

DECEMBER 2023

Are We There Yet?

After a bumpy 2023, we see signs of “normal” in 2024

Introduction

We entered 2023 on uncertain footing. The Federal Reserve was battling inflation not seen since the 1980s, the bond market was coming off the biggest calendar-year rout in recorded history, and despite a resilient labor market, investors were questioning whether the Fed could pull off an historically elusive “soft landing.”

In Pathstone’s [December 2022 CIO Letter](#), we forecasted a “bumpy road back to normal.” We believed that despite the severity of the moves seen in 2022, the market and economy were on the road back to a scenario where more persistent returns would emerge. Nearly a year later, we have certainly seen some bumps (three major bank failures, debt ceiling crises, continued geopolitical tensions), but we also see signs for smoother roads ahead: The Fed has signaled the end of its rate-hiking cycle, the economy has strengthened while inflation has cooled, and equity markets have rebounded. Investors may now be asking, “Are we there yet?”

To address that question, we need to understand what “there” means.

In this edition of our annual year-end letter, Pathstone’s Chief Investment Office examines the state of the markets and economy and offers insights on where we are on our journey and what our destination might be in 2024. Our leaders will address the macro outlook, what a long-term “normal” environment might look like, emerging secular trends poised to break free of the economic cycle, as well current trends and actionable investment ideas across listed and private markets.

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Economic Outlook: Reasons for Optimism

2023 Review

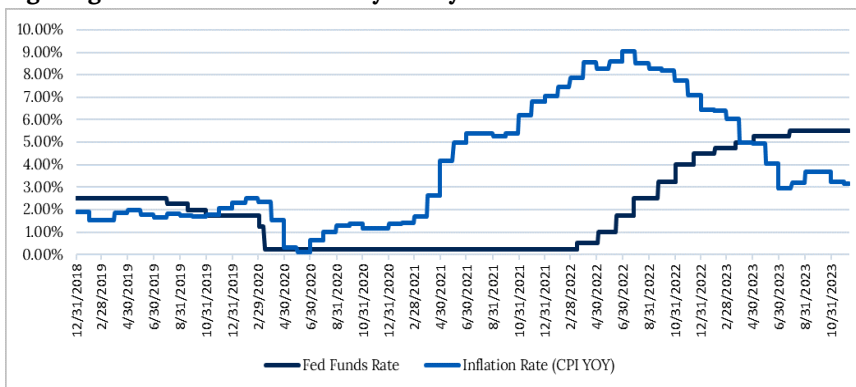
Financial markets are constantly climbing a wall of worry and 2023 was no exception. Markets had to navigate two ongoing military conflicts, two of the three largest bank failures in U.S. history, three consecutive quarters of negative earnings growth rates for the S&P 500 (Q4 '22, Q1 '23, and Q2 '23), a significant real estate crisis and weak post-Covid recovery in China, and several threats of a U.S. government shutdown. In the end, it appears we will avoid an unprecedented third straight year of losses for investment grade fixed income, while equity markets globally are on track to log double-digit gains for 2023.



JOHN WORKMAN
MANAGING DIRECTOR
INVESTMENT STRATEGY

Consumers, supported by a strong employment market, continued to spend down the savings they accumulated during the pandemic. Government stimulus programs, including the Inflation Reduction Act, continued to bolster economic activity. All of this despite the headwind of global central banks pushing interest rates higher to slow economic activity enough to tame inflation. The Fed drove rates from 4.5% at the beginning of 2023 to 5.5% by the end of July, when they paused action but stated that rates would stay high for longer. As of November's reading, CPI has been cut in half from 2022, going from 6.5% to 3.1%, suggesting the Fed is winning the fight.

Fighting Inflation with Monetary Policy



Source: Bloomberg.

2024 Outlook

As we approach the start of 2024, investors are focused on two primary scenarios for the economy: soft landing or recession. Markets appear to be placing a lot of weight on central banks' monetary policy as one of the primary determinants of which scenario unfolds. The recession-minded will focus on rising unemployment rates, extreme home prices relative to income levels, excess office vacancies and the potential ripple effect through the banking sector, growing debt service levels for the government, a pick-up in corporate defaults, and rising consumer delinquencies on auto loans and credit cards. Those anticipating a soft landing are counting on inflation falling further so that central banks can lower interest rates, thus providing relief for borrowers that need to refinance debt in the coming years. Relatively stable employment, rising wages, and productivity growth will be needed to support rising GDP per capita under

this scenario. Lastly, there must be a belief that a pick-up in defaults/bankruptcies will be no greater than the market's available liquidity to address those issues.

Human nature suggests that we are more likely drawn to wanting to protect against the worst-case scenario than to anticipate the best; however, there are reasons to be optimistic. We are at a technological inflection point that could unlock further economic growth leading to higher standards of living around the world. New technologies can be anticipated to change the landscape in energy production and efficiency, improve healthcare, and foster significant leaps in productivity. These factors suggest we can be hopeful not just for a soft landing but for the growth that could emerge in an environment of lower inflation and lower interest rates. The strong rally in equity and bond prices in November suggests that the markets believe in this possibility a bit more than they did in October. The Federal Reserve's mid-December update of economic projections validated the markets optimistic outlook.

