BECK MACK + OLIVER

# Newsletter: October 2023

## Market Update

From its recent high of approximately 4,600 at the end of July, the S&P 500 declined by more than 6% during August and September, but the index was still up more than 13% year-to-date as of quarter-end. Perhaps a more notable market development during the quarter was the increase in the yield of the 30-year US Treasury bond, which went from 3.86% at the end of June to 4.70% at the end of September. That was the largest quarterly increase in the 30-year Treasury yield since the first quarter of 2009.

A major contributor to this yield expansion is revised expectations regarding the future interest rate policy of the Federal Reserve. What changed was not how *high* interest rates are expected to go—the futures market continues to price in a peak fed funds rate of approximately 5.4%—but the *pace* at which the fed funds rate is expected to decline from this peak level thereafter. As inflation data continue to improve, the market still believes that the Fed is near its final rate increase of the current cycle and that the fed funds rate will decline over the course of 2024, but the market is now pricing in fewer reductions in the fed funds rate next year.

These revisions to expectations regarding short-term interest rates tend to reverberate throughout the fixed income market, but probably only explain part of the observable move in the 30-year Treasury bond. The other factors are more difficult to discern. Faster economic growth and inflation *over the long run,* and not just during the current cycle, would be consistent with higher long-term bond yields. That would be roughly the opposite of the "secular stagnation" thesis of low economic growth and low inflation that was regularly debated in the period between the 2008 financial crisis and the pandemic of 2020. Another factor could be the country's fiscal situation. It has long been cliché to describe Washington as dysfunctional or to note the seemingly inexorable rise in the amount of Federal debt outstanding. What has changed more recently, however, is the interest rate that the government pays on that debt, which is exacerbating the country's fiscal burden. More speculatively, we would also point to the ongoing diminution of the banking system as a source of credit throughout the economy, which is a long-term trend that seems to have accelerated in the wake of the bank panic in March of this year, and to the efforts by the Fed and other central banks to shrink their holdings of government bonds.

As stock investors, however, we care less about the precise composition of macroeconomic causes behind the rise in yields than about what higher yields portend for our stock selection. Just as accelerating inflation during 2021 and 2022 underscored the importance of owning businesses with pricing power, higher yields today put companies with healthy balance sheets and smart capital allocation at a distinct advantage. Interest rates are ultimately the measure of the cost of capital, and thus businesses that generate and have robust access to capital—and whose management teams and boards of directors have the wherewithal to intelligently deploy it—are more likely to thrive in the current environment.

**Stock Spotlight: Blackstone and Apollo**

Several years ago, Beck Mack + Oliver identified the alternative asset management industry as a major beneficiary of ongoing, long-term trends related to the creation and management of wealth, both in the US and around the world. As our society becomes richer, and as investable wealth therefore grows more quickly than the underlying economy, the ability to efficiently invest this wealth across different asset classes, geographies, and investment structures has become ever more important, especially for institutional investors such as pension funds, but also, increasingly, for individual investors. The alternative asset management industry has been at the forefront of these developments, which has resulted in impressive growth rates for the sector, which we believe will continue for a long period of time.

What makes an asset "alternative"? At its most basic level, an alternative asset is one that falls outside of the conventional categories of common stocks, government or corporate bonds, and cash. By this definition, asset classes such as real estate, commodities, and artwork are considered to be alternative, as are investment vehicles such as private equity, venture capital, and hedge funds. The late David Swenson, who managed Yale University's endowment for multiple decades, was an early proponent of investing in alternative assets. The original attraction to alternatives was based in part on the prospect of superior returns, but even more so on the prospect of *uncorrelated* returns: if the S&P 500 were in a bear market, for instance, then owning non-equity assets in other parts of the world might be a way to protect the overall value of the portfolio. The price of such diversification was often paid in the form of owning less liquid investments, which is a tradeoff that a large university endowment, such as Yale's, was in a favorable position to make.

We have expressed our investment theme on the alternative asset management sector primarily via our investments in Blackstone (BX) and Apollo Global Management (APO), which were founded in 1985 and 1990, respectively. In the early days, both companies were variations of what we would loosely refer to today as private equity businesses. They would raise a private fund from investors; invest the fund's capital by acquiring assets or businesses; and, as the investments were sold, return the capital, plus a return, to the fund's investors. Blackstone tended to do leveraged buyouts, where it would use borrowed money, in addition to the investors' capital, to finance the acquisitions, while Apollo focused more on distressed situations, where it might buy debt at a discount to its par value. Both Blackstone and Apollo demonstrated that they were skilled investors adept at identifying mispriced investment opportunities, which led to strong fund returns and the ability to raise progressively larger funds. Over time the companies expanded into other asset classes, such as real estate and hedge funds, and geographies outside the US. They made money by charging management fees based on the amount of capital that they raised from investors as well as performance fees based on the returns that were generated on that capital.

