Pensions Triple Down

Retirees Take One More Step Out On the Risk Spectrum

'For albeit the spirit be willing and ready, the flesh is frail and wavering, and, through your quietness, I shall be much more the quieter.'

So the 'Good Duke' beseeched the incensed and raucous crowd before him with the hopes that he could go in peace in prayer, that the gold sovereigns he'd handed the executioner would ensure a swift swing of the ax. Witnesses that chilly morning on January 22, 1552, said the end did come quickly to the soldier who had faced death on the battlefield many a time. Tower Hill was the last place it had seemed the life of Edward Seymour, Duke of Somerset would end when his nine-year old nephew Edward VI ascended to the throne five years earlier, nearly to the day. Appointed Lord Protector of England, for nearly three years Seymour governed as king in all but name. Alas, usurpers pounced with a grab for power when his efforts to soften the authoritarian rule imposed by the king's father, Henry VIII, to improve the poor's wretched station sparked widespread rebellion.

Seymour's legacy lives on today as an affront to Jeff Bezos' infamous quote: "Your margin is my opportunity." England's Somerset House was started by the Good Duke in 1547. To this day, its namesake Studios housed there remain, "an experimental workspace in the centre of London connecting artists, makers and thinkers with audiences." Literary luminaries such as Thomas Carlyle, Charles Dickens, John Stuart Mill, Ralph Waldo Emerson and the scientist Thomas Henry Huxley gathered there; book publishers naturally followed them to the intellectual hub. Blame Dickens for referring to Strand as "The Strand," an error that became so ingrained "No. 1, The Strand," which has since been replaced as No. 1, London, was the very first street address in London history.

An avid collector of rare antique books from a young age and thus inspired by the books bequethed by literary luminaries, in 1927, with $300 of his own and $300 borrowed by a friend, Ben Bass opened The Strand on New York City's Fourth Avenue "Book Row." The store became its own magnet to the era's Greenwich Day avant-garde community, and ultimately the sole surviving storefront. Ben's son Fred had embraced the family business by the age of 13. And it was he who moved the store just around the corner, to East 12th Street and Broadway where it, including its two million books on four floors that span a total of 18 miles, remains to this day thanks in large part to Fred's daughter, Nancy, who joined the family business when she was 25.

The pandemic and NYC's overbearing shutdown, however, changed things. In an October 23, 2020 letter, Nancy Wyden made an open plea to customers in the face of a 70% decline in revenues over the prior 12-month period: "We've survived just about everything for 93 years -- the Great Depression, two World Wars, big box bookstores, e-books and online behemoths. Because of COVID-19, we cannot survive the huge decline in foot-traffic, a near complete loss of tourism and zero in-store events compared to 400 events pre-pandemic."

The response was overwhelming. Per the *Washington Post*, 25,000 online orders and $170,550 were generated in in-store purchases, in two days. And The New York Times reported that the shop set a single-day record of 10,000 online orders, causing the website to crash as one woman purchased 197 books.

In an ironic twist, echoing its chief rival, Nancy is besieged by unions demanding better pay and working conditions. She has also been called out for buying $115,000 in Amazon stock despite assurances that any profits will be plowed back into the business. One can only imagine the bittersweetness among all bookstore victims when they first saw the November 2015 news that Amazon was opening its flagship brick-and-mortar store in Seattle. Per CNBC, the NYC Amazon Books location, which followed in 2017, "selected the Columbus Circle neighborhood on Manhattan's west side based on data about nearby book purchases." Last July, The Strand opened its second location at 450 Columbus Avenue, replacing Book Culture, once a fixture whose finances did ultimately succumb to the pandemic.

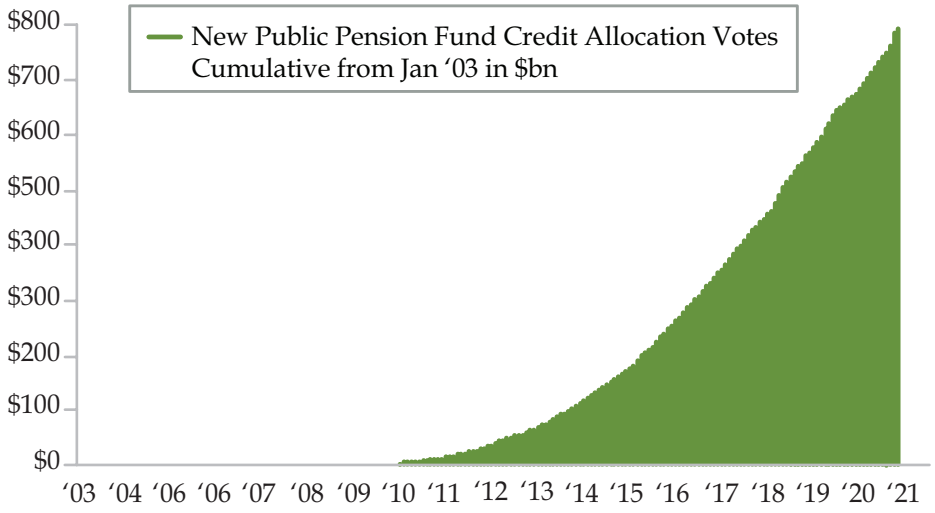
It's anybody's guess what physical stores' U.S. footprint will be once the last of the online battles have been waged. No doubt, the coronavirus accelerated the decline of bricks and mortar in America. The latest data show that foot traffic is down a scant 3.5% compared to 2019 levels as stimulus checks fuel pent-up demand to be out and about. Some retailers that have sunk their futures into building their online presences will inevitably fail trying to balance those who will remain online and shoppers who can't shake the tactile need only sated by the in-store experience. Adding to the near-term uncertainty is retailers' business models that rely too heavily on just-in-time inventory replenishment against a backdrop of a persistently snarled supply chain and shipping delays. And finally, goaded by erstwhile but misguided politicians, the push to unionize appears to be gaining, rather than losing, steam.

