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Graziella Scassillo: [00:00:04.95] Welcome to RPM, the podcast that explores the world of private markets. I'm your host, Graziella Scassillo. Many of the direct and indirect effects of the war materialized quickly, to name a few. The diaspora with Ukrainians across the globe and allegations of war crimes, as well as volatile markets for key commodities including oil, natural gas, wheat and potash. However, implications for portfolios and private markets are perhaps less clear. Joining me today to address some of the questions LPs may have is Christian Frei StepStone partner and head of risk. Christian, I would say welcome back to our pan because this is not your first time here, right?

Christian Frei: [00:00:50.04] Hello, Graziella. Glad to be back on the RPM. Yes, you're correct. We've been talking about the COVID impact on private markets, but also about strategic asset allocation together on RPM.

Graziella Scassillo: [00:01:05.07] Yes. Now, in one of your presentations to us, it became clear that the crisis in Ukraine has taken a more negative turn than most of us have hoped. In general, were you surprised by the event?

Christian Frei: [00:01:19.65] So the potential of an escalation of the conflict between Russia and Ukraine has been somewhat on our radar as part of the risks on our geopolitical landscape, as part of our regular outlook. However, like probably most of us, we didn't give it a high likelihood or assumed it would be certainty. And so, as such, geopolitical risks are difficult to assess in terms of the likelihood as well as their implications. What we typically recommend is to keep diversified portfolios to be not exposed disproportionately to such single events.

Graziella Scassillo: [00:02:00.99] When it became clear that things could take a more negative turn, what did we do?

Christian Frei: [00:02:06.39] So when thinking about risk and risk management, it always starts with understanding what your exposures are. And for that purpose, Stepstone has built a set of tools that allows us to understand exposures, not just of our portfolios that we manage, but also a portfolio that we oversee and more broadly across the industry. So already before the invasion, we use these tools to screen assets that are in Ukraine and Russia and later also Belarus. And in general, what we found is that there's only marginal exposure to these countries. And the reason is probably that it takes typically specialized chips that are active in these countries, but risk doesn't stop at borders. And so, to fully understand exposures to the conflict, we had to have a closer look at individual assets and ask how they might derive revenues from these this region or how they might be affected by having operations or staff on the ground in the countries. And as you can imagine, this is a slightly more difficult task to do because you need to understand the details of a business or an asset.

Graziella Scassillo: [00:03:34.50] Well, considering this second step and starting with the corporate world. Where did the teams focus their attention to?

Christian Frei: [00:03:42.48] So on the corporate side, the focus was on companies with revenue derived from the region, companies which use inputs from the region, as well as companies with operations on the ground in either of the countries where companies derive revenues from the regions, if any. These were typically or typically in the single digit to low teens, percentage points of total revenue. But even, you know, not all revenue is equally at risk to be affected. So, for example, medical or pharmaceutical products are currently exempt from sanctions, but even this exemption might have impacts on the business as there are certain shipping companies that stop delivering or shipping to the region. And so even if maybe your product is not sanctioned, you nevertheless might face challenges shipping your products to the region. So, you know, that requires close monitoring.

And anyway, then on the input side, energy is certainly in the first. Nice to look up to now. You know, gas has been flowing to the west and Western Europe freely. And businesses like chemicals or utilities have mainly been impacted by higher energy prices, not by disruptions. But given the recent steps by Russia or plans of the EU to potentially get off Russian energy completely. That represents certain risks for these businesses as well. And when it comes to operations on the ground, companies are facing two types of challenges on the one side, trying to avoid business interruptions, but then on the other side as well, caring for their staff and making sure their safe. And Ukraine is well trained IT professionals. And so, if we think about the operations on the ground, that could include I.T. companies, which is maybe not something that one would think of in the first place. In general, I think these thoughts illustrate that risk doesn't stop at the border. So even if you don't have your domicile in either of these countries, you can be negatively affected, of course, by the crisis.

Graziella Scassillo: [00:06:31.04] Thank you, Christian. And if we want to move also to real assets, would you mind sharing some thoughts on the challenges companies are facing in this asset class as well?

