Investing in Private Equity

RESEARCH | AUGUST 2024

No longer the exclusive domain of institutional investors, private equity investments are increasingly playing an important role in the portfolios of individual investors. Expanding a traditional 60/40 portfolio to include an allocation to private equity may help build portfolio resiliency, adding a new source of diversification and uncorrelated returns. Understanding private equity and its potential benefits can help advisors consider how this asset class may fit with a client's long-term financial objectives.

What is private equity?

Private equity (i.e., "PE") investments are equity investments in privately held companies. Private equity investments are generally structured in the form of partnerships, or funds, that usually consist of 10 to 20 equity investments in individual companies.

The private equity market provides a large arena for investing as private firms far outnumber public companies. In the US, there are approximately 1,000 private companies for every publicly listed company,[1] and the number of total public companies has declined significantly since peaking in the late 1990s.[2] Thus, the potential opportunity set in private equity is substantially larger than that of public equities.

[1] Source: Statista, data as of Q4 2023.

[2] Ibid.

Today, private equity investments come in many forms, including venture capital funds, buyout funds, and growth equity funds. These distinct types of private equity investments produce significantly different returns from traditional investment classes and even exhibit different fundamental characteristics from each other.

Who invests in private equity?

Institutional investors such as pension funds, endowments, and foundations comprise most of the capital allocated to private equity, though high-net-worth individuals also participate. The long-term time horizon of these investors often makes them more willing to invest some portion of their portfolio in illiquid assets. They have also tended to invest significant capital in private equity, allowing them to create long-term relationships with general partners. They may also be seeking higher returns and enhanced equity diversification beyond that available through the public stock market. And they must also be willing to accept greater or different risks than are present with traditional public market assets.

In recent years, new investment products such as interval funds and tender funds have been developed and made private equity easier and more convenient for average retail investors to access and invest in.

Why Invest in private equity?

There are three key reasons that make private equity an attractive investment.

1st

Adding private equity may increase the expected return of a portfolio.

2nd

Private equity is an area with the opportunity to generate significant "alpha" via fund/manager selection.

3rd

An allocation to private equity may also reduce the observed volatility of the portfolio relative to other ways to increase returns (e.g., increasing the public equity allocation).

Potential Returns

Investors generally assume they will earn more from their private equity portfolio than they will from public equities. This has been the case for the asset class historically.

Research studies show private equity has the highest expected return among firms that produce capital markets expectations. Annually, Horizon Actuarial Services publishes a survey of capital market assumptions (see Figure 1) that they collect from various investment advisors. The average expected return is higher for private equity than for any other asset class, both over the 10-year and 20-year horizon.

Asset Class	10-Year Average	20-Year Average
US Equity (Large Cap)	6.9	7.4
Developed Non - US Equity	7.5	7.8
Emerging Non - US Equity	8.2	8.6
Real Estate	6.0	6.3
Hedge Funds	6.0	6.2
Private Equity	9.5	10.1

FIGURE 1

Expected Returns for Equity-like Asset Classes

Source: The survey by Horizon Actuarial Services is published annually and is the most comprehensive survey of capital markets expectations of which we are aware. In the 2023 survey, the 10-year horizon included 42 respondents and the 20-year horizon included 27 respondents.

Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

Historically, private equity investors have earned 2% to 5% per year more than investors in comparable common stocks (see Figure 2), even after paying substantial management fees and other expenses.

