What secular stagnation will mean for you

by **Andros Payne**

For a brief period during the 2009 global financial crisis, US productivity spiked as unemployment pushed close to ten per cent. Since then, it has hovered around zero with brief dips below the line. Larry Summers' recent article in *Foreign Affairs* has brought a theory that was first developed by Harvard economist Alfred Hansen in the 1930s back into the mainstream to explain what is going on. Then, as now, secular stagnation drove a persistent lack of productivity growth, rising shadow unemployment and political upheavals like we are currently witnessing in western democracies. For private equity, secular stagnation will mean more money to deploy, more pressure for returns, more risk and a coming transformation from within.

In his TED talk, Northwestern's sociologist and economist Robert Gordon explains the problem. Industrialised nations are faced with four headwinds which are depressing productivity growth for the long term: high debt levels, constrained access to education, reduced workforce participation and growing wealth inequality. According to Gordon, these forces reduce the average historical rate of productivity growth from 2.8 to 0.7 per cent per annum. And when income from technology innovation is concentrated with a few knowledge-workers at the likes of Google, Apple and Facebook, it won't fill pockets or the growing productivity gap.

This has huge sociological and political implications and poses both opportunity and risk for private equity. With lower productivity growth, standards of living will stagnate for the first time in 250 years. This will require a painful reset of expectations defined in a unique period of steady productivity improvement.

Brexit, and the rise of populists across the globe, is part of this re-setting process. So too is the retirement funding bomb that most politicians still kick down the road. The demographic problem of a baby-boomer bulge exiting the labour force with unrealistic retirement expectations is compounded by low interest rates in response to sluggish growth – what Blackstone's Tony James refers to as "the hidden crisis in America that no one is talking about". And growth is not materialising. US output per hour worked increased just 0.5 per cent in 2014, decelerated to 0.3 per cent in 2015 and is projected to be only 0.2 per cent up for 2016. Where will the money come from, and how to keep the social peace?

Alternative assets and actively managed private equity are one of few remaining asset classes offering a higher and more sustainable return. It's therefore no surprise that funds under management have ballooned to more than $4trn, with $1.3trn of dry powder. The effect of secular stagnation is expected to accelerate flows into private equity from sovereign wealth funds, public and private pension funds and family offices looking to meet their commitments.

But, in the bigger picture, private equity is just a small slice of the total asset management universe. In order to reasonably cope with the tsunami of money still coming, it will need to morph from the cottage industry it has been to an industrialised business – likely painful for those who have enjoyed the unique privileges of a private niche in the past.

Integrating qualified investment professionals and transferring hard-gained knowledge about active investing is indeed another challenge facing funds. There is a shortage of people who bring the diverse competencies needed in both transactional finance to buy and sell correctly, and process-driven value growth during the holding period. Selection, training, leadership and development in funds and portfolio companies will all need to improve.

Finally, pressure for returns will force private equity investment into more complex and difficult (higher risk) buyouts. Whether this takes the form of en vogue Africa funds, lower mid-market or niche theme funds, more work will be needed to buy, develop and sell tomorrow's assets. And as all funds add the operational capabilities to define strategy, optimise pricing and reduce procurement cost, the next wave of more complicated arbitrage on leadership performance, behaviours and productivity will need to be addressed.

Funds are increasingly focusing on the inner workings of portfolio company organisations and leadership, with the recent addition of specialised "HR operating partners" as a leading indicator of what is to come. However, unlike more tangible operational growth levers, the benefits of organisational excellence are more difficult to quantify in the short term. Most likely, the effect will only be noticed over time and with sustained, high valuation exits. Secular stagnation is thereby stimulating increased competition and innovation in the funds industry. Which players will step up to the challenge?

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