One sad reality looks to be unavoidable – the further loss of small businesses, including retailers that don't have the bargaining heft to compete for precious supplies nor, unlike their biggest counterparts, the means to pay up for labor. Adding to the insult will be geography, as federal and state taxes set to rise assure a continued hollowing of tax bases in the country's most expensive places to call home and conduct business.

While in ruder health than they've been in some time, public pensions in the most fiscally reckless states will exacerbate the tax plight. Nowhere is this more evident than the desperate and continued moves into credit. As Brian Reynolds, a longtime QI friend, expounded, "In April, we counted a record $13.2 billion that public pensions voted to allocate to credit and related products before any leverage that may be applied. These flows have surged since late winter as states and cities have seen their financial footing firm up. In the last three months, we have counted a record setting $48.3 billion of these votes, shattering the record of $37.3 billion that was set in late 2019 before the virus set in."

In a world of interest rate suppression, the upshot is that the bulk of these credit monies cannot be plunked into fiduciarily appropriate fixed income and are instead funneled into alternative investments. Because pensions have for years shunned hedge funds struggling to perform living a "Don't Fight the Fed" existence that rewards passive investments that make the Amazons of the world more Amazonian, pensions have increasingly poured money into private equity. The obvious objective is to meet outsized return assumptions. The alternative is to plow more cash they don't have into satisfying future liabilities. And not that pension managers grasp this truth, their hope and prayer should be that the Fed will be able to replicate its March 2020 bailout of the credit markets, which not coincidentally, saved the hides of countless private equity firms and their holding companies.

Pensions Allocate Record New Monies to Credit



Source: Reynolds Strategy, P&I, Bloomberg, Pension Funds

The irony is that so many of those holding companies would have been better off had they not been acquired via leveraged buyouts. The financial media has been quick to eviscerate the antiquated business models that caught retailers wrong-footed as Amazon radically rewrote the rules of engagement. Too few, by contrast, speak to the swarms of private equity (PE) firms -- weighed down by too much of their investors' dry powder, especially that of anxious public pensions -- that loaded up retailers (and energy firms, and restaurant and hotel chains) with unsustainable debts that left them vulnerable to a minor recession, to say nothing of a global pandemic.

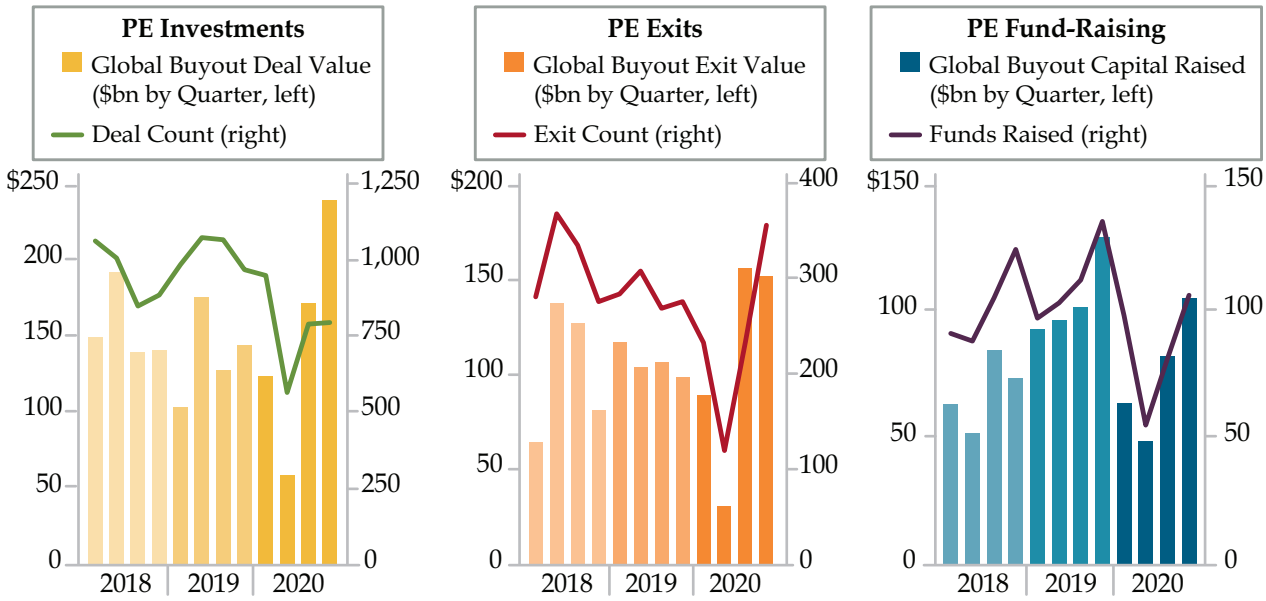
The media also proved not up to the task of connecting a few simple dots in the aftermath of the Federal Reserve's bailout of the corporate bond market by failing to ask one simple question: "Who profits the most by the Fed's keeping the junk bond market wide open for business?"