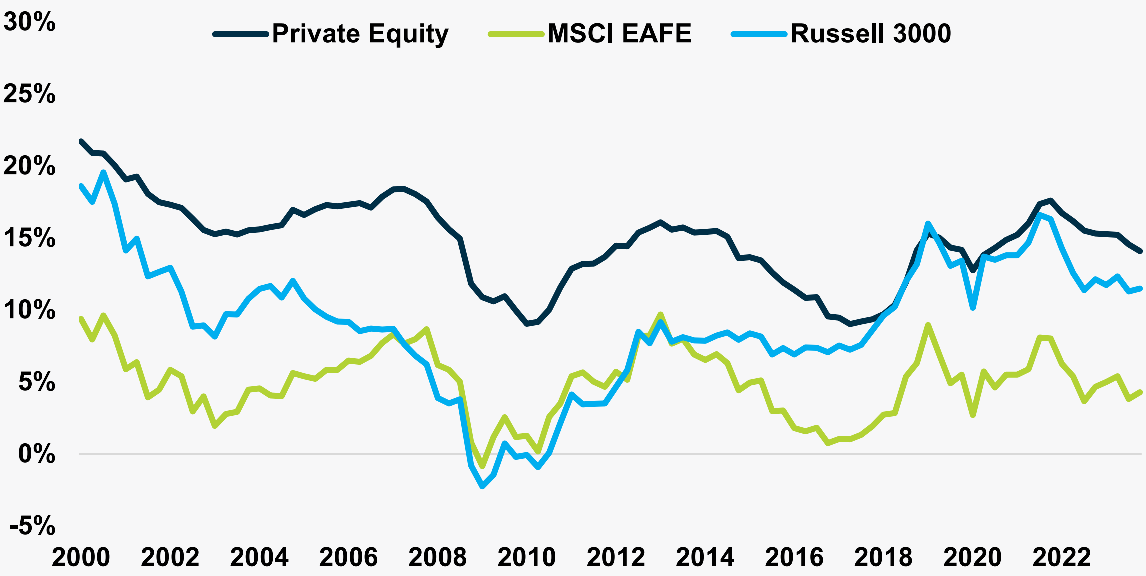

FIGURE 2

Rolling 10-Year Annualized Quarterly Pooled IRR

Source: Cambridge Associates via IHS Markit as of 12/31/2023. Returns are annualized quarterly pooled IRRs. Indices used: Cambridge PE Composite, Cambridge MSCI EAFE Index, Cambridge Russell 3000 Index.

Historical performance presented in this chart is net of fees.

Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

Academics and practitioners have offered a number of explanations for the superior performance of private equity historically.

→ **PE investors can "sell" unneeded liquidity to capital-needy businesses.** Generally, investors demand a premium for liquidity risk; that is, they expect to earn a higher cumulative return as compensation for giving up liquidity on a short-term basis. The businesses that need the capital are willing to pay this premium for several reasons, including the desire to grow the business, make strategic acquisitions, cash out a founder, etc., all while keeping the enterprise in private hands.

→ **General partners ("GPs") can create a better alignment of interests between owners and management.** Private owners generally produce better financial results. This is often ascribed to the inherent longer-term approach they take to management and capital expenditures.

- **GPs can improve the value of the asset by being a "control" investor.** Most investors in public companies have minimal influence individually over how those companies are run. In contrast, most private equity funds either take a controlling stake or a position where they can exert considerable influence over strategic and management decisions. Many private equity managers have experienced in-house operations teams and expertise in turning around a struggling business, ramping up growth of a mature business, or accelerating the trajectory of a rapidly growing firm, among other strategies. These teams can assist in and add value to the company's business strategy formation, operational execution, mergers and acquisitions, and capital raising.

- **GPs can take advantage of mispricing opportunities that are larger and more frequent than those in public markets.** Information asymmetries in the private markets may allow PE managers to invest in companies at a discount to fair value. Private companies, especially those in the small/mid-market segment, have historically been valued at significantly lower EV/EBITDA multiples than public companies.

- **GPs can use leverage to a greater extent.** Many GPs engage in financial engineering to boost the return of the funds they manage. Adding debt to finance acquisitions or to pay dividends boosts the return to investors in companies for which the gains exceed the cost of borrowing.

Lower observed volatility

Private equity returns have exhibited less volatility than public equities (see Figure 3). This is because, unlike public market securities, private equity assets are not priced daily. Rather, they are valued quarterly, and managers have wide latitude in applying valuation methodologies.

