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Michael Venne: Hi and welcome to RPM, the podcast that explores the world of private markets. I'm your host, Michael Venne. In today's episode, I have the opportunity to sit with StepStone's co-CEO Scott Hart to discuss the current state of private markets and what investors might expect going forward. Scott, welcome to RPM.

Scott Hart: Thanks, Michael. Thanks for having me.

MV: Scott, I'd like to begin with Covid-19. Despite some earlier signs of promise, Covid appears to be far from over. Countries whose case count was declining have now had a reversal of fortune. But stock markets have, for the most part, recovered most of their earlier losses. With the benefit of nearly one years' worth of data. How are private markets faring?

SH: Well, I think one of the things that have had a bit of a hard time doing through the Covid pandemic is really making generalizations, because whether you look at the public markets that you referenced, which have really been driven by a small number of large-cap technology stocks, or whether you look at the private markets where we have seen different sectors of the market, different geographies, different assets impacted in dramatically different ways, really ranging from a complete shut down for a period of time to those businesses that may have actually been net beneficiaries of the pandemic.

I do think it can be hard to generalize. But I'll try. And I would say that I think the private markets have generally been performing pretty well. Some of that is driven by the sector exposures that we currently have. And if I use private equity as an example, some of the sectors that have been most active from a private equity standpoint over the last several years have been things like technology and software, health care, consumer discretionary, less investment activity in some of the harder hit sectors like energy, like parts of the financial sector. That certainly does not mean that we've been immune to what's going on around us. In fact, some of the biggest trends from an investment standpoint included things like health and wellness, travel and leisure, focusing on experiences and live experiences over things. And those are certainly areas of the market that have been particularly hard hit.

But I think overall, again, using private equity as an example, the exposure to some of the more resilient sectors like technology, health care, parts of the consumer market have certainly helped. I think the other things that have helped from a performance standpoint really kind of go back to some of the reasons that you invest in the private markets in the first place, the governance model, and sort of the control orientation. And I think we've certainly seen many of our managers and underlying management teams really spring into action during the pandemic, helping to preserve value, helping to guide their portfolio companies through what is obviously been a very difficult period of time.

The other reason to invest in the private markets is really for the returns and from it from a diversification standpoint and looking to perhaps reduce volatility in your portfolio. And I think when you look at the performance of the public markets in the first quarter in the US, public markets were down about 20 percent. Private markets were down about half. That certainly means that in the rebound, they may not rebound to the same extent that we've seen in the public markets. But overall, I think it has helped to reduce volatility across portfolios. So really performing the way that we would hope that it might through a period of dislocation like the one we've just experienced

MV: And in some ways accelerating trends that were already underway.

SH: Well, I think that's exactly right. And I sort of referred to health care for example.

And I think we certainly think about healthcare as a more defensive industry, oftentimes think about it as being recession resilient. But I think one of the things that we found early in the Covid crisis is that it may not be Covid-resilient. And you certainly saw patients that were staying away from the emergency room, staying away from hospitals, postponing procedures unless absolutely necessary. Well, that's something that you can postpone for a period of time. But not forever. On the other hand, if you look at segments of the market like retail, where we've seen an acceleration of certain trends that were already in process, like you mentioned, with the acceleration of the trend towards e-commerce, that's a trend that's probably here to stay. And so what kind of implications does that have on retail businesses, restaurants, and other businesses that may be impacted by that trend?

MV: So are you seeing any differences between individual asset classes or do some of those broad strokes, those generalities apply to all the private markets?

SH: Well, I think we're seeing a similar trend in the sense that within each of the private markets, asset classes, you are seeing different segments of the market or different underlying assets impacted in very different ways.

In private debt, I think we're seeing many of the same trends on the corporate side to what I've just described in private equity, but if we look at real estate, for example, you're certainly seeing strong performance from industrial assets, data centers, really assets that are benefiting from some of the same trends I just talked about, e-commerce, obviously the work from home environment, whereas retail assets, the hotel businesses, they're being impacted by limited travel are being more negatively impacted. I think if you look at infrastructure, you'd find the same. Communications assets, renewables are holding up well during this environment where more energy, focus, or transport-oriented assets are being negatively impacted. So, I think the similar trend we are seeing is that there's really a bifurcation in terms of the impact of the pandemic on different types of assets.