Over the years, Bain Capital has punched above its weight among its peers in analyzing the PE market. Its April release of "The Private Equity Market in 2020: Escape from the Abyss" was no exception. It goes without saying that the Fed "bailout" was not mentioned, per se. That would be unbecoming.

But hopefully you get the gist and appreciate the paradox contained within the report's opening refrain: "While a short-lived opportunity for distressed investors produced deals like the multimillion-dollar recapitalizations of Wayfair and Outfront Media, the value window slammed shut quickly. Both global credit and public equity markets rebounded with blinding speed over the summer, pulling private asset prices (which are highly correlated with public equities) along with them. Consider that it took nearly seven years for the S&P 500 to get back to its precrisis high after the global financial crisis of 2008–09."

Deal flow did indeed evaporate for a moment in time "during the period of disorientation immediately following Covid-19's global spread." The report then channels the best of understatement, "But the mood flipped when central banks in the U.S. and Europe aggressively pumped trillions into the financial economy, easing liquidity concerns for firms and their portfolio companies. That shifted attention from portfolio triage back to making deals." As you see, the PE machine didn't merely recover, it came roaring back to life with investments and exits skipping to multi-year highs. As has been the case for so many over-levered entities, the pandemic proved to be a perverse blessing, at least as gauged in dollars and cents.

Let's Make a Deal. Lots of Them!



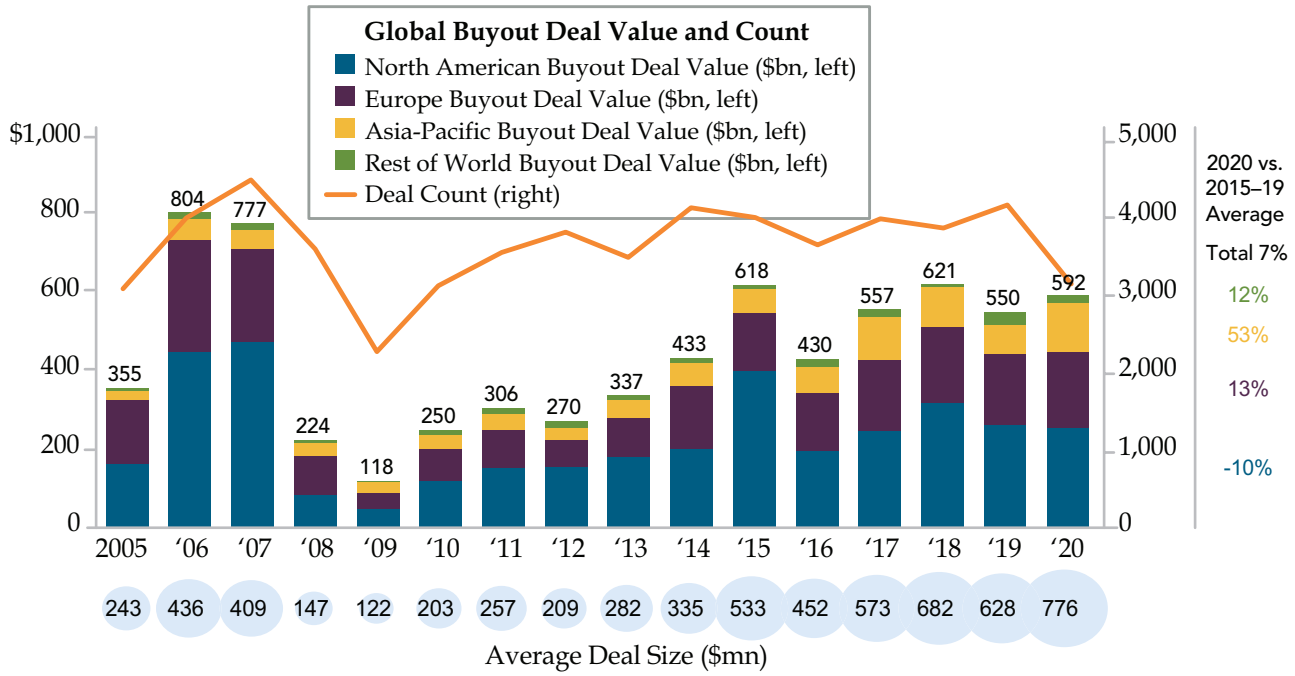
Source: Dealogic; Preqin; Bain analysis. Notes: Investments—includes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; Exits—bankruptcies excluded; IPO value represents offer amount and not market value of company; Fund-raising—includes closed funds only and represents the year in which funds held their final close; buyout includes buyout, balanced, coinvestment and coinvestment multimanager funds

And while fund-raising was down for the full year by a tad, it too rebounded smartly. Bain Capital is among those reaping the rewards of the grab for returns conditioned behavior. Late last week, it announced its 13th flagship buyout fund had surpassed its target, raising $11.8

billion including roughly $1.8 billion from former and current employees. Per the *Wall Street Journal*, "Other investors in the vehicle include the Alaska Permanent Fund Corp., which committed $25 million in March, and the Virginia Retirement System, which pledged $225 million in August. Other commitments from public pension plans include $50 million from the New Mexico Educational Retirement Board and $150 million from the Tennessee Consolidated Retirement System." If your grandparents only knew.