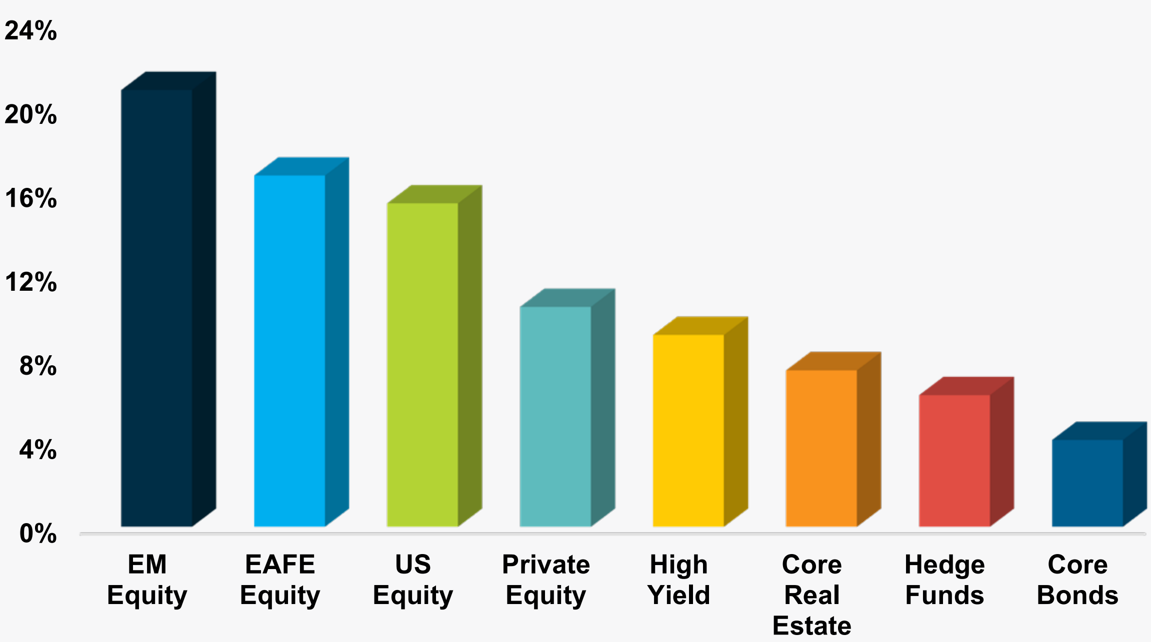

FIGURE 3

Trailing 20-Year Volatility

Source: Bloomberg and *Cambridge Associates via IHS Markit as of December 31, 2023. Private Equity is annualized quarterly pooled IRRs, Core Real Estate is annualized quarterly returns, all others are annualized monthly returns. Indices used: Cambridge Private Equity & Venture Capital Composite, Russell 3000, MSCI EM, Bloomberg US Corporate High Yield Bond, NCREIF ODCE Equal Weighted Net Total Return, MSCI EAFE, HFRI Weighted Composite, Bloomberg US Aggregate Bond Index. Note that private markets performance presented in this chart is net of fees.

Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

Moreover, price changes tend to be reflected on a lagged basis in reporting, taking as long as two quarters to reflect equivalent changes in public securities. The result is a “smoothing” of the returns experienced by private equity investors (see Figure 4).