MV: So, Scott, there's been a lot of discussion about the shape of the recovery. "Ls," "Ws," "Ks," and just a couple of weeks ago, we added "backward square root" to the list. How do we account for that macro-level uncertainty in our investment process?

SH: Well, I think you may have actually even left out a few other shapes. The "U" shape, the "V," the "Nike Swoosh." But I think as we think about the macro-level uncertainty, one of the things that we do is try to recognize that in the same way that we were not going to be able to predict the exact timing or the exact cause of the recession in the first place, I'm not sure we can predict the exact shape or timing of the recovery. But what we can do is we can evaluate a wide range of different economic scenarios.

We can look to construct portfolios that are built to withstand a continuing, challenging environment. And one of the ways that we do that is through diversification.

And during the last six months, our teams across the globe have held thousands of calls and video meetings with our managers, with the underlying management teams.

One of the things that we have found across those calls is that those portfolios that are being most heavily impacted are ones that had concentrated positions either in the wrong sector, in the wrong underlying asset, or were perhaps not diversified from a vintage year standpoint. I think that that was easy to do in some cases after a 10 plus year bull market run to start to become complacent, to start to invest funds much more quickly without the level of vintage or diversification that one would normally expect. I think this crisis has certainly highlighted the importance of diversification across a variety of different metrics.

The other way that I think we and our clients can try to account for the macro uncertainty is look, to try to take advantage of some of the opportunities that may come out of the current market environment, certain of those buying opportunities may or may not have emerged quite as quickly as we might have initially expected, but we're still taking the time to prepare and to get ready. If you were to talk to our private debt team today, you're certainly thinking through not only more defensive strategies. Investing in senior secured loans on the corporate side, but also starting to think about more opportunistic strategies that might take advantage of distressed opportunities as the opportunity plays out. As you speak with our real estate team and think about their recapitalization strategy, really a strategy that was developed coming out of the global financial crisis. That, again, is one that ought to be well-positioned to take advantage of the opportunities that come out of this uncertain environment.

MV: So, Scott, I'd like to linger on the idea of diversification for just a moment longer. And you've mentioned sector diversification and the importance of vintage year diversification. But can you speak to the importance of strategy, diversification, and the reasons that LPs might consider secondaries and co-investments as a key part of their portfolio?

SH: Well, I think we've always been big believers that secondaries and co-investments are important tools to have in your private markets toolbox. And I think that's both from a portfolio construction standpoint and using them as tools to help mitigate the J-curve to help reduce the overall fee burden across the private markets portfolio. But also from a diversification standpoint, as you mentioned. And I think in particular as we're talking about opportunities that might come out of the Covid crisis, it's sometimes hard to capitalize on those opportunities with a long term strategy, such as a primary fund investment, where you're really committing capital that will be drawn over the next three to five years and realized over a five year period beyond that. That's a difficult strategy to use to time the market. And I think in general, we feel like timing the markets and private markets is difficult to begin with.

But I think clearly strategies such as co-investment and secondaries have become really important tools across each of our asset classes, not only private equity, but private debt, real estate, infrastructure where we're seeing an emerging opportunity in the secondary space really is that asset class has matured both with some of the funds that were raised around the time of the financial crisis now reaching the end of their lives or on the back of a pretty significant amount of fundraising that has taken place over the last 10 years. And so I think across asset classes, even across underlying strategies. If you think about some of the activity we've seen out of our venture and growth team that have really used secondaries and co-investments to help address some of the challenges of investing in the venture market. Things like high loss ratios and higher fees in venture capital, we've been able to help mitigate that through co-investing into growth equity opportunities or into buying into established venture-capital portfolios in an effort to really generate attractive risk adjusted returns.