As we look ahead to 2024, we accept that there will be volatility but are relatively optimistic that inflation will remain in a more tolerable range and that short-term interest rates should move lower. Household and corporate balance sheets are in relatively good shape. Other than an adjustment to prices of office buildings, where demand was likely permanently changed due to the pandemic, there are few other imbalances that are likely to challenge the economy's ability to plug those holes. We enter the year with portfolios positioned much the same way as 2023, overweighting segments that we find offer a better risk/reward trade-off and underweighting those that are priced most dearly.

What Is Normal?

The challenge of addressing a question like "Are we there yet?" is that the implied destination - "normal" - can be hard to find. A map based on data from the last 25 years provides only a crude rendering of the landscape because of the persistent and unusual money policies pursued during the period in response to crises including Long-term Capital Management, Y2K, the tech bubble, 9/11, the global financial crisis, European monetary troubles, and the Covid pandemic. The three decades prior to 1998 saw price shocks and extremely abnormal interest rate movements with the 10-year Treasury yield making a round-trip from 5.0% to 15.8% and back. Older maps, though perhaps right for the time, may not be as relevant today because the terrain has been changed by technology, geopolitics, and the structure and behavior of markets. As such, we're left with theory, judgment, and experience to determine whether we've made it to our destination. Acknowledging that an evaluation such as this is much more art than science, we offer the following observations.



DAVID BELEJ, CFA
MANAGING DIRECTOR
CHIEF INVESTMENT OFFICE

Among financial variables, longer-term interest rates appear the furthest along the path to normalization. One framework for gauging the current level of long-term interest rates is to compare them to the expected nominal trend growth of the economy. A simple rule of thumb suggests that the two values should track each other over time. Or, to paraphrase "bond-king" [Jeff Gundlach](#) from a 2018 CNBC interview, interest rates are like a dog that's tied to a stagecoach (GDP growth) on a cross-country trip. There are times when the dog will run ahead of the coach and there are times when the dog will trail it, but there's no question that they're making the journey together. Given that the Federal Reserve currently forecasts future nominal

GDP growth will lie in a range between 3.6% and 4.5% in the longer run, today’s yield on the 10-year Treasury (4.11% as of December 6) appears to have arrived at normal for now. There is an intermediate-term risk, however, that higher rates coupled with our government’s challenging fiscal position (high debt and persistent deficits) could alter the supply-demand balance for bonds, driving rates higher.

Next, certain segments of the capital markets are in the process of arriving at normal – much the way a train approaches a station. (“Is it here yet...?” “Well, the front part is but the back’s still way down the track.”) One good example of this process can be found in the domestic stock market. However, unlike many trains, this one is led by the caboose - small cap stocks. Based on valuation metrics for the S&P 600 Small Cap Index, this segment of the market arrived at normal valuations some 18-24 months ago and now trades at levels that are quite attractive historically. (The same cannot be said for the Russell 2000 small cap index, which includes a significant number of companies that have negative earnings.)

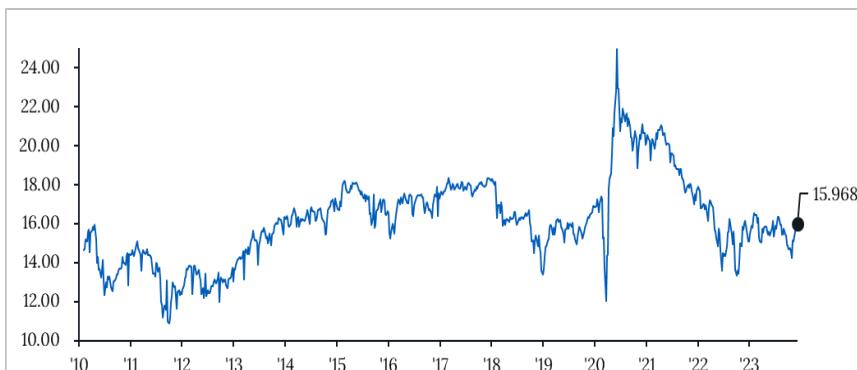
S&P 600 Small Cap Index Forward P/E Ratio (Blended 12 Months)



Source: Bloomberg

In the middle of the train, large cap stocks – excluding a handful of mega-caps – are nearing the station. The S&P 500 Equal Weight index and the S&P 500 index, excluding the mega-caps, are trading at relatively normal price-earnings multiples of 16.0 - 17.0x. It’s mostly the mega-cap engines at the back of the train that still have some distance to go. The fact that the largest companies currently have higher multiples than the rest of the index may not be abnormal in itself; it happened before with the Nifty Fifty in the 1960s-70s and the tech bubble in the late 1990s. However, investors should remember that in both cases, the engines powering the trains eventually ran out of steam.

S&P 500 Equal Weight Forward P/E Ratio (Blended 12 Months)



Source: Bloomberg

Notwithstanding that the valuations of small, mid, and most large cap stocks appear around normal, there is still some concern whether the rapid normalization of interest rates is fully reflected in their prices. For instance, a [June 2023 staff working paper](#) from the Federal Reserve Board of Governors found that, from 1989 to 2019, the fall in long-term interest rates from roughly 8.0% to 2.0% significantly reduced corporate interest expense and was responsible for almost 20% of the growth in real, after-tax corporate profits. Loss of this tailwind could cause earnings to grow more slowly in the future. Furthermore, as higher interest rates work their way through the system, they could slow economic growth, further pressuring earnings growth.