Bain is not alone. In all, PE firms are sitting atop a record $1.6 trillion in dry powder, or unspent cash. The effect of the unprecedented frenzy is, of yet, unknown. We cannot make any determinations about the 2018 or 2019 vintages because peak buyouts were not stress-tested by recession, such has been the force of the Fed's defense against such price discovery. At best, what we can surmise of the cycle that took off in earnest in 2014 is that it's un-arrested. The $592 billion in deals penned in 2020 were right in line with the average of $555 billion in the five years through 2019.

Going Big in Number as Well as Size as if Never Going Home

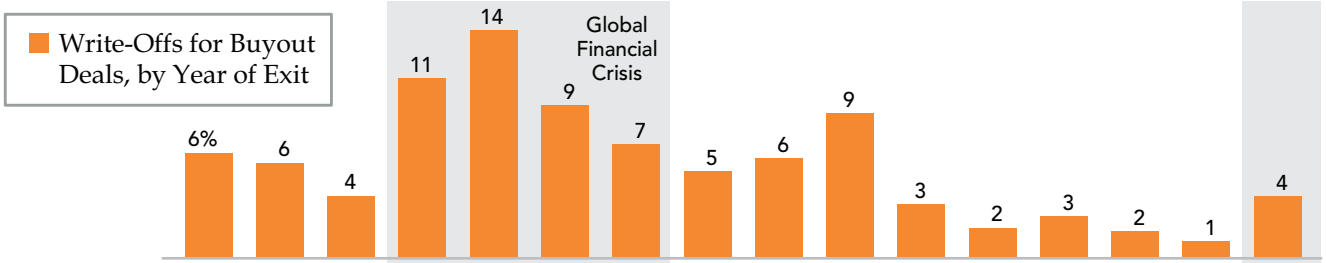


Source: Dealogic Notes: Includes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location; average deal size calculated using deals with disclosed value only

The lingering mystery is the magnitude of the rot that remains in past vintages to say nothing of the deals being made in the here and now. PE is, by its very nature, a high-risk asset class. Recessions are, thereby, the cleansing agent to correct for deals made at too rich of valuations and unacceptable levels of debt for a company to remain a going concern.

According to the Institute of International Finance, the $24 trillion tacked on in 2020 brought the global total to $281 trillion. It's a safe bet 2021 will see the $300 trillion milestone crossed. Apples-to-oranges it may be to present the biggest picture but the holistic matters as it's driving the non-financial train. Fiscal and monetary largesse is the linchpin of the bravado in the private sector, especially that of its most private corner which needs the most protection. With that said, how on earth does a rational investor square the 14 buyouts written off in 2009 with last year's four? The question has no answer. That's by design.

How to Quantify the Fed Calling a Moratorium on Write-Offs?



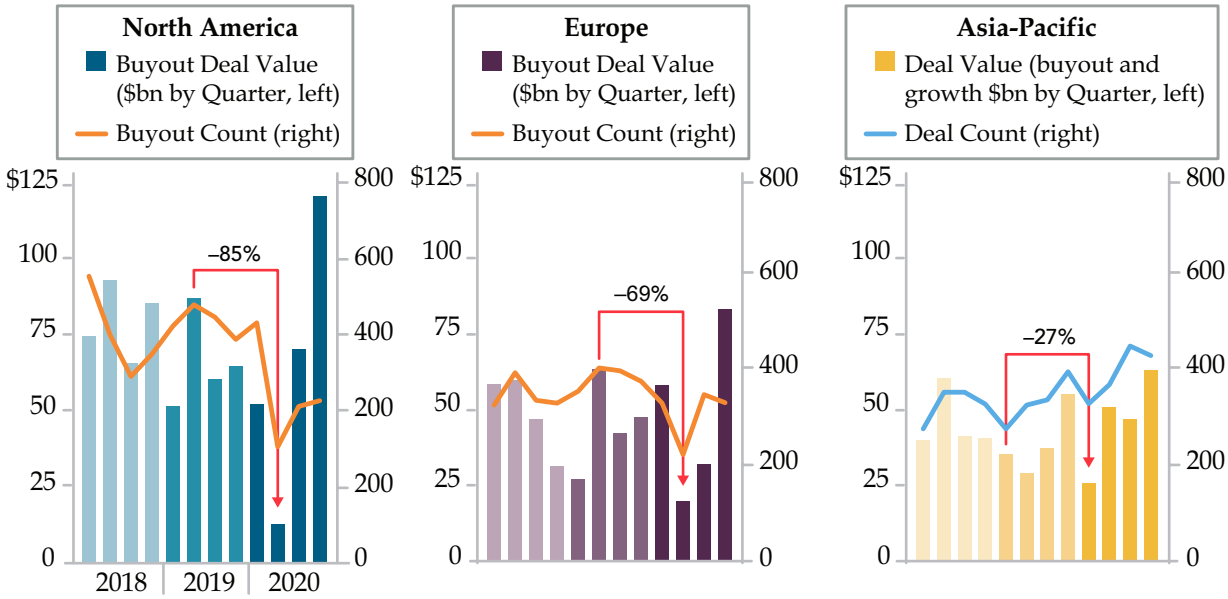
	2005	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20
Loss Rate (%)	12	17	10	26	30	23	27	19	12	23	14	9	17	12	9	14
Share of Deals with MOIC less than 1 (%)	22	19	17	26	37	25	33	20	19	27	21	20	27	22	13	20

Source: CEPRES Market Intelligence. Notes: Write-offs are poor-performing investments that are classified by the investment manager as unrecoverable and usually considered a complete loss; loss rate is the ratio of loss on defaulted deals (total value to paid-in of less than 1) and total contributions to all deals; MOIC is multiple on invested capital; includes fully realized global buyout deals with more than $50 million in invested capital; excludes real estate and infrastructure deals.