Christian Frei: [00:06:41.51] In the review, the realize the team is paid special attention to assets related to air travel as well as assets located in neighboring countries. So, if you think about airports can be affected in multiple ways. So historically, leisure travel behavior has been affected by conflicts as travel destinations have changed or trips might have been canceled outright, and airports that depend heavily on routes through Russia or Ukraine airspace might experience additional headwinds as passenger flow or passenger volume decreased, and agriculture and food supply chains have been heavily impacted. It's something that my colleague Ryan Ramsey just discussed in an earlier podcast. And so, I don't want to dig much deeper here on that aspect.

Graziella Scassillo: [00:07:39.08] And what about the real estate asset class instead?

Christian Frei: [00:07:42.65] Generally, what I hear from the real estate team is that it's very unusual for our clients or the cheapest that they track to have exposure to real estate in Russia or Ukraine for a host of reasons. And that's also what we saw when we checked our exposures. And they did also do a deeper analysis on asset level with the focus on identifying projects that might face delays due to supply chain issues because of the conflict. But there's hardly any impact there as well. And what Chip is report is that the Central European real estate market is not really affected by this crisis.

Graziella Scassillo: [00:08:33.62] So now, Kristen, can you explain how you assess your indirect exposure to the conflict?

Christian Frei: [00:08:40.34] So the global economy has already been suffering supply side constraints before the invasion and the disruptions that we see resulting from that conflict only intensify that pressure. So, the broadest indirect impact will be coming through higher energy and commodity prices, feeding into higher inflation. This will, on the one side erode purchasing power, but on the other side, higher inflation will also increase the pressure on central banks to hike interest rates. And given that the seeds for higher inflation have been planted already during the pandemic with these generous fiscal stimuli and loose monetary policy, I think it's difficult, if not impossible, to assess even the impact of this crisis. And it's also not the first time that we talk about inflation and input price pressure. You might recall our podcast in July last year with Tom Keck. I talked about the topic, and he had elaborated on the need to focus on businesses that have the power to pass inflation or increased input prices through to the customers. Below the surface, below the inflation surface, however, some segments of the economy will be much more impacted than others. This is particularly because Ukraine and Russia are dominant producers in some key commodities more than others. And in some ways, infrastructure is benefiting from these. These trends for utilities, high inflation often boosts revenue and subsequently value, as they typically have in direct pass through of inflation in their rate making mechanisms.

Christian Frei: [00:10:40.23] Increased energy prices for a longer period can provide positive asset valuation impact on midstream asset as well as on power generating assets and transportation assets. There is also often an inflation component in underlying contracts that can result in enhanced revenues. And then we have agriculture, which also benefits from inflationary environment. Again, there's something Ryan Ramsey already talked about in his podcast, and I'll not spend more time here. Real estate in contrast. So, despite long term also being protective against inflation has been experienced negative impact from market trends already before the invasion and the context of a generally healthy real estate market to dramatically rise in construction cost due to supply chain issues, labor issues and robust demand meant that fewer new development projects were economical, and these conditions also have made it difficult to secure fixed price construction contracts. And on the interest rate side, particularly in the US, where the US central bankers start to raise interest rates. This also means that very high-level buyers which have been prevalent in the market are less common and therefore marginal prices are coming down. But I think it's interesting if we look through these different parts of the economy and see how they are affected differently, some more positive, some maybe slightly negative. I think it's a very nice way of showing or demonstrating diversification in a different way in a multi asset portfolio at work.

Graziella Scassillo: [00:12:48.75] Given the recent increased volatility in public markets, what should investors expect from the markets?

Christian Frei: [00:12:56.76] There are a couple of aspects to be considered. So first, private market valuations react slower to dislocations than prices of traded assets. So, it indeed makes sense to ask the question what liquid markets might signal for private markets. Second, and we've talked about this aspect at the onset of the COVID crisis in one of our webcasts when measured peak to trough. Private markets only capture a fraction of the downside of at least listed assets. In past analysis, we found that private equity captures in the range of 50 to 60% of a downside of listed equity indices. And similarly, for private debt, one can show that market value declines or by about a factor of five bigger or larger than subsequent credit losses. That's something I've talked about in a recent webcast for our Stepstone clients, where I was focusing on the impact of the crisis on private debt specifically and considering these characteristics of private market allocation can have an important stabilizing role in portfolios.