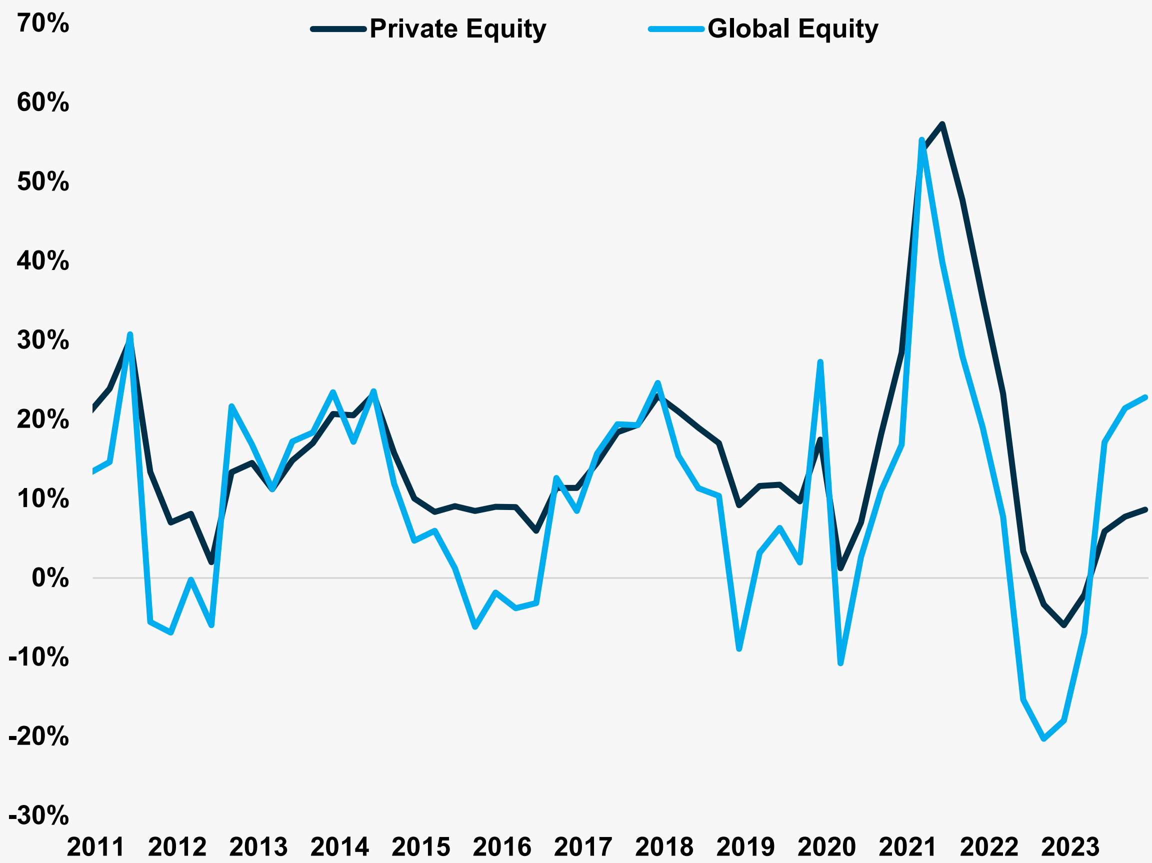

FIGURE 4

Rolling 1-Year Annualized Quarterly Pooled IRR

Source: Cambridge Associates via IHS Markit as of 12/31/2023. Returns are annualized quarterly pooled IRRs. Indices used: Cambridge PE Composite, Cambridge MSCI ACWI Index. Note that historical performance presented in this chart is net of fees.

Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

This lower observed volatility does not mean that private equity is less risky. It is often quite the contrary. Private equity portfolios tend to be more concentrated and the underlying companies more highly leveraged (in the case of buyout funds) with less diverse revenue streams than their public market counterparts. That said, the perception of lower risk (from smoothed returns and a more rational valuation process) does have a real-world effect on investors maintaining consistent exposure to this risky asset class.

The importance of manager selection

Private equity asset classes show considerably higher performance dispersion as measured by interquartile spreads (see Figure 5). These interquartile spreads can be interpreted as how much potential value lies in selecting superior active managers within each asset class. When comparing interquartile spreads between private and public markets managers, it is worth noting that the private market databases are often smaller, and with a more limited history, than public market counterparts. Private equity funds also tend to have more concentrated portfolios; hence, more dispersion should be expected among private equity funds.