Finally, there are those quantities that are still quite far from normal. Short-term interest rates, which are deliberately being controlled by the Fed as a policy tool, are one example. Theory suggests that a short-term lender to a creditworthy borrower shouldn't be overly enriched. Instead, the lender is entitled to maintain purchasing power and, perhaps, earn a small real return of around 50 basis points. Given that the year-over-year change in the Consumer Price Index was recently 3.2%, one might expect short-term rates to be about 3.7%, not 5.4% as they are today. While short-term rates clearly "aren't there yet," many analysts expect their 18-24 month journey back to normal will begin during the first half of 2024 as the Fed begins to signal some optimism about their progress on inflation.

So, are we there yet? In general, we're getting closer but, as history teaches us, circumstances will change and "New Normals" – to borrow a phrase from Mohamed El-Erian – will become our destinations. In the end, perhaps it's change that's normal. We simply need to adapt to its bumpy road.

Investment Themes That Transcend the Cycle

2023 has been a decisive reminder that investing in secular growth is a key driver, perhaps a necessary feature, of successful long-term portfolio outcomes. Indeed, 2023 has been a seminal year for understanding and appreciating technological disruption.



SARB SHAH
MANAGING DIRECTOR
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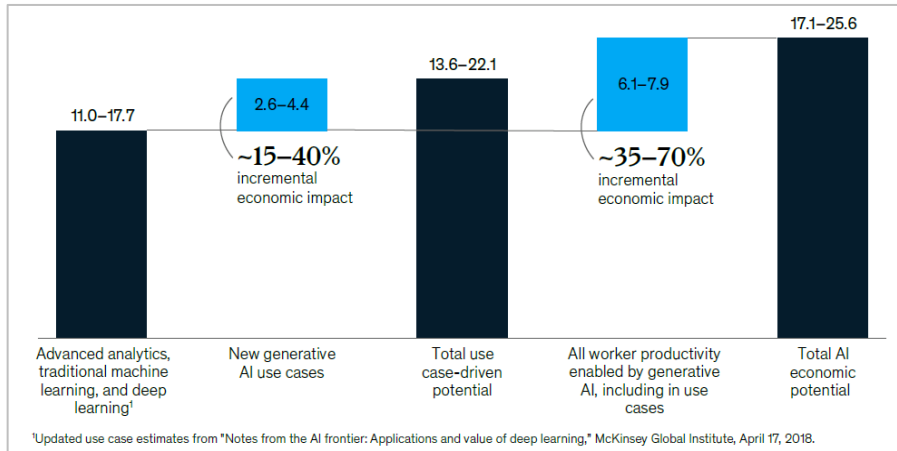
Among many impactful disruptive forces, two have had outsized market capitalization impact with potentially broad industrial implications: artificial intelligence (AI) and glucagon-like peptide 1 (GLP-1) agonists, the class of drugs used in the treatment of diabetes and, increasingly, obesity. There was little talk of either entering the year, and now discussion of their game-changing potential is ubiquitous across corporate earnings calls, public policy forums, and even in casual conversation. For this letter, we thought a short recap of the data that could make these advancements so pivotal would shed light on the importance of investing in cross-sector disruptive themes.

The AI Revolution

Software and hardware engineering have seen extraordinary progress over the last 20 years. Constant improvement of computing architecture enabling new software tools has led the world from Enterprise Resource Planning to Cloud Computing to Artificial Intelligence, with countless intermediate extensions along the way. Each of these parallelized software/hardware developments has generated durable

productivity gains, and AI has potential to drive the most significant leap forward yet. McKinsey and Company assessed a wide set of cross-functional, cross-industry AI use cases and estimates the potential impact of generative and non-generative AI to be \$17.1 trillion to \$25.6 trillion¹ – roughly one-sixth to one-fourth of global GDP. Goldman Sachs believes capital investment on AI in the U.S. alone could go from under 0.5% of the GDP to nearly 2.5% of GDP over the next 10 years².

AI's Potential Impact on Global Economy (\$ Trillion)



Source: McKinsey & Company

The staggering economic implications of AI adoption have driven enormous gains in market capitalization in 2023 for early leaders like Nvidia and Microsoft. Opportunities for other, lesser-known beneficiaries will surface in the coming years.

Beyond Health: The Promise of GLP-1 Drugs

While GLP-1s may not (yet) have the potential economic impact of AI, their use could disrupt many industries, also with economically large implications. A 2016 study by the Milken Institute concluded that obesity-driven chronic disease drove \$480.7 billion in direct U.S. health care costs and \$1.24 trillion of indirect costs due to lost economic productivity³. When this analysis was conducted, the total direct and indirect costs represented nearly 10% of GDP. Today, GLP-1 is primarily used for diabetes management and increasingly weight loss; however, it is being widely considered for numerous other indications, including cardiovascular, kidney, and other gastrointestinal disease. TD Cowen believes GLP-1 sales could reach \$102 billion in 2030 from roughly \$35 billion in 2023, with only 40% attributable to weight loss use. Successful penetration into other diseases could lead to significant impact. TD Cowen further believes GLP-1 adoption by the obese population could result in significant reductions in health spending⁴. As noted below, a 50% adoption rate could generate more than \$500 billion in net savings.

