SECOND QUARTER 2025

One place to look for opportunities is to go where capital has departed. There has been an enormous flow of human and financial capital into private markets. In public markets, flows have been skewed to passive index funds or short-term strategies, whether multistrat, systematic, or retail-driven euphoria. We think there is the greatest share ever of investment resources doing deep fundamental work in private markets and a dwindling share doing similar long-term work in the public arena.

Yale's endowment, a pioneer in private asset investing, recently moved to offload a significant slice of its private equity portfolio. The deal, reportedly struck at $3 billion, would mark one of the largest secondary sales in history and meaningfully pare back Yale's holdings. This may be a harbinger of things to come.

We have a great deal of respect for private equity professionals. As like-minded long-term investors, we often feel that we have more in common with them than many of our public market peers. That said, the industry faces three significant problems and a challenging path forward. First, it is a victim of its success. Oversupply of capital has pushed up valuations, and the industry's maturation has reduced the ability to generate alpha. Second, fees are too high given this reality. Third, performance is difficult to measure, and the investment structure is illiquid.

Many limited partners ("LPs") in these funds are heavily allocated. If it becomes apparent that targeted returns are unlikely to be generated from current valuation levels, they may look to reduce exposure. If enough new money can be raised elsewhere, then returns may muddle along as the industry continues to invest with excess capital. On the other hand, if there isn't enough new money to offset the capital that wants to de-risk, we could see a more significant downturn.

<u>A victim of its success</u>

In the early days, private equity was made up of a small group of skilled practitioners pursuing a broad range of opportunities. Funds could buy undermanaged companies at low valuations, improve earnings, and use financial leverage to magnify the returns. Because interest rates were secularly declining, there were attractive opportunities to refinance, and eventual buyers of the assets could use ever-lower debt costs in their own underwriting.

Strong performance drove significant inflows, which were accommodated by the launch of more and larger funds. This growing supply of capital supported exit values, which further boosted returns. Throughout the industry's history, it has raised more capital than it has distributed. This contrasts with public markets, where dividends and share buybacks exceed equity issuance. We suspect that private equity returns are more reliant on these net inflows than many LPs realize.

Most of the tailwinds that supported the industry are no longer present. Private companies are not cheap, often trading at a premium to similar public counterparts. Sellers are more sophisticated, with bankers auctioning companies to the highest bidder. The industry's talented human capital has competed down excess returns, with firms conducting similar analyses, change management processes, and financial engineering. Interest rates are no longer in secular decline. Net inflows are moderating.

We can learn from what happened to the hedge fund industry and residential real estate almost two decades ago. By the mid-2000s, hedge funds had grown to a point where the industry had become too large to extract enough alpha from markets to cover the high fees. However, the backward-looking data still looked good, and money continued to flow. It took a decade of poor performance before the consensus changed.

Around that time, housing prices peaked and began a long decline. U.S. housing was a good fundamental story that went too far. Low interest rates, irresponsible lending, a consensus that prices would always continue to rise, and voracious demand from investors for mortgage bonds drove real estate to extreme valuations. This illiquid, levered asset class took nearly a decade to adjust to a new normal.

There is a risk that the private equity industry combines the alpha squeeze of hedge funds with the asset overvaluation of housing.

High costs

Fees should be proportional to the absolute return generated and the incremental value added. For example, in public markets, investors typically pay little to nothing to capture the market's beta. Clients are generally looking to pay for the value added by the manager. This approach applies to both long-only and hedge fund buying behavior.

In private equity, despite increasing commoditization, there are not broad, cheap indexation options, and fees have remained resilient. Private equity funds charge hefty management fees in addition to performance fees based on total returns rather than value added. Yet, total returns and value added are both declining. If the private equity market delivers 10-15% net returns, which may be optimistic, then fees approximate 400bp.[1] This fee translates to a significant percentage of the total return and well over 100% of the value added for most managers, the majority of whom are simply capturing private market beta.

In public markets, allocation decisions are often made based on tens of basis points. And yet, asset pools have increased exposure on the private side, where fees are frequently ten times higher. Due to this mix shift, the total costs paid by many allocators have increased despite declining returns.

We believe that the U.S. private equity industry now collects more fees than the U.S. public equity industry. This is striking. The industry has more human capital to invest against its $3 trillion of AUM compared to what is spent against the entire U.S. public market capitalization of more than $50 trillion. Is it realistic to believe a market with this much competition is still so inefficient that it can be burdened with nearly ten times the fee load and generate good risk-adjusted returns?