MV: One more time, I want to go back to the idea of Covid accelerating trends that were already underway. If everybody is crowding into these more defensive and resilient sectors like health care or like industrial real estate, that's obviously going to drive up prices. How big of a concern are asset valuations for LPs today?

SH: Well, look, I think you're right. I think some of the trends that I mentioned are not ones that only we here in StepStone are focused on or that only our clients are focused on.

And I think the result is that you do see an increase in purchase prices and valuations for those assets that are viewed as more defensive in this environment.

Look, I think to us what that brings into focus is the importance of sourcing, and having a number of different opportunities to choose from so that you can be selective in this or any market environment. I think that's the strongest defense to a competitive valuation environment, is having a number of either deals or funds or opportunities to choose from so that you can be selective in which ones you ultimately pursue.

MV: And speaking of some of these changes, based on some of the discussions that you've had with LPs and GPS, are there any changes that they're making maybe at the organizational the operational level that are here to stay?

SH: Well, I think at the operational level, I think everyone has their own views as to whether, for example, this current work from home environment is here to stay and whether we'll all be working from home or whether we'll all go back to the offices exactly the way that we operated previously. Look, I think realistically, the answer is probably somewhere in between. But I think what is here to stay is a more flexible environment. And I think one of the reasons for that is if you really think about [how] the pandemic is allowed, many of us to really step back and think about and re-evaluate, you know, what's truly important to us and what we can live without. And that's probably true from both a personal standpoint, but also from a professional standpoint.

I'll give you one example. And I remember early in the pandemic reading articles about ESG and responsible investment and the fact that this was really the first time that certain ESG strategies had been tested with a real market correction. And would they really have staying power? Because I think it's easy to focus on things like ESG and responsible investment when you're in the midst of a 10-year bull market run, but during a period of dislocation, would that focus remain? And I think that was a question early on in the crisis. Well, I think with the benefit of the last six or seven months, I think it's pretty clear that these are some trends that are here to stay. And look, whether that's because the Covid pandemic did happen to coincide with other events that really drew attention to inequality, drew attention to climate change and its impacts, or whether they had just had the staying power to begin with. I think really the focus on things like responsible investment and ESG are clearly some changes that that are here to stay.

MV: As someone who has invested now through multiple cycles. What's one piece of advice you would give someone for whom Covid is their first real test?

SH: Yeah, well, I think it has been a real test and I think it's a good question because one of the things that we did early in this crisis was sort of step back and think about our own team. And we clearly have a large and experienced team and many professionals who have operated through multiple crises. But as we looked at it, we also had about half of our team where this was the first crisis that they were working through from a professional standpoint and really had not even been in the workforce during the financial crisis. And so, we thought a lot about those lessons and those key takeaways that you have from operating through this type of period. It really was a period that that none of us had lived through professionally. I think a couple of the observations would be, one, that the importance of communication. I think clearly during this type of environment, there's going to be bad news that emerges. And I think it's important that bad news is communicated quickly. So, as we've thought about the type of organization that we want to build, it's one that is transparent and where we can openly communicate not only the good news when it comes, but the bad news as well. And that's both internally and with our clients.

I think a piece of advice would be just to occasionally step back and think about some of the lessons and observations, you know, that you're experiencing during this crisis because I think they will benefit you at future points in your career when you're living through similar periods of time. And I know you had a number of conversations either with colleagues or former colleagues during the Covid crisis about some of the experiences we had during the global financial crisis and what we could take away from that and how it was benefiting us in the current environment. So I think those would be two pieces of advice: the importance of communications, as well as the importance of stepping back occasionally to reflect on some of the things that will ultimately be valuable takeaways for future or future periods of dislocation.

MV: Scott, that's my last question. Thank you so much for your time.

SH: Thanks again for having me, Michael.

MV: That does it for this episode of RPM. Stay tuned for new episodes every few weeks. And please remember to follow us on Apple Podcasts, Spotify, Stitcher, or anywhere podcasts are found. To learn more about StepStone Group, visit us at www.stepstoneglobal.com.