¹ <https://www.mckinsey.com/capabilities/mckinsey-digital/our-insights/the-economic-potential-of-generative-ai-the-next-productivity-frontier>

² The Magnitude and Timing of the AI Investment Cycle. Joseph Briggs and Devsh Kodnani, Goldman Sachs Research. July 20, 2023

³ America's Obesity Crisis, The Health and Economic Costs of Excess Weight. Hugh Waters and Marlon Graf. The Milken Institute. October 2018. https://milkeninstitute.org/sites/default/files/reports-pdf/Mi-Americas-Obesity-Crisis-WEB_2.pdf

⁴ Will GLP-1s Eat the World? TD Cowen Research. November 15, 2023.

Estimated GLP-1 Impact On Hospital Revenues Considering Only Obesity-Related CV, Orthopedic, and Bariatric Procedures

| | | Net (Costs)/Savings (\$B) | | | | | | | |
|----------------------|-----|--|--|---------|---------|---------|---------|---------|---------|
| | | % Reduction of Obesity-Related Cardiovascular, THR/TKR, Bariatrics | | | | | | | |
| | | 10% | 20% | 30% | 40% | 50% | 60% | 70% | 80% |
| % Obese Pop on GLP-1 | 10% | (\$116) | (\$109) | (\$103) | (\$96) | (\$89) | (\$82) | (\$75) | (\$69) |
| | 20% | (\$244) | (\$237) | (\$230) | (\$223) | (\$216) | (\$210) | (\$203) | (\$196) |
| | 30% | (\$371) | (\$364) | (\$358) | (\$351) | (\$344) | (\$337) | (\$330) | (\$324) |
| | 40% | (\$499) | (\$492) | (\$485) | (\$478) | (\$471) | (\$465) | (\$458) | (\$451) |
| | 50% | (\$626) | (\$619) | (\$613) | (\$606) | (\$599) | (\$592) | (\$585) | (\$578) |
| | 60% | (\$754) | (\$747) | (\$740) | (\$733) | (\$726) | (\$720) | (\$713) | (\$706) |
| | 70% | (\$881) | (\$874) | (\$868) | (\$861) | (\$854) | (\$847) | (\$840) | (\$833) |
| | 80% | (\$1009) | (\$1002) | (\$995) | (\$988) | (\$981) | (\$975) | (\$968) | (\$961) |
| | | | Net (Costs)/Savings % US Total Health Spending | | | | | | |
| | | % Reduction of Obesity-Related Cardiovascular, THR/TKR, Bariatrics | | | | | | | |
| | | 10% | 20% | 30% | 40% | 50% | 60% | 70% | 80% |
| % Obese Pop on GLP-1 | 10% | (-4%) | (-3%) | (-3%) | (-3%) | (-3%) | (-3%) | (-2%) | (-2%) |
| | 20% | (-7%) | (-7%) | (-7%) | (-7%) | (-7%) | (-6%) | (-6%) | (-6%) |
| | 30% | (-11%) | (-11%) | (-11%) | (-11%) | (-11%) | (-10%) | (-10%) | (-10%) |
| | 40% | (-15%) | (-15%) | (-15%) | (-15%) | (-14%) | (-14%) | (-14%) | (-14%) |
| | 50% | (-19%) | (-19%) | (-19%) | (-19%) | (-18%) | (-18%) | (-18%) | (-18%) |
| | 60% | (-23%) | (-23%) | (-23%) | (-23%) | (-22%) | (-22%) | (-22%) | (-22%) |
| | 70% | (-27%) | (-27%) | (-27%) | (-26%) | (-26%) | (-26%) | (-26%) | (-26%) |
| | 80% | (-31%) | (-31%) | (-31%) | (-30%) | (-30%) | (-30%) | (-30%) | (-30%) |

Source: TD Cowen.

The impact of reducing obesity could reach far beyond healthcare as well, particularly in the large food and beverage markets. While it is very early in assessing the long-term effects from using GLP-1, the potential for economic disruption is clear.

Lessons from Disruption

We highlight AI and GLP-1 because of the pace and magnitude of their emergence. Already, the convergence of AI and biotechnology is driving drug development costs significantly lower and could have massively positive effects on the cost and reach of healthcare globally.

While AI and GLP-1 have received much of the attention, several additional investable themes set up well for 2024. These include:

- the reshaping of global supply chains due to geopolitical shifts,
- the growing demand for infrastructure related to a data-driven world, and
- the multi-dimensional transition of power and energy systems.

We believe we are in the early innings of many of these themes and are building exposures in both public and private markets to ensure clients stay invested in them. Productivity-enhancing disruption may be needed now more than ever, considering elevated indebtedness across much of the developed world. In the middle of this multi-year path (bumpy or not) of normalizing the economy, there are parts of the investment world that overpower the cycle and make “Are We There Yet?” a less relevant question.

Listed Markets: Fundamentals Are Back

Since the Covid pandemic began in early 2020, markets have been dominated by macro themes. From new variants to geopolitical turmoil to the Fed’s next move, the fundamental picture of a company has been an afterthought. As we look ahead to 2024, the macro picture looks as uncertain as ever. Experts are split between a soft landing and an interest rate-induced recession. So, are we at either destination yet?