Another oft-missed headwind is the indirect costs that are hard to calculate. There are transaction costs to buy and sell the asset. There may be tax friction. There are monitoring fees and consulting fees. The most significant cost is paying a control premium to a seller who knows the asset well and is often running an auction to extract maximum value. When Eagle invests in a company, we are buying from the marginal shareholder who likes it the least and may be selling it for a multitude of reasons. If we had to buy the entire company, our returns would be far lower.

Investment structure

It is difficult to measure private equity performance. IRRs overstate returns because they don't properly account for the opportunity cost of having capital committed and not yet drawn. Multiples of invested capital ("MOICs") are hard to compare because LPs receive distributions at varying intervals along the way, not just a single lump sum at the end.

When an LP makes an investment commitment to a private equity fund, it is typically invested over 3-5 years and then harvested over the remainder of a ten-year term. The IRR is calculated on drawn funds, not committed funds. But, of course, tying up money that earns no return while it waits carries an economic cost.

An LP who commits to a fund typically has three options while waiting for the funds to be drawn. First, it can hold its committed capital in cash. In this scenario, it takes no risk but earns a low return. The effective return to the LP is therefore lower than the reported IRR. Or, the LP can use a liquid risk asset like the S&P 500 as a placeholder. This allows the LP to earn equity returns during the interim period on the undrawn capital, but if markets decline then the LP is exposed to that risk. Finally, the practice commonly followed is to operate somewhere in between. LPs forecast cash draws and cash distributions, aiming to be neither totally exposed or totally in cash. But this is an educated guess, not a contractual agreement. The recent liquidity squeeze caused by lower-than-expected private equity distributions illustrates the problem with this approach.

We can analyze and price the risk the LP is taking. An LP that holds cash is writing a free call option. If risk assets go up during the deployment period, the LP is underinvested. An LP that goes into the S&P 500 to get equity return during the investment period is essentially writing a put and being paid zero premium by the private equity fund. If risk assets go down, the LP is exposed. An at-the-money option like this on the S&P 500 would pay a little over 400bp per year.[2]

Properly adjusting IRRs for the embedded optionality that an LP is giving away would reduce target IRRs from the mid-teens to an adjusted return in the low double-digits. Unsurprisingly, this fits with the targeted returns that private equity is marketing for evergreen funds. Since these vehicles are fully funded from day one, they don't offload the cost of the option to the LP.

The other principal challenge with private equity funds is the lack of liquidity. It may be problematic to be levered and locked up if we are entering a period of heightened creative destruction due to the emergence of AI. AI is likely to change profit pools for wide swaths of the economy. If fundamental uncertainty is higher, the value of changing one's mind must be worth more. And yet, private equity appears to be getting less liquid as elevated valuation marks make it more difficult to IPO or sell assets.

The low volatility and smooth returns that private equity funds report may be illusory if LPs can't extract capital from the asset when they want to. The purpose of low volatility assets is to create additional flexibility for the asset pool, particularly during periods of stress.

The road ahead

Many current LPs are overallocated to private equity. Funds are overwhelmingly invested in small-cap companies, many of which are then highly leveraged. A 20% allocation to private equity arguably accounts for approximately 40% of a portfolio's risk.[3] A portion of incumbent owners are likely to follow Yale in scaling positions lower.

Private equity firms are orienting their distribution capacity towards the wealth and individual retirement markets. The White House recently issued an executive order that reduces the obstacles to placing private assets into 401(k) plans. The industry's high fees enable it to spend heavily on sales and marketing within these channels. There is a good chance they will be successful from a business standpoint. It's less clear that this success will be beneficial for the clients.

One of the pushbacks we hear is that while private equity overall may face headwinds, funds have higher dispersion than in public markets. The thinking here goes that this dispersion justifies the fees. People tend to forget dispersion is necessarily higher. If one took U.S. public market funds, selected only concentrated ones, and leveraged them, there would be more dispersion. Leverage and concentration mathematically widen outcomes.

The question is not whether there is dispersion, but whether there is persistent and predictable dispersion—and there isn't much. The data show modest persistence in venture and little in buyouts. There used to be more, and it has declined over time as LP dollars have flowed to the better managers, best practices have proliferated, and the industry has matured.

To be sure, private equity still retains some great features. Board control that drives alignment and enables rapid course-correction is superior to the typical public company governance situation. Leverage at the company level that isn't cross-collateralized is also advantageous. The problem is that these remaining strengths aren't enough to offset the various other headwinds.