With all deference to those in the PE industry, bigger deals are not emblematic of a sign of the times but rather the need to put to work the massive funds allocated by public pensions and other deep-pocketed investors seeking returns in a world that promises everything today and precious little tomorrow. That in no way makes bigger deals a surer thing.

Total deal volumes slipping in 2020 reflected the dearth of values to be had after the Fed's March 23rd bailout. The vanishing of that value did not, though, resolve the posh predicament of PE firms sitting on capital that needed to be spent. The solution, as funds went on a parallel demand-fueled fund-raising bonanza, was size. Average deal size swelled by 24% to $776 million last year. By the end of the year, PE firms had increased their share of mergers and acquisitions, capturing 16% globally. Most notably, deal volumes by dollars expended blew away recent history and by a wide margin in the United States and to a lesser extent, Europe.

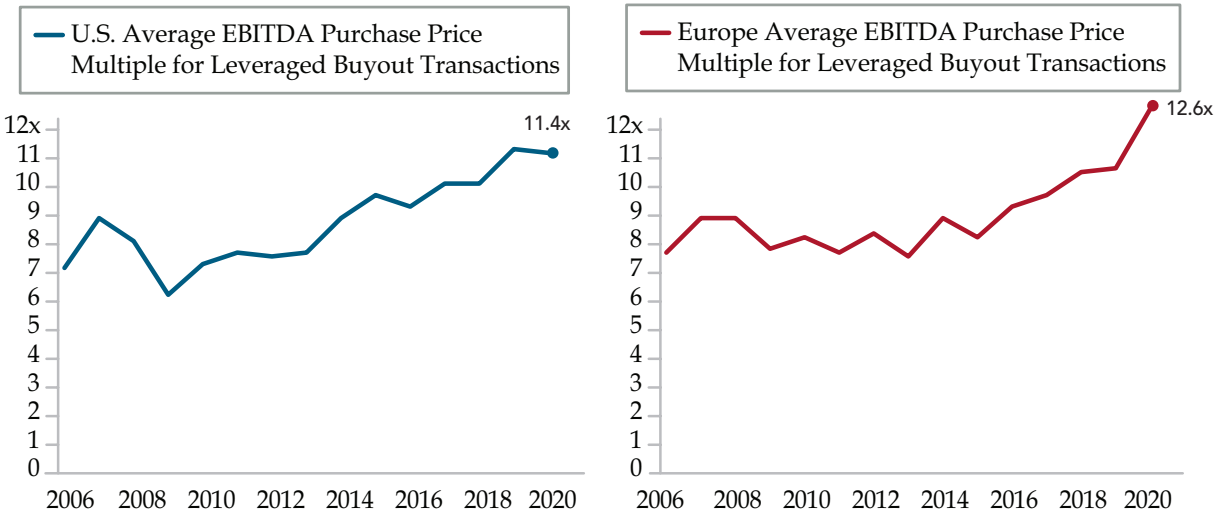
After Precipitous Falls, Deal Values More than Recapture Prior High Points



Source: Dealogic; AVCJ; Bain analysis. Notes: North America and Europe—includes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location; Asia-Pacific—includes buyout, growth, early-stage, private investment in public equity, turnaround and other deals; excludes real estate and infrastructure

In some realms, volume discounts apply. That is not the case with PE. Again, to the Bain report, "According to a December 2020 Preqin survey, investors see asset valuation as the most significant challenge in trying to generate strong returns. Amid heavy competition and a flood of investment capital—both debt and equity—buyout multiples continued to defy gravity in 2020, averaging 11.4 times earnings before interest, taxes, depreciation and amortization (EBITDA) in the US as of year-end and a record 12.6 times in Europe." As a 25-year veteran of financial markets, certain junctures beg fewer words when the pictures say more than you want to see. This would be one of those moments.