CHRIS MARTIN, CFA, CAIA
DIRECTOR
LISTED MARKETS RESEARCH

For the first time in years, it might not matter. What does seem to matter now is the fundamental financial situation of each individual company, which should provide a very attractive set-up for active management across many asset classes. Non-zero interest rates, regardless of how long they last, have introduced dispersion within and across asset classes that was lacking for several years.

Equities – Seeking Performance Dispersion

In an environment focused on rewarding individual company fundamentals, we see the greatest opportunities in sub-asset classes with high performance dispersion, both at the manager level and at the security level. In particular, US Small/Mid Cap and Emerging Markets fit this description and may see even greater dispersion in 2024 as a result of non-zero interest rates.

The percentage of companies in the Russell 2000 Index with negative trailing 12-month earnings has been climbing since 1995 and has been particularly elevated since the onset of the Covid pandemic. Companies in this situation need regular access to capital markets, often debt capital markets. Lending rates materially above those of a few years ago will further impact such companies’ ability to turn profitable and potentially even remain going concerns. Within Emerging Markets, higher U.S. interest rates can make assets offered in EM economies less attractive, reducing financial flows to these countries. This increases the cost of borrowing in emerging markets, depressing demand.

Percent of Russell 2000 Members with Negative Earnings



Source: Bloomberg

Asset managers’ understanding of these factors and the integration of them into their fundamental view of a company’s prospects should increase the performance differences between the top and bottom performers.

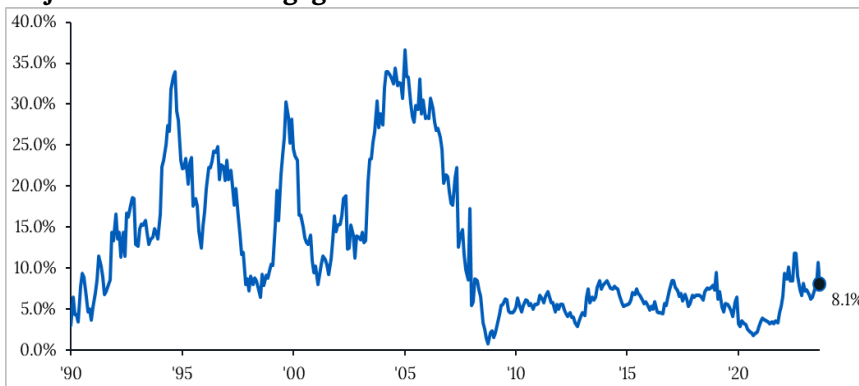
Credit – Refocusing on Fundamentals

Credit markets have also been driven primarily by macro factors in the last few years as global bond performance has followed inflation and interest rate expectations, mainly through the lens of central bank activity. As we see inflation continue to come down and central bank rate hikes slow, the market is turning to company fundamentals to determine the appropriate price (and thus yield) of existing and new issue debt capital.

While the current backdrop as we've just described may sound normal, many companies and consumers got very comfortable with a near zero interest rate environment. The material shift from near zero to normal is where much of our focus lies within the credit universe. First and foremost is stressed and distressed credit strategies. Companies and management teams that got too comfortable with the prior interest rate environment will have a difficult time managing their balance sheets in the face of higher borrowing costs. These potential issues, which we have already seen begin to play out in 2023, could create a material opportunity in 2024 for managers who have expertise in capital solutions, bankruptcy, and restructurings.

As for the consumer, there are plenty of both positive and negative signs to point to regarding consumer financial health. Auto-loan delinquencies are picking up, but unemployment is still near record lows and wage growth has been strong. Multi-sector bond managers that can allocate across the liquid credit spectrum should be able to add value by investing in areas that are oversold or avoiding those that look stretched. A deep, experienced team will be crucial for this type of widespread fundamental analysis. As an example, increases in mortgage rates have had a material impact on Mortgage-Backed Security performance in 2023. However, with most homeowners having built significant equity in their homes, very few existing mortgages exposed to interest rate risk, and a chronic undersupply of housing, we believe the sell-off in Mortgage-Backed Securities could be an overreaction, presenting highly engaged asset managers a unique opportunity to allocate capital to a beaten-up asset class with a strong fundamental outlook.

Adjustable Rate Mortgages - % of Loan Volume



Source: Mortgage Bankers Association, Bloomberg.

Diversifying Strategies – Benefiting from Equity and Credit Trends

Even as broad financial markets have been driven predominantly by major macro events, the increase in volatility initiated by the Covid-19 pandemic has provided a highly attractive multi-year environment for our diversifying strategies. Diversifying strategies are comprised mostly of our multi-strategy, relative value and macro hedge funds. As discussed previously in this note, we expect that volatility to move from a macro level to a micro level, which should continue to provide these managers with increased opportunities relative to the period preceding the pandemic. As most of our diversifying strategies invest across a broad range of asset classes, all of which will likely be affected by an increase in micro level volatility, this new regime should prove highly attractive.