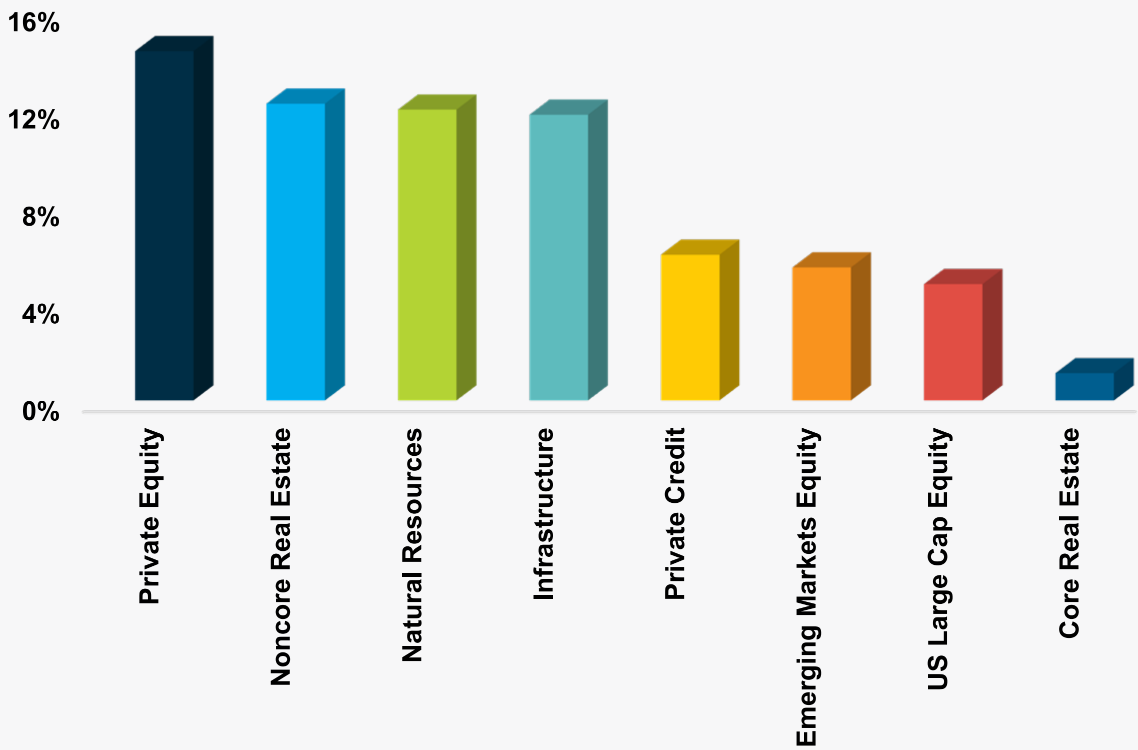

FIGURE 5

Trailing 10-Year IQ Spread

Source: *Cambridge Associates via IHS Markit, annual Pooled IRR quartiles by vintage year as of 12.31.23, data pulled 5.24. eVestment data as of 12.31.23, data pulled 1.24. NCREIF data as of 12.31.23, from Q4 2023 report. With the exception of Core Real Estate, private markets funds raised Vintage Year 2012 to 2021 (2022 and 2023 excluded as they are too recent). No data for Natural Resources vintage years 2020 -2021. Public markets data for the trailing 10 years as of 12.31.23. Indices: Cambridge PE & VC Composite, Cambridge Private Credit Composite, Cambridge Infrastructure Composite, Cambridge Natural Resources Composite, Cambridge Real Estate Composite, NCREIF NFI-ODCE, eVestment US Large Cap Equity Universe, eVestment Emerging Markets Equity Universe. The private market performance presented in this chart is net of fees. Public Market performance presented in this chart is gross of fees. Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

Several of the factors that explain the relative outperformance of private equity also help explain the large dispersion of returns among private equity funds. For example, because of both the vast number of investable firms and the lower amount of readily available financial and operational information about such firms, private equity is a much more inefficient asset class than public equity. This means that skilled investment managers should be able to take advantage of the larger mispricing opportunities to add value. Likewise, managers who are more skilled at growing or turning around a business are more likely to add value relative to their peers.

What Risks Can Investors Expect?

To obtain the higher returns that private equity investors are looking for, they often must also take on additional risks. These include:

→ **Liquidity risk.** Private equity is notably not a liquid investment. The lack of a public market to transact, complexity of investment structure, and long-term capital commitments to improving portfolio company operations can create a challenge for investors to balance current capital demands.

→ **Business risk.** Investments in private equity may involve providing capital to early-stage companies, companies in distress, or companies that are using higher leverage to accelerate growth. Because these companies may be less stable than their public market counterparts, it raises the potential of business failure and lost investor capital.

→ **Economic risk.** By investing in companies that could potentially be less stable, economic downturns and other economic events may impact private equity investors more so than public market investors.

A Simplified Way To Access Private Equity

New products, including interval funds and tender offer funds, provide individual investors with greater access to private equity investments with lower investment minimums, the potential for liquidity (subject to certain limitations), easier eligibility, and simplified tax reporting. Regulated by the SEC, these product solutions can make investing in private companies almost as straightforward and simple as investing in public companies.

The biggest differentiator for an interval fund from a traditional mutual fund is its quarterly liquidity (subject to certain limitations) feature. These investments are classified as closed-end mutual funds that don't trade on an exchange and only allow share redemptions at certain intervals, such as quarterly, and are subject to a maximum redemption amount. Redemptions are available only at intervals because these are long-dated, long-term assets, and best suited for the long-term investor.

Risks and Disclosures

***There is no complete and reliable data set for private investments. The information is extremely limited, and most data is compiled from funds that elect to self-report and tend to be biased toward higher performing funds. Losses are underreported. Funds included in these measures lack commonality and transparency. Over time, components of the data may change. Funds may begin or cease to be represented based on these factors, thereby creating a "survivorship bias" that may additionally impact the data reported.**

This document is for general information and educational purposes only and must not be considered investment advice or a recommendation that the reader is to engage in, or refrain from taking, a particular investment-related course of action. Any such advice or recommendation must be tailored to your situation and objectives. You should consult all available information, investment, legal, tax, and accounting professionals, before making or executing any investment strategy. You must exercise your own independent judgment when making any investment decision.

All information contained in this document is provided "as is," without any representations or warranties of any kind. We disclaim all express and implied warranties including those with respect to accuracy, completeness, timeliness, or fitness for a particular purpose. We assume no responsibility for any losses, whether direct, indirect, special, or consequential, which arise out of the use of this article. All investments involve risk. There can be no guarantee that the strategies, tactics, and methods discussed in this document will be successful.

Data contained in this document may be obtained from a variety of sources and may be subject to change. We disclaim any and all liability for such data, including without limitation, any express or implied representations or warranties for information or errors contained in, or omissions from, the information. We shall not be liable for any loss or liability suffered by you resulting from the provision to you of such data or your use or reliance in any way thereon.

Nothing in this document should be interpreted to state or imply that past results are an indication of future performance. Investing involves substantial risk. It is highly unlikely that the past will repeat itself. Selecting an advisor, fund, or strategy based solely on past returns is a poor investment strategy. Past performance does not guarantee future results. Meketa Capital is an investment advisor registered with the U.S. Securities and Exchange Commission.