Paying Up to Play

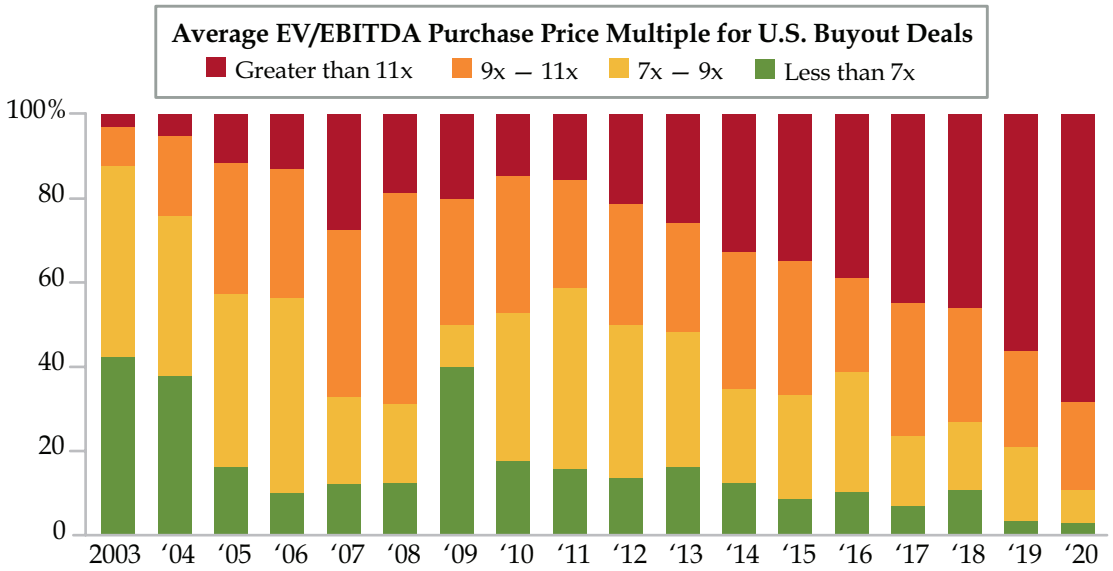


Source: S&P LCD

If you take with you no other chart from today's *Quill*… Scratch that. If you take no other chart with you from the last 12 months' *Quills*, take this one. Take a screen shot of it. Save it. The next time any of your peers suggests valuations are somehow justified historically in any asset class, whip this out. They'll be silenced immediately.

As a measure of how hot the market was in 2020, the year of the pandemic, when the decade of buildup of plaque in the credit markets was exposed, the great takeaway was that upwards of 70% of US buyouts priced above 11 times EBITDA. History has been buried. It is dead.

The Pervasiveness of Richness Has Run Off the Rails



Source: Refinitiv LPC. Note: Includes deals with disclosed purchase price and leverage levels only

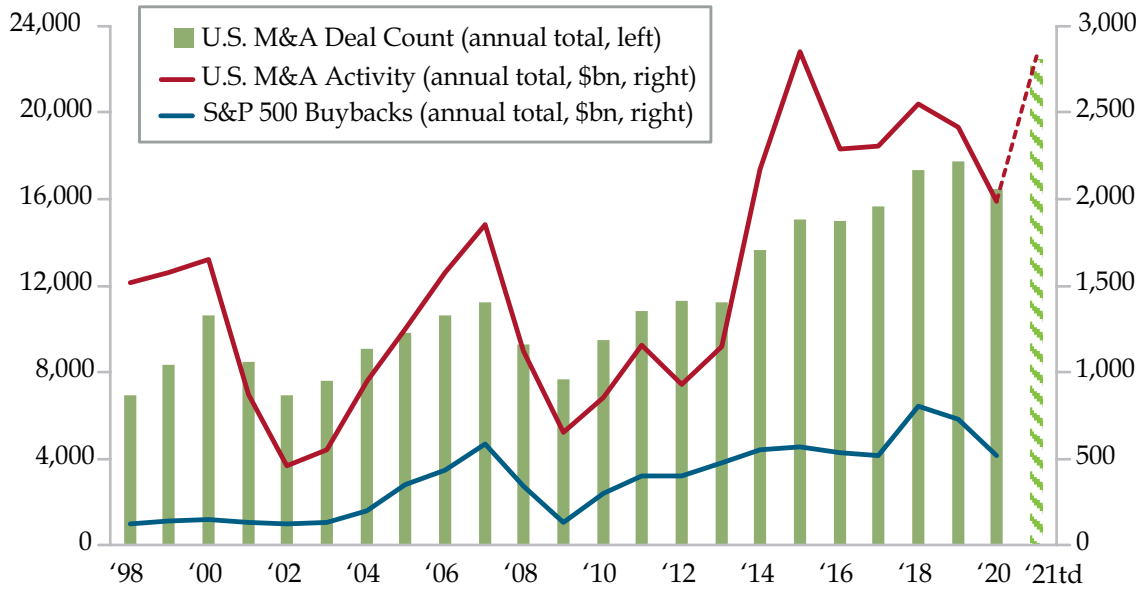
It goes without saying that you may not be preoccupied with the health of public pensions. You may already live in a state immune to what's to come. Afraid that doesn't indemnify you to the outgrowth of how PE firms have influenced the everyday dynamic of investing. Consider the next three graphs as that many exhibits.

When flooded by PE cash as has been the case, "Merger Mania" is given new meaning. In a nutshell, the term, coined by none other than Ivan Boesky, refers to despondent companies paying insane prices to buy revenues, and hopefully profits. That's where we are today, with no signs of the trend reversing any time soon. Unlike the less politically palatable shareholder buyback, M&A is not nearly as open to attack. That shouldn't imply that record amounts of cash on firms' balance sheets won't burn a veritable hole in their collective pockets. It will and they will resume buybacks under the auspice of little scrutiny given the scale of lobbying dollars flowing into the pockets of their bought and paid-for Congresspeople.

Moreover, to our friend Brian Reynold's long-standing bullish posture, valuations are not nearly as distended as they could be. It comes down to the differential between the lowest rung of junk bonds, CCC's and the broader high yield market. It would seem that this ratio has not even fallen to the median of the last three credit cycles (third panel below). In his view, "Thus, there is the potential for low-rated yields to fall even more. This analysis does not mean that those low-rated yields will fall more. But it does show they have room to run, especially since pension and insurance flows are slated to increase in the years ahead. Whichever part of the credit market those flows impact, the result is likely going to be more stock buybacks and M&A activity."