We believe this rings particularly true for macro strategies. As market participants try to assess the fundamentals of individual businesses and regions, it is increasingly likely those opinions will differ in material ways. Thus, whether it is U.S. small/mid-cap equities, fixed income sub-asset classes, or even interest rate policy differences across the globe, macro strategies are in a unique position to leverage their expertise to invest long and short across an array of opportunities. As an example, the makeup of GDP in the U.S. and the U.K. are markedly different. As both regions try to tame inflation, interest rates policies of the Fed and the BOE may diverge as different areas of their respective economies slow at different rates. A macro manager can invest in a region's interest rates or currencies to benefit from this type of divergence. We believe these types of opportunities will become increasingly common in 2024.

Conclusion

We are excited about the 2024 prospects for our highest-conviction asset managers across many parts of our client portfolios. Fundamental analysis of company balance sheets and forward-looking prospects should provide increased opportunities for managers who can find companies in the best positions and avoid those who may have a more difficult time navigating an uncertain economic picture. We believe our thorough due diligence process populates client portfolios with managers that have the experience, depth, and processes to generate alpha, particularly in an environment where fundamentals matter.

Private Markets: Manager and Asset Selection Key

Private Markets continue to evolve and mature in the face of changing economic conditions. We are observing distinct trend shifts in fundraising flows, continued specialization on the part of GPs, and a notable level of support/resilience for the asset class in institutional allocation frameworks. While the environment calls for a new playbook, private markets are innovating to keep stride.



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 DIRECTOR
 PRIVATE MARKETS RESEARCH



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 PRIVATE MARKETS RESEARCH

Private Equity to Remain a Central Source of Capital

Leaving behind a decade of near-zero interest rate policy, private equity firms are resetting their toolkits for both capital formation and value creation. Today, leverage is more expensive and less available, underwriting to valuation multiple expansion and profit margin expansion is challenging, and competition for high-quality assets remains. Manager and asset selection take on elevated importance in this environment.

We believe that those GPs able to help portfolio companies drive top-line growth, manage the complexity of corporate carveouts and distressed opportunities, and thoughtfully invest in innovation themes that transcend cycles, are well positioned. Ultimately, we will continue to use private equity to seek outsized returns and exposures not otherwise available to investors in traditional 60/40 portfolios.

Change is the only constant

In 1996, the number of listed domestic companies in the U.S. peaked at just over 8,000. By 2002, when the Sarbanes-Oxley Act passed, that figure had fallen by more than 30%. Today, the number of public companies listed in the U.S. has roughly halved from the 1996 peak. Regulation, the pace of technology innovation, and global development trends may partly explain this phenomenon. However, its impact on investors and general economic well-being is less clear. To date, the most apparent effect has been to limit opportunities to benefit from the growth and profits of successful operating companies. Further, public markets may be more concentrated, with a smaller number of companies producing returns and less ability to offer appropriate diversification.

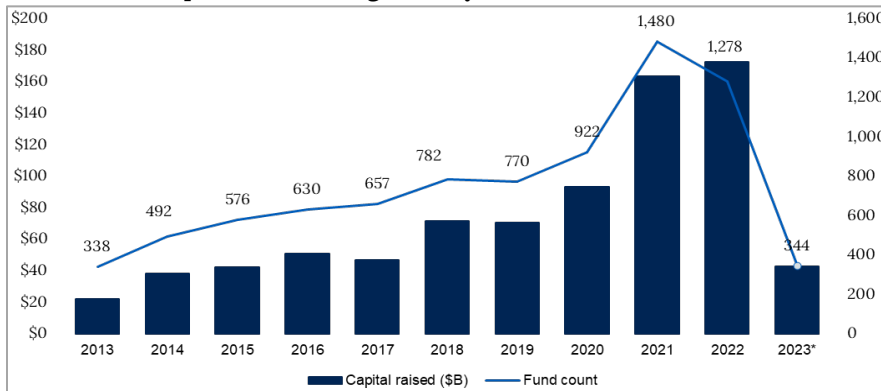
Paired with an elevated interest rate environment, we believe that private equity markets have an important role to play by:

1. Offering investors exposure to the full spectrum of a company's value creation lifecycle;
2. Developing pools of capital that allow companies to remain private for longer, a trend that we do not see abating in the near term; and
3. Continuing to serve as capital provider to companies unwilling or unable to weather the current environment as public entities.

On the first point, the early-stage investment ecosystem has experienced the largest reset of any market segment over the past two years. Median entry valuations have trended back to pre-pandemic levels as

fundraising and transaction activity have fallen. More attractive entry points may be available, but we do expect a material thinning of the manager herd in VC land over the coming several quarters. Fundraising headwinds and limited exit activity are likely to challenge capital raises, particularly for emerging firms. We believe that firm viability risk is elevated in this environment. While this cohort faces an uphill climb, a prospective flight to quality may benefit existing and established platforms. In a market driven by access we are watching how scaled players balance larger capital pools with their significant sourcing, underwriting, and investment capabilities.

U.S. Venture Capital Fundraising Activity



Source: Pitchbook. *2023 through 9/30.

We are also observing the continued maturation of several private market segments. Secondary markets, which captured headlines during the year, are a good example. The universe of offerings has deepened materially over the past five years, and we expect further specialization by managers going forward. This development will serve LPs looking to more precisely tailor exposures as well as the broad market by facilitating enhanced liquidity and private-for-longer trends.

