Debunking Private Equity Prestige

In recent years, private market investment allocations have soared, with U.S. defined benefit pension funds increasing their allocations to private equity fourfold since 1998.[1] According to a BlackRock survey, institutions now allocate, on average, 24% to private markets.[2] These allocations are often justified by the robust and diversified returns private equity is perceived to offer over public equities. However, we argue that public growth equities may present a more favorable opportunity due to a number of attributes such as transparency, liquidity, and fees, making them a potentially more attractive asset class compared to private equity, in our view.

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Rethinking Private Equity Esteem

Private equity has been lauded for its strong historical performance relative to public markets. Allocators often cite robust and less correlated returns as reasons for increased allocations. According to PitchBook data, private equity has outperformed public equities consistently. [3] However, this perceived advantage warrants careful scrutiny. Private equity internal rates of return (IRR), a measure of annualized performance achieved over the holding period of an investment, are typically compared against returns of public equities. Unfortunately, IRRs are not representative of reality, in our view, as private equity investors must often wait years before their capital is fully deployed (while often paying management fees on total committed capital, including that which has not yet been deployed), which of course is not the case in public equities. One study found that more than half of funds' IRR can be attributed to timing capital calls (i.e., the process by which a manager asks the investor to contribute a portion of committed capital) and distributions (i.e., the transfer of capital to the investor after the fund exits its position in one of its investments). [4] A particularly egregious form of timing manipulation occurs when a private equity fund borrows against investor commitments in order to delay capital calls, thereby increasing the IRR, all else being equal.

Lockups and Liquidity

While some private equity return data tries to account for the timing of cash flows through so called public market equivalent accounting, where public equity investments are made on the same cadence as the private equity cash flows, that is simply handicapping public equities in our opinion. It may be apples-to-apples, but public equity investors don't have to tie up their capital and wait to make investments, and they have much fewer liquidity constraints in exiting their investments as well. We question the value of private equity investments with significant illiquidity and durations of 10 years or longer, which is common according to studies and our own experience.[5] This may be particularly negative for older investors where access to capital may be necessary for the fulfillment of a rewarding retirement as well as unexpected expenses (both joyous and sad).

Taking a Closer Look at Performance

To illustrate our point, we looked at cumulative return comparisons between private and public equity. When we examine industry data from PitchBook, we find that the S&P 500 has outperformed cumulative private equity returns in nearly three quarters

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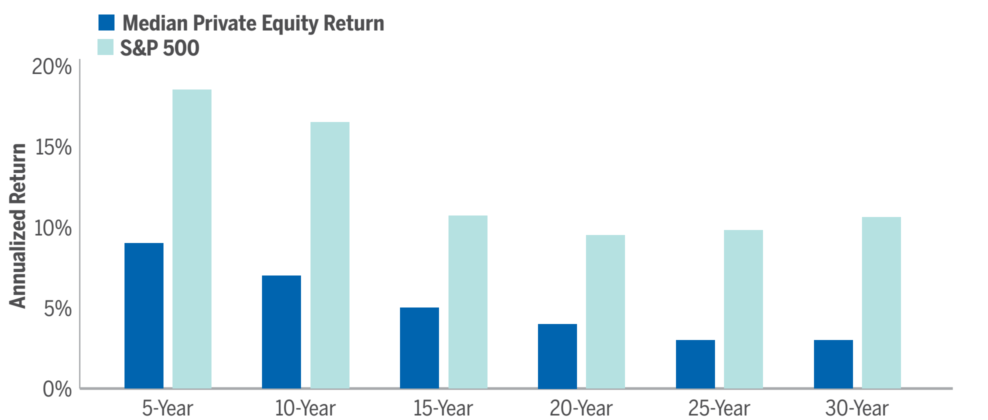
of the vintages—defined as the year when the initial capital is invested—since 1996. If we look at only the past 20 years, that public equity outperformance increases to 85% and if we look at large cap growth stocks as represented by the Russell 1000 Growth, it rises to 90%. To confirm our analysis, we examined the private equity returns of CalPERS, the largest U.S. public pension fund which now allocates 40% of plan assets to private markets (its private equity allocation is 17%).[6] Similarly, we found that both the S&P 500 and Russell 1000 Growth outperformed its private equity investments on a cumulative basis in 90% of the vintages from 2002 through 2021.

Another issue with private equity is that the dispersion in returns between managers is extremely wide. The variance is so large that Mark Anson, CEO of CommonFund, writing in a paper published in the Journal of Portfolio Management called private equity as much of an “access class” as an “asset class.”[7] The point is that if you can’t access the “best” performing managers, the returns you experience may be quite a bit lower than the pooled asset returns. The paper showed, using Burgiss data, that median private equity returns over the past 10, 20 and 30 years ending 2021 were 61%, 73% and 83% below pooled returns, respectively. These median buyout private equity funds underperformed the S&P 500 over every time period analyzed, from 5 years to 30 years, ending 2021, by approximately 500-900 basis points (bps) annually (See Figure 1).