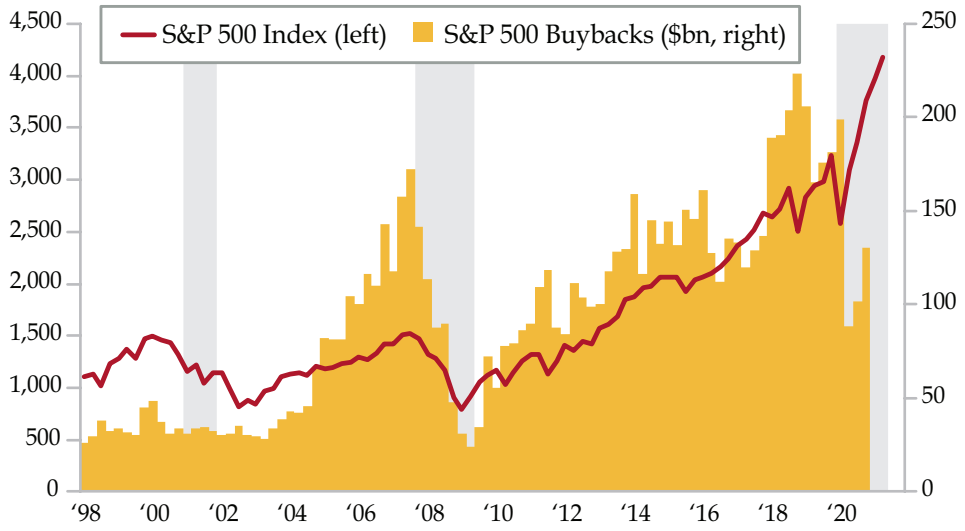
Stretched can, it would seem, become stretched further. Buyback fever can, and is by all anecdata on hand, taken hold anew. And as nuts as record M&A deal flow is, it too can keep setting fresh records. Junk can become junkier still. The bottom line is that the Fed's insistence that liquidity is not in peril could further inflate this bubble. For nimble investors, this is still a bet that is on the table.

M&A, Buybacks and Junk Pricing Have Room to Run

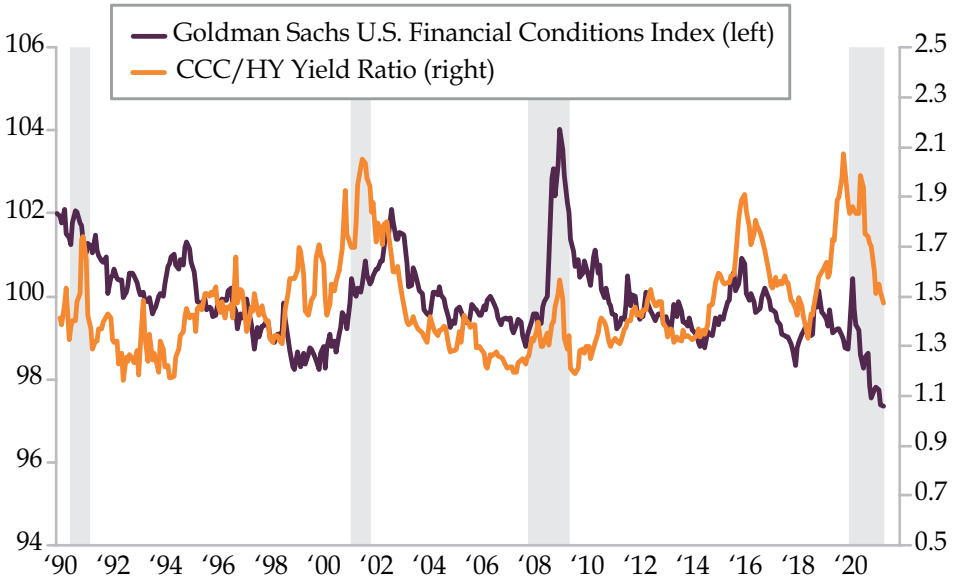


Source: Quill Intelligence, Bloomberg, Standard & Poor's. 2021 is annualized rate from January to April.

While worthy of a future *Quill*, we'd be remiss to omit the fallback guy – hard assets. The alluring offsetting narrative is irresistible, a tale of inherent protection. The truth is, a scant $1.8 billion of distressed asset sales took place in 2021's first three months, a whopping 1.8% of total transaction volumes. We've come so far in a post-pandemic environment distorted by zero interest rate policy that distressed sales are nearly a third less than 2020's fourth quarter.



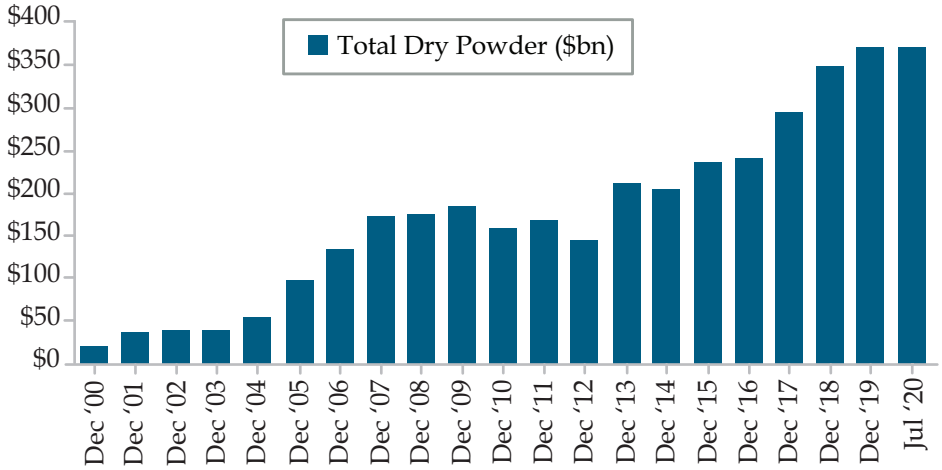
Source: Quill Intelligence, Standard & Poor's



Source: Quill Intelligence, Bloomberg

Per Morgan Stanley, "Distressed sales volumes have recently been lower than what was observed pre-COVID, as post-COVID quarterly volumes averaged $1.2bn versus $2.8bn between 2015 and 2019." Public pensions are regularly sold on private equity real estate funds being the ultimate diversification vehicle. In truth, with near record mounds of dry powder burning a hole through their fee-collecting pockets, PE real estate funds are likely to be paying the highest premia in the months and years to come.