Finally, we believe that private markets broadly are well positioned to serve as a liquidity mechanism for companies unable to weather a more challenging macroeconomic environment. We expect that elevated debt costs will continue to challenge unhedged borrowers and present opportunities for managers able to embrace complexity and stress. Further, stabilized macroeconomic conditions may give corporations the certainty needed to divest of non-core assets, offering additional opportunities to pursue take-private and carveout transactions.

Carveouts/Divestitures as a Share of Buyouts by Quarter



Source: Pitchbook.

While the opportunity sets and drivers of return continue to change, we remain highly constructive on the private equity asset class. Continued specialization on the part of managers, deepening products sets for allocators to select from, and broad capital constraints in the market should present compelling opportunities for patient investors to capture returns in the private markets. We continue to believe that building early exposure to innovation trends, such as applied AI, the sustainable energy transition, the future of healthcare and more, is an exciting and necessary part of long-term portfolio construction and well-pursued via the private markets.

Private Real Estate Facing Headwinds

In 2023 the Fed added another 1.0% of rate hikes from February to July, increasing the federal funds rate to 5.50%, up from 0.25% less than two years ago. Continued rising rates and the expectation of above-neutral rate policy have hindered commercial real estate transaction volume across all sectors during the year, as buyers push for lower valuations and owners reluctantly begin to adjust to a new time. Quarterly volume in 2023 is running roughly half the average levels recorded in the prior two years.⁵ In Q3, transactions were down 54% year-over-year.

With low deal activity, trades are starting to establish higher cap rates and lower valuations. Recent commercial real estate return sources vary widely as mark-to-market measures are different across index providers. For example, in the first half of 2023, NCREIF Fund Index (NFI-ODCE) reported diversified real estate performance down 6.2%, while MSCI Burgiss reported total returns down less than 1% over the same period. Although 3Q Burgiss results are not yet available, it is worth noting that the ODCE index declined another 2.1% in 3Q, bringing the trailing four-quarter period to -12.9%.

As real estate borrowers across all sectors face higher rates, banks are constrained in their ability to provide new loans. Loan origination was driven to peak levels from a prolonged period of economic expansion, and this contributed to the “wall of maturities” expected through 2027. Real estate loan maturities are forecasted to be approximately \$500 billion per year over this period. This outlook comes as regional banks face compounding factors of diminishing deposits and a higher concentration of distressed real estate loans. As a result, defaults are rising and discounted loan sales are impending. Alternative lenders are better positioned than banks and able to help bridge the gap, but terms come at high cost and are centered on the best operators. Credit conditions will remain tight, as represented by wider spreads and lower loan proceeds.

Fundamentals vary by property type

The disruption in the capital markets impacts all real estate sectors but fundamentals across property types vary. There is fundamental strength in multifamily, industrial, and specialty sectors as occupancies and rents are relatively stable. This operational performance helps mitigate the impact of higher interest rates. Office properties, on the other hand, are experiencing low occupancies and reduced rents. It is now evident that after nearly four years of remote/hybrid working, this approach is widely accepted within the business community. Following an initial pandemic tech boost to leasing, companies are now consistently giving back significant space as leases roll over. As a result, the likelihood of a full office market recovery over the intermediate term has diminished. This is not unlike the impact e-commerce had on retail, which started in force ten years ago. Some malls became obsolete and repurposed, while others continued to thrive. This bifurcation exists with office space – older inventory will need to be repurposed while new construction

⁵ Source: CBRE Research

with the right amenities will attract the most attention. This reset will take a toll on office owners as competition is fierce and costs to convert to other uses are high.

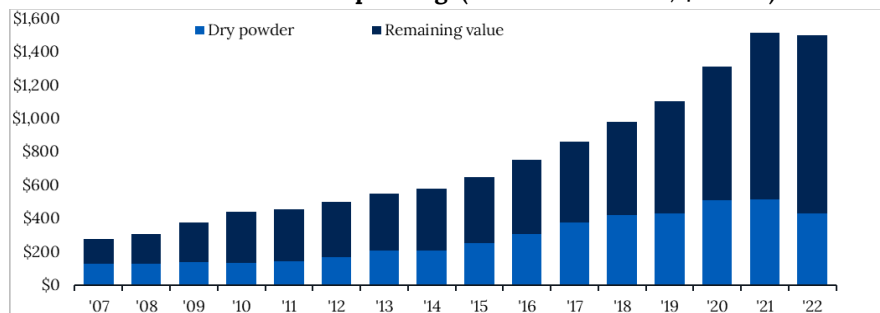
Even as dislocation and distress persist, attractive opportunities remain in the pipeline. Pathstone has built relationships with proven real estate managers that provide consistent access to both equity and debt capital. These sponsors have strong investor relationships with institutional capital sources and deep relationships with active lenders. Pathstone’s real estate sectors of interest include multifamily, industrial, and specialty areas where fundamentals remain relatively strong and distress is low. We also expect select opportunities through discounted loan sales, where banks may sell performing and/or non-performing credits. We expect these conditions to persist for an extended period while capital calls could be paced over the next two to three years.

Valuation adjustments in private markets can take time, but acceptance of the market environment is increasing across market participants and volume will return as market clearing prices become more transparent. This step is essential to recalibrate returns going forward.

