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Private Equity: Viable Alternative Investment or Empty Promise?

Brad Case, Ph.D., CFA, CAIA, Senior Vice President, Research & Industry Information at NAREIT, the National Association of Real Estate Investment Trusts®, joined a Brandes Institute Advisory Board (BIAB) meeting to debate the merits of private equity (PE) investing. Following is a synopsis of the roundtable discussion.

Summary

In this lively roundtable debate, members of the BIAB and Brad Case discussed the pros and cons of private equity and whether the investment class is a viable alternative. While some Board members shared their successes, Case cited challenges in the structure of private equity funds and the credibility of their performance reporting. During the discussion, key considerations surfaced in support of private equity, balanced out by a number of key issues questioning its viability. Ultimately, like any other investment, pros and cons should be weighed according to an investor's long-term financial goals, risk tolerance and the probability of success.

Private equity[1], which consists of investors and funds that invest directly into private companies or conduct buyouts of public companies, offers advantages and disadvantages:

Private Equity: Pros

- Seeks higher than public-equity returns
- Potential diversification benefits

Private Equity: Cons

- Illiquidity and high fees
- Ambiguous performance measurement
- Lack of transparency

The Debate: Why Consider Private Equity?

Among the many discussed advantages of private equity were potentially higher returns.

Case asserted that strong performance among private equity firms, if it exists at all, has been generated by applying leverage. "Look at the academic research that studies the actual cash flows between limited partners and general partners," Case said. "You find private equity is simply a highly leveraged investment in small- and mid-cap stocks with alpha that is very close to zero on a long-run basis. If all you're doing is investing in small- and mid-cap equities with significant leverage, you can do that yourself." He added later that REITs (real estate investment trusts) generally use more leverage than core private equity real estate funds (but less than value-added or opportunistic funds).

"…private equity is simply a highly leveraged investment in small- and mid-cap stocks…." –Brad Case

Lifting Curtain of Secrecy for Private Equity?

Recent *New York Times* (NYT) articles have described how private equity (PE) funds can reduce or eliminate their fiduciary duties, potentially putting the funds' interests at odds with investors. PE investors seeking information about the funds' legal obligations, fees