Graziella Scassillo: [00:14:19.05] With private companies that generally have more leverage, suffer more from the downturn in the economies they participate in.

Christian Frei: [00:14:28.11] I think absolute leverage numbers are only one side of the coin. I think we must also consider the cheapest tend to be very active shareholders so they can push management to take corrective actions. They can also provide financing to make it through a rough patch and capture opportunities in turbulent, turbulent times. And if it is needed, they can even change management where necessary, and in general they can react quickly. You know, if we look at the COVID crisis, this episode provided that provided ample good examples of active of the active roles of peace and not just as sponsors, but also as lenders helping manage companies through difficult times.

Graziella Scassillo: [00:15:24.23] So now, Chris, in putting that crisis to the side for a minute, besides supply chain disruption and interest rates that you've just mentioned, what other risks are investors worried about?

Christian Frei: [00:15:36.92] So the waters indeed moved certain topics into the background. First and foremost, the COVID pandemic, while in the Western economies we're accustomed to being almost back to normal. This is not necessarily the case everywhere. And thinking about China, it seems that they're in a particularly uncomfortable spot as they try to maintain their zero COVID policy and partially related to that. We have the supply chain constraints coming into 2022. There were positive signs that some supply chain issues would ease, for example, in the semiconductor space. However, with some suppliers of consumer and intermediate goods and forced to regular shutdowns of at least parts of their economies, we think that supply chain issues might persist longer than originally hoped. Another challenge seems to persist in the US labour market, where it's harder and harder to find staff in recent weeks and where wages are increasing. And aside from these short-term worries, there are also longer term economic, ESG or geopolitical issues that bear certain risks. And most of them we've already featured on our regular outlook, so they're not necessarily new on the economic side. These are demographics and globalisation and their respective impact on productivity and longer-term inflation. On the ESG front, I can think of climate change and rising inequality, which are important challenges to be addressed. I mean, both, if left unaddressed, have the potential to haunt us in the future. And finally, on the geopolitical side, the most obvious question in the current context is how China is positioning itself vis a vis Taiwan. But then we also have the unresolved disputes with Iran and North Korea.

Graziella Scassillo: [00:17:57.41] And finally, Christine, please give us some good news. Do you think that we will face a recession?

Christian Frei: [00:18:04.49] Trying to call recessions has always been a tricky exercise, and this time around is probably even more challenging. And I'm saying this because there's several variables and moving parts which are to some degree even interdependent, starting with the conflict itself. We don't know what decisions the warring parties will take. And that, of course, is profound implications for the duration of the conflict. But then there is also the response of not directly involved nations, first and foremost in terms of sanctions. And if we think about plans of the EU to get off Russian energy supply, that will have negative implications for the European economy. But then there's, as mentioned above or earlier, the COVID situation, COVID is still out there and as it seems and negatively affects China and supplies out of China in particular. And so, there's a lot of uncertainty to deal with and uncertainty in general tends to slow down economic activity. But then there's the inflationary pressure and the question of how central banks react to it. The fact that the current inflation has demand side as well as supply side, the component greatly complicates the job of central banks, in my view, and when they try to withdraw the external extraordinary measures that basically have been in place for a decade. So, with all these different decisions, there's a broad set of scenarios one can envision. And so that's why I'm saying I think it's probably particularly difficult this time to call recessions. I think part of. Probably feel comfortable saying is that Europe has the higher risk of ending up in a recession than the US. However, you know, that might end at that. So, we believe that it's difficult to call recessions and time markets and that's specifically true for private markets. And so, we think the best way to deal with this is to stay the course and follow the longer-term plan that one has. That doesn't mean there wouldn't exist pockets of relative value or opportunities that can be exploited on the short run. But we think this shouldn't turn an asset allocation plan upside down.

Graziella Scassillo: [00:20:49.33] Thanks for listening to this episode of RPM. If you enjoyed it, please visit our show page at www.stepstone.com where you can find other episodes and research on private markets. You can also subscribe to RPM on Apple Podcasts, Stitcher, Spotify and other podcast platforms.