Private Credit Continues to Attract Interest

The private credit market continues to expand, offering borrowers an alternative to the broadly syndicate loans or high-yield debt markets. Investors too are attracted to the additional diversification private credit can bring to their asset allocation frameworks. Over the last five years, the private credit market has increased over 50% in value to achieve an estimated \$1.5 trillion market size. Both borrowers and lenders are interested in the flexibility and customization of private transactions, especially as banks are constrained in their lending activities. Recently, the broadly syndicated bank loan market has required greater equity capital alongside its debt terms; equity contributions to clear leveraged buyout (LBO) deals in the syndicated loan market rose above 50% for the first time on record. Concurrently, issuance in the high-yield market has declined over the last three years, underscoring the importance of private credit investing as an alternative for well-run companies.

Private Credit Markets Are Expanding (Private Debt AUM, \$Billion)



Source: Pitchbook.

Private credit returns have been consistently strong across private senior debt, delivering 7-8% annualized returns over the trailing 4 quarters (ending 2Q-2023)⁶, which is also in line with the most recent five-year period. Performance has also demonstrated less sensitivity to higher rates compared to intermediate traditional fixed income securities. Floating rate debt, common within private credit, adjusts more quickly

⁶ MSCI Burgiss

to changing economics, keeping periodic valuations more stable. Mezzanine and distressed debt investing can contribute to enhanced gains albeit with more risk; allocations should be sized accordingly.

Looking ahead, we believe that private credit assets remain well positioned but that diversification and manager selection are key to success. We continue to build a core set of credit managers in direct lending that are established leaders in the upper-middle market. We also emphasize private equity backed companies where active owners can pull levers to manage through various environments. These characteristics can produce consistent income with less price volatility relative to intermediate investment grade credits.

Regarding smaller-cap companies, we remain selective as this market segment can be more vulnerable to economic downturns or be challenged to refinance amid higher rates. However, a few proven distressed managers are positioning deployments for dislocation and debt turnarounds in 2024. Unhedged borrowers can be a target, especially where revenue growth begins to level off and margin contraction takes hold. Access to these strategies may be through drawdown structures or hedge fund vehicles. Our dialogue remains active.

As noted in the real estate section above there are key disruptions within real estate debt markets that are keeping commercial real estate transaction activity low (constrained banking and lower real estate valuations from higher rates). Higher lending rates coupled with lower loan-to-value ratios are building the foundation for alternative asset managers with debt origination capabilities to deliver strong double-digit debt returns going forward. We expect this opportunity to persist over the next two to three years. This emphasis will be on performing credit to deliver high income backed by quality real estate. Sectors with these characteristics are multi-family, industrial assets, and other specialty sectors such as student housing and medical office.

Closing Remarks: Creating a New Normal at Pathstone

Much like the market, the investment industry is constantly evolving. There are time-tested approaches that can weather economic cycles, but as technology changes the way we invest, the road ahead does not always look like the one we have driven countless times before. Pathstone has long believed that navigating these dynamics successfully requires both a disciplined investment framework and thoughtful innovation. Embracing this approach, we made significant strides in 2023 to advance the way we source, analyze, and execute on investment ideas across public and private markets.



ALEX HART, CFA, CAIA
CHIEF RESEARCH OFFICER

In the public markets, we successfully completed the first phase in our plan to integrate the technology of our sister company [Advisor Partners](#). Pathstone can now implement both passive and actively managed equity strategies at significantly reduced costs relative to conventional investment structures and optimize the full portfolio to increase tax efficiency. We believe this structure represents the next wave of innovation within the investment industry, and we are only scratching the surface of what is possible in the future as we continue development.

Within the private markets, we leveraged the growing scale and reputation of our investment team as a partner of choice to source, diligence, and access direct investment opportunities in some of the highest-conviction ideas from the private fund managers with whom we have established trusted relationships. These opportunities offer clients the ability to reduce fees and increase potential returns. Success in private markets has historically required a deep network such as ours to source and access high-quality investment opportunities but we are also looking ahead to evaluate how technology may enhance opportunities in this space. New investment structures such as evergreen offerings, an expanding market of secondary transactions, and technology solutions to simplify the investment subscription process, among other innovations, are poised to challenge long-standing conventions. As we think about how to thoughtfully position our clients to be a generation ahead, this is an area we expect to focus on in 2024.

On the team front, we have expanded our group to more than 30 dedicated investment research professionals through Pathstone's acquisition of [Veritable Partners](#). This expanded team brings not only depth and experience, but fresh perspectives and new approaches that we are confident will benefit all of our clients over time. As part of this expansion, we are excited to announce [David Belej](#) has joined our Chief Investment Office. David brings over 30 years of experience to our investment leadership group, with deep expertise in investment strategy and portfolio management.

In many ways 2023 was a year of optimism. Despite the challenges, the market was largely unrattled by the bumps along the way, consistently pricing in a smoother road ahead. While we believe there are likely to be more bumps to come, we could not be more optimistic about our capabilities to navigate them. On behalf of the Chief Investment Office and all of the Pathstone family, we are thankful for your continued trust and partnership on this journey. We wish you and your family happy holidays and a prosperous New Year.

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