When David Swensen and others began investing in private markets, they were contrarians using duration as a competitive weapon to extract alpha from the market. Today, there's a risk that much of the asset class is a high-cost bet without positive asymmetry. Time will tell.

Our view is that there is too much distinction between public and private markets. Both are simply vehicles to own real economic assets. Arguably, today's contrarian trade is to bring a long-term private equity approach to the public arena. Despite the secular trend of increasing market efficiency, excessive focus on short-term earnings momentum is creating real opportunities. These conditions have benefited Eagle over the past few years, and we think they position us well over the coming decade.

As always, if you have any questions or would like to discuss anything herein, please call us at (212) 293-4040. Also, if your financial situation or investment objectives have changed, if your IPO eligibility or U.S. Person status has changed, or if you would like to modify or discuss any investment restrictions or guidelines, please reach out to your contact on the client team or email ClientServices@eaglecap.com.[4]

[1] Structures vary. Assumptions behind 400bp of fees are a 1.5-2% management fee and 20% performance fee with an 8% hurdle and catch-up. 16.5% gross returns become 14.75% after management fees of 1.75%. 20% incentive on 14.75% is another 2.95%, but we assume only 2.25% because the return may not be far enough above the 8% hurdle to clear the entire catch-up. This then drives 12.5% net returns, the middle of the 10-15% range cited.

[2] Source: Bloomberg pricing for at-the-money put/call SPY options with 1-3 year tenor.

[3] In a traditional 60/40 portfolio, 85-90% of risk comes from the equity portion. Buyouts, on average, are of smaller companies and twice as leveraged as public market companies. Venture-backed companies are early-stage and unproven. Fundamental risk for either is at least 1.5x public markets. A 20% allocation to private equity, assuming it is funded from public equity, translates to approximately 40% of risk in private equity, 50% in public equity, and 10% in fixed income.

[4] Eagle Equity Composite holdings during Q2 2025 were as follows: AA; AER; AMZN; AON; ASML; BAYRY; CHTR; CMCSA; COF; COP; DFS; DHR; EL; ELV; GEV; GOOG/L; HLT; HUM; INTU; LBRDA/K; LEN; LNSTY; META; MLM; MSFT; OXY; PROSY; PTC; SAFRY; SAP; SHEL; TSM; UNH; VMC; WDAY WFC; and WWD.

Past performance is not indicative of future results, and there is no assurance that Eagle Capital's investment objectives will be achieved or that the strategies employed by Eagle Capital will be successful. Except where otherwise indicated, the information contained in this content is based on matters as they exist as of the date of preparation of such material and not as of the date of distribution or any future date. This document does not constitute an offering of advisory services or advice or a recommendation or offer to sell or a solicitation to deal in any security or financial product in any jurisdiction. It is provided for informational purposes only and on the understanding that the recipient has sufficient knowledge and experience to be able to understand and make their own evaluation of the content described herein, any risks associated therewith and any related legal, tax or other material considerations. Recipients should not rely on this material in making any future investment decision. To the extent that the reader has any questions regarding the applicability of any specific issue discussed above to their specific portfolio or situation, clients and prospective investors are encouraged to contact Eagle Capital as well as to review other materials produced by Eagle Capital (including those available at eaglecap.com). Discussions herein relating to risk or any efforts to mitigate risk do not imply that any actions taken by or investment strategies employed by Eagle Capital are in any way low risk or risk free.

This document expresses the views of Eagle Capital as of the date indicated and such views are subject to change without further notice. Eagle Capital has no duty or obligation to update the information contained herein. Certain information contained in this content constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue," or "believe," the negatives thereof, other variations thereof or other comparable terminology. Due to various potential risks, uncertainties or actual events, the results or the actual performance of Eagle Capital's investments may differ materially from those reflected or contemplated in such forward-looking statements.

Any discussion of specific companies contained herein is for informational purposes only and does not represent all of the securities purchased, sold or recommended by Eagle Capital. The reader should not assume that any investments in the securities identified and discussed herein were or will be profitable.

Any index referenced herein is presented because Eagle Capital feels that it serves as a useful point of comparison with aspects of Eagle Capital's portfolio management. The S&P 500 Index includes approximately 500 leading companies and captures more than three quarters of the total market capitalization. It is float-adjusted and based on the market cap weightings of the securities that comprise the index. In contrast, the Eagle Equity Strategy is highly concentrated and may contain companies not listed in the S&P 500 Index.