In 2007, Blackstone became one of the first alternative asset managers to conduct an initial public offering, thereby providing public equity investors the opportunity to invest in the business. At the time, it had assets under management of $79 billion, the largest portion of which was in private equity. As the public markets recovered in the wake of the 2008 global financial crisis, Apollo conducted an initial public offering in 2011. At the time, it had assets under management of $68 billion, the largest portion of which, like Blackstone, was in private equity. Other alternative asset managers also went public around this time, including KKR & Co., The Carlyle Group, and Ares Management Corp. Public equity investors could now invest in a variety of alternative asset managers, all of which had been privately held just a few years prior.

In their first years as public companies, the alternative asset managers generated attractive total shareholder returns, though their share prices tended to be volatile and public market investors struggled to understand and appropriately value the entirety of their businesses, in part because GAAP accounting obscured the economic reality of their financial performance. While the recurring and stable management fees were reasonably straightforward to analyze, the market seemed less comfortable with the lumpier and less predictable

performance fees, which wax and wane based not only on the performance of individual funds but also on the timing of sales of individual investments within the funds. As a result, this important albeit more volatile part of their earnings was typically valued at a significant discount in the public market. Moreover, Blackstone and Apollo, like the other publicly traded alternative asset managers, were initially organized, for tax purposes, as partnerships rather than corporations, which entailed more burdensome tax filing requirements for shareholders, which in turn limited the shareholder base and had a negative impact on how the stocks were valued. Throughout this period, however, the alternative asset managers generated robust earnings growth, driven by both management fees and performance fees.

The ultimate cause of Blackstone's and Apollo's rapid earnings growth was that they excelled at two critical functions—raising money and investing it. The investors, or limited partners, in the companies' funds included institutions such as pension funds, university endowments, insurance companies, and sovereign wealth funds, as well as accredited individual investors, i.e., those who met minimum net worth or income requirements. As Blackstone and Apollo consistently made good investments and generated high returns in their funds, they deepened and broadened their relationships among their limited partners, who in turn allocated a progressively greater portion of their investable capital to the companies' funds.

Despite this success, it was not lost on the alternative asset managers that the *total* amount of capital at the disposal of their limited partners far exceeded the amount that was being allocated to them. Thus, the industry, led by Blackstone and Apollo, evolved in a variety of ways that substantially enlarged its addressable market and opened up exciting new avenues for growth. First, there was a great deal of innovation at the fund level with respect to asset types and investing strategies. Whereas Blackstone and Apollo for many years had been known primarily for funds related to private equity, real estate, and distressed investing, over the last decade they have expanded their fund offerings into infrastructure, performing loans, private credit, growth equity, real estate debt, energy transition, life sciences, tactical opportunities, specialty finance, private equity secondaries, general partner stakes, and more—and all of these in every major region of the globe. This growth and innovation did not happen overnight but took many years of deliberate and careful efforts to hire and nurture the right investment teams and to ensure that the appropriate infrastructure was in place for sustainable success.

Second, the industry innovated beyond its original drawdown fund structure with high targeted returns and introduced perpetual capital vehicles with somewhat lower targeted returns. The drawdown structure refers to the historical pattern of raising a fund via capital commitments from limited partners; calling, or drawing down, those capital commitments as the fund made investments; and eventually returning the capital, plus a return, to the limited partners as the investments were sold. A traditional private equity fund would target annualized returns, net of fees, in the mid- to high-teens, and there have been many instances over the years of individual funds having generated net returns well above 20%. A perpetual capital vehicle, by contrast, has no obligation to sell investments and return capital to its limited partners. This structure is more appropriate for investments that are attractive to hold indefinitely rather than for a limited period of time, and it also is commensurate with lower targeted returns—usually high-single to low-double digits, depending on the asset class. A significant number of limited partners turned out to have a large appetite for these lower-return perpetual capital vehicles, which allowed them to put more capital to work for longer periods of time and still generate attractive risk-adjusted returns.