Beware of "Real Estate is a Hard Asset" Sales Pitches

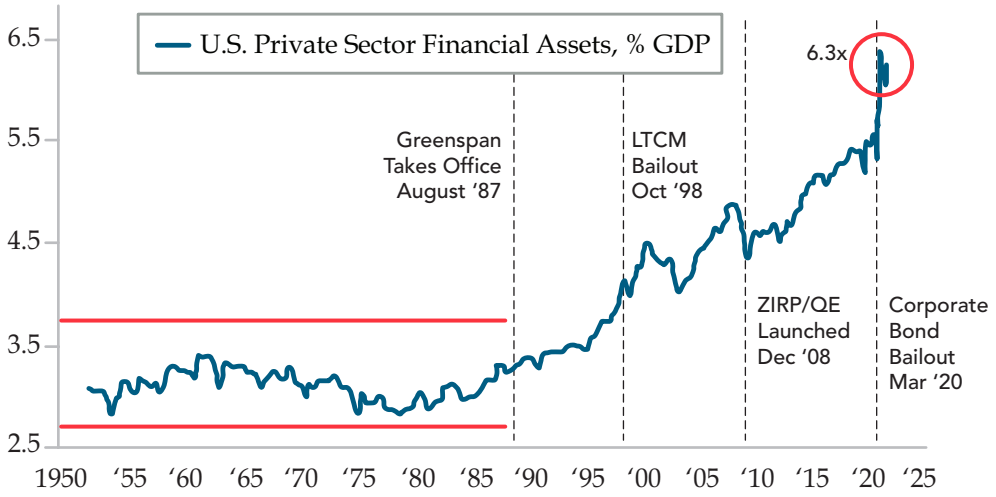


Sources: Preqin, Morgan Stanley Research

Perhaps we should not angst. Paying up has become the norm. The impetus to shrug off prices has been increasingly ingrained ever since Alan Greenspan first leaked the Fed's intentions to inject liquidity into the financial system in the weeks and months that followed the crash of 1987. Each iteration has further upped the ante, dared the gambler to roll the dice one more time, in the name of testing the mettle of the Fed Put. Never has the individual lost the roll culminating in last year's mammoth bailout of the corporate bond market.

You rightly observe that y-scales are meant to be heightened. For 34 straight years, investors have been rewarded for stepping one more rung out on the risk spectrum. Yesteryear's graphs were just as damning…until the Fed stepped in with its next, bigger bailout. What's to stop the scale from getting taller yet?

Insanity Becomes the Norm



Source: Quill Intelligence, BoA Global Investment Strategy, Bloomberg, Haver

To answer that question, according to Edward Siedle, author of Who Stole My Pension?, about 1,000 current and retired Ohio educators. Backed by $75,000 in funds raised by the teachers, Siedle is conducting a forensic audit of Ohio's $90 billion state pension fund. The former Securities Exchange Commission attorney has pressed the Ohio Supreme Court to force the State Teachers Retirement System, serving some 500,000 active, inactive, and retired members, to release information that investment firms have claimed is proprietary or a trade secret. Just think, those whose futures have been entrusted are demanding justification for being charged egregious fees in exchange for the promise of delivering outsized and fantastical returns. In plain English, PE firms have grown accustomed to robbing public unions blind and getting away with it. To Siedle's wholly sound petitions that PE firms lay bare their "secrets," we wish him all success.

In the meantime, states with stretched budgets continue to hide the truth as it pertains to the biggest drag on their cash flow. In the words of the tragically circumspect Warren Buffett as he's aged, "The pension situation is terrible in a great many states," As a company, "you have to be very careful… before you go into some state with a huge pension deficit and a declining population because you're going to be the last man left."

In May 2019, Buffett was a bit more forthright: "We have seen a number of proposals from private equity funds where the returns are really not calculated in a manner that I would regard as honest. If I were running a pension fund, I would be very careful about what was being offered to me."

Per Siedle: "You might think that underfunded pensions struggling to pay benefits would heed Buffett's advice and seek to cut the fees they pay Wall Street. Embrace austerity. Tighten their belts. Trim the fat. In fact, every forensic investigation I've ever undertaken has exposed that the nearer a pension is to insolvency, the higher the fees and the greater the risks the pension takes on."

Circles are increasingly harder to square. Institutional investors are presumably adept at trading positions and wary of glaring valuations and signals that are impossible to ignore. Pension managers, however, move slowly. They're paid to be methodical. The price is unquantifiable: They've been sold the lie that the risk they're taking will only be rewarded from the product of a shotgun marriage between 1999 and 2007 which has not, nor ever will have, consequences. Should the flesh, as Sir Seymour begged, be so quieted.

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