Figure 1: **Median Private Equity Manager Underperformed Public Equities**



Source: Data adapted from Burgiss, as cited by Mark Anson in Perspectives on Private Equity and Venture Capital, The Journal of Portfolio Management, p. 29, for the time periods ending December 31, 2021. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**

An Illusion Through Leverage

Further, we believe that the risk and subsequent increased return from high leverage in private equity is not correctly accounted for in many investors’ analysis vis-à-vis stocks. First, private equity risk in terms of volatility is generally smoothed as reported and is significantly higher when adjusted, such that it is actually in-line with large cap public equity indices.[8] Second, private equity returns benefit from significantly higher leverage than used in public equities.[9] A paper by Nicolas Rabener in The Journal of Investing is among several studies to show that leveraging small capitalization public equities would replicate the returns of private equity. Rabener examined whether a stock portfolio could compete with private equity returns, writing “adding leverage as a factor contributed to high abnormal returns given that interest rates were declining consistently between the 1980s and today [2020] and provided a positive tailwind for the highly leveraged portfolio companies." Using historical data from PitchBook that shows private equity funds have employed 54% debt with a 5.9% cost of borrowing, we calculate that leverage has contributed over 400bps to private equity annual returns over the past ten years, ending September 30, 2023. With interest rates now significantly higher, private equity returns may decline as less and more expensive debt is employed.

We believe these public equity attributes make them an attractive and often overlooked asset class for both individual investors and institutional portfolios.

Democratizing Private Equity

Given high minimum investment requirements and long capital commitment periods, investments in private equity have been largely limited to institutional investors. We see that changing. A number of alternative asset managers have identified individual investors as a potential untapped market and have introduced innovative structures and technology solutions to reduce some of the burdens around illiquidity and minimum investment requirements. This increased access has been met with some enthusiasm. Indeed, Bain & Company predicts that private wealth allocations to global alternatives could grow from approximately $4 trillion in 2022 to over $13 trillion by 2032.[10] That said, while new innovations may help improve individual investors' access to private equity, the vast majority of the category remains in traditional private funds that still have significant shortcomings relative to public equity investing, in our view.

Conclusion

While private equity is often touted for its high returns, our analysis reveals that, after accounting for factors like illiquidity and the timing of cash flows, the dispersion of manager returns and the weak long-term performance of the median manager, private equity may not be as compelling as it is commonly perceived, especially when compared to public equities. Public growth equities, on the other hand, offer greater liquidity, and potentially competitive returns without the burden of complex management fees or the need for extensive capital lock-up periods. Accordingly, we believe these public equity attributes make them an attractive and often overlooked asset class for both individual investors and institutional portfolios.

Given the rapid progression of innovative public companies that can quickly scale up and disrupt industries, coupled with the inherent challenges within private equity, we advocate for a strategic pivot towards public growth equities. In our view, public equities not only mitigate many of the burdens associated with private investments but also capitalize on the rapid innovation and scalability that drive modern economies.

Therefore, we urge investors to reassess the traditional prestige associated with private equity and to consider the robust, more accessible opportunities available within public markets. By doing so, investors can engage with more flexible, transparent, and responsive investment vehicles that are better suited to the demands of contemporary financial environments and personal investment goals.

[1] CEM Benchmarking study October 2023, "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States 1998-2021."

[2] BlackRock Global Private Markets Survey 2023

[3] PitchBook Global Benchmarks Q2 2023

[4] Larocque, Shive, and Stevens, "Private Equity Performance and the Effects of Cash-Flow Timing," The Journal of Portfolio Management," 2022.

[5] Here we are talking about the experience of the Alger Family as well as studies such as Larocque, Shive, and Stevens, "Private Equity Performance and the Effects of Cash-Flow Timing," The Journal of Portfolio Management," 2022.

[6] https://www.calpers.ca.gov/page/newsroom/calpers-news/2024/calpers-will-increase-private-markets-investments

[7] Anson, "Perspectives on Private Equity and Venture Capital," Journal of Portfolio Management, 2022.

[8] PitchBook Private Capital Indexes Q3 2023 page 7 reports adjusted private equity annualized volatility estimates are actually 16.4% since 2000, much higher than the 9.9% reported data, and in-line with the S&P 500 annualized volatility of 16.7%

[9] Nicolas Rabener, "Private Equity Is Still Equity, Nothing Special Here," The Journal of Investing, December 2020.

[10] Bain & Company, "Why Private Equity Is Targeting Individual Investors," February 2023. 2032 data is forecasted.