Finally, the industry has expanded beyond its traditional limited partner base of institutional and accredited individual investors by establishing distribution channels for non-accredited individual investors to access the companies' myriad offerings. One example is Blackstone Real Estate Investment Trust (BREIT), which is a real estate-focused perpetual capital vehicle that was launched in 2017 and today has approximately $68 billion of assets under management. BREIT shares, which are not publicly traded, can be purchased monthly from select financial advisors. BREIT shareholders include institutions, accredited individual investors, and non-accredited

individual investors. We believe that Blackstone is among the best real estate investors in the world, and a decade ago it was virtually impossible for a non-accredited individual to invest with Blackstone. BREIT's rapid growth and success are a testament to the magnitude of demand within what is often referred to as the retail channel.

Another example of innovation in the retail channel is Apollo's highly effective expansion into retirement services, which has led others in the industry, including Blackstone, to follow suit. Apollo's cofounder and CEO Marc Rowan in 2009 helped to form an insurance company called Athene, which sells fixed annuities and related insurance products and which for many years had a partnership with Apollo whereby the insurance premiums earned by Athene would be invested in Apollo's various funds. Then, in early 2022, Apollo acquired Athene. We believe that Athene is an excellently run insurance business in its own right, but the beauty of the combination is that it supplies Apollo a with large source of effectively perpetual capital from a largely retail investor base—a similar outcome that Blackstone achieved with the creation of BREIT.

All of this innovation and expansion have resulted in truly outstanding growth over many years. Today Blackstone has more than $1 trillion in assets under management, which is 128% more than it had five years ago and 336% more than it had 10 years ago. Apollo has $617 billion in assets under management, up 131% and 451% from five and 10 years ago, respectively. <u>More important for our investment thesis, however, is the incredible runway for *future* growth that we believe these businesses have</u>. Blackstone President and Chief Operating Officer Jon Gray, who more than anyone has been responsible for the staggering success of the company's real estate investing, recently pointed out that there is approximately $85 *trillion* of wealth among individual investors with at least $1 million to invest. Those individuals, on average, have no more than 1-2% of their wealth allocated to the kinds of products that Blackstone and Apollo offer. This compares to 25-30% for the companies' institutional clients, who have increased their allocations in recent years in part because of the product innovation noted above. The opportunity to take that 1-2% to 5% or 10% or even 25% over time, even as the $85 trillion itself grows—and all the while continuing to expand the vast institutional business—represents an exciting potential growth trajectory for the industry in the years ahead. Accordingly, both of these alternative asset managers have ambitions to at least double their assets under management over the next five years.

In addition to their long runway for future growth, our enthusiasm for Blackstone and Apollo as investments are rooted in the following observations:

- These are high-margin, cash-generative businesses that do not need to reinvest their cash flow in the business in order to grow. As a result, they can both pay attractive dividends and continue to grow their earnings. They also have net cash on their balance sheets.
- The most important component of their revenue base is the management fees, which are recurring and whose contribution to earnings has increased in conjunction with the shift into permanent capital vehicles. Thus, not only are earnings growing, but the intrinsic value per dollar of earnings is increasing.
- Clients tend to be repeat customers, investing in successive funds and in multiple products at the same time. The track record of investing excellence breeds long-term trust and loyalty among the client base that are difficult for other companies to replicate. Very few other alternative asset managers can provide the full spectrum of offerings across the entire globe in the way Blackstone and Apollo can.
- At any point in time, Blackstone and Apollo hold large amounts of "dry powder"—i.e., committed but uninvested capital—which allows them to move decisively and take advantage of market dislocations and opportunities, which in turn contributes to strong investment returns and growth during downturns. For instance, recently the respective credit businesses of the two companies have expanded their market share at the expense of regional banks, which remain under pressure stemming from the bank crisis in March of this year. We believe that the alternative asset managers will be the source of a rising percentage of credit creation more generally throughout the economy in the years ahead.

- Both companies attract the best employee talent. Insiders own a lot of stock. Founders are still involved in the business, while succession has been managed well. The companies converted from partnerships to corporations and simplified their share class/ownership structure. (Blackstone was recently added to the S&P 500.)
- Although the businesses may no longer be as misunderstood, and the stocks no longer as mispriced, as they were in the years following their initial public offerings, we believe that Blackstone and Apollo remain undervalued relative to their future growth potential. Furthermore, while the public equity market has increasingly recognized the intrinsic value of the companies' management fees, in our opinion it still undervalues other important sources of earnings, such as the substantial performance fees generated by both companies and the earnings that Apollo generates by investing Athene's insurance premiums.

Our investment theme on the alternative asset managers, as expressed primarily in our long-running ownership of Blackstone and Apollo, illustrates many of the essential characteristics that we look for in an investment and the power of owning great businesses as they compound their intrinsic value over time. We look forward to periodically discussing other investment themes in future newsletters.

Partners of Beck Mack + Oliver