in technology and the resulting need for storage. Developments such as AI, VR, IOT and autonomous vehicles are driving the next wave of data growth, following on from growth in email and shift to cloud. Amazon and Microsoft are especially voracious consumers of this new capacity with 40%+ YOY revenue growth in both the AWS and Azure businesses. This space is also attractive to large infrastructure players and sovereign wealth funds (who can typically achieve returns of 15%+ which is in excess of their large cap private equity targets) so we believe the exit market for these assets is likely to remain robust.

Portfolio Protection

The level of the VIX, which is a measure of the price to protect against equity market volatility, has continued to reside at very low levels. What is unusual is that this has happened at the same time that the measure for bond market volatility is at historically high levels. It is difficult to explain what this means. We can only surmise that equity markets are calm because the Fed now has some room to cut rates to stabilise the economy should signs of weakness emerge (the old Fed Put). However, the "cost" of these cuts is uncertain, and this is likely what is contributing to elevated bond volatility relative to that of the equity market. Nonetheless, given the very low cost of hedging at the moment, the risk of a policy misstep, and geopolitics impacting more than in the past, we think it is very much worth spending a modest amount of portfolio returns in order to own strategies that work in a low probability but deeply negative scenario.

Fig 20: Equity volatility collapsed in 2023 reaching pre-pandemic levels in contrast to elevated bond market volatility – we do not think this relationship will hold with convergence likely once the economic path becomes clearer



Source: BYOB

FINAL THOUGHTS

We have not seen such strong and diverging views on the future paths of economies for a long time. As a result, we have taken this time to reflect on both top-down and bottom-up fund and instrument selection to make sure we are not particularly exposed to one specific outcome.

In our view, the best risk/reward opportunities mainly lie in credit (senior secured, income-orientated strategies in public and private, as well as more opportunistic strategies) and areas where there is stress, such as secondary dealing of private equity holdings. There are also some good opportunities in liquid markets such as AT1s. And we believe that private equity and real estate in smaller funds focussed on less levered deals should offer a good return opportunity for the long-term investor.

Lastly, we have added to tail-risk hedges given the attractive pricing of protection relative to the prevailing market risk.

READING AND PODCAST LIST

In keeping with the last two editions of our letter the team has shared their favourite books and podcasts from the last twelve months.

Books

1. **Power Law, by Sebastian Mallaby.** This is a must-read for anyone seeking to learn about venture capital. The book tells the story of the VC industry's early beginnings as a cottage industry on the US West Coast in the 1970s and 1980s to the modern-day VC landscape dominated by large investment funds.

2. **Chip War by Chris Miller.** The most important commodity in the 21st century? Semi-conductor microchips argues Chris Miller. Chris provides an overview of this highly strategic input into our modern world, and how we are increasingly reliant on a handful of large companies with manufacturing facilities in vulnerable locations like Taiwan to provide this vital input into almost all our devices. He also covers the birth of this important industry from the beginning when it primarily served the US military to the global industry today where chips are prevalent everywhere.

3. **The Fund by Rob Copeland.** Rob Copeland is a NY Times journalist and has been following the hedge fund Bridgewater for many years. From hundreds of interviews with former employees and reviewing of publicly available information, Rob provides an inside view into the goings on at the firm and the personality of its founder, Ray Dalio.

4. **LIV and Let Die by Alan Shipnuck.** Alan Shipnuck offers an entertaining account of the biggest golf story this century – a lively page-turner for golfers (we have quite a few in our office) and anyone interested in following the ongoing reach of the Saudi Arabia Public Investment Fund (PIF) and sovereign money into sports and geopolitics. Shipnuck weaves history and his unparalleled access to the sport's influencers into an insightful narrative on the birth of a new tour and golf's bitter feud around sportswashing.

Podcasts

1. **Money Maze: Investing lessons from 40+ years at the FT & Bloomberg with John Authers.** John has been working in the financial journalism industry for over 4 decades and he shares some of his key memories over that period including reporting on the emerging market crises of the late 1990s, the dot com bubble and the 2008 financial crash whilst working in New York City for the FT.

2. **The Memo: Sea Change with Howard Marks.** Howard Marks, founder of Oaktree Asset Management, asserts we are not going back to the world of zero rates and all that came with it. Money now has a price, and this represents a "sea change" in how investors allocate going forward.

3. **Odd Lots: Four big structural forces holding back China's economy with Zongyuan Liu.** Oddlots is a weekly podcast by Bloomberg covering topical macroeconomic themes. This discussion with Zongyuan Liu of the Council of Foreign Relations explains how the 4 Ds are holding back China – debt, demographics, demand and de-coupling.

4. **Capital Allocators: Timeless Value Investing with Seth Klarman.** Capital Allocators features in-depth interviews with leaders in the institutional investment management industry. This podcast interviews Seth Klarman, a legendary value investor and CEO of The Baupost Group. The conversation covers Seth's early experience in business and investing, the evolution of value investing principles and Baupost's application of value investing across sourcing, diligence, portfolio construction and risk management.

5. **Money Maze: Are we educating our children the wrong way, with Sir Anthony Seldon.** Sir Anthony is a leading figure in British education who questions the relentless focus on the "tangible" outputs of schooling (i.e. exam scores) at the expense of other skills and attributes. He also believes AI can revolutionize how we teach and can improve the capacity of educators.

DISCLAIMER

Capricorn Private Investments

https://www.capricornprivateinvestments.com

Malta House, 36-38 Piccadilly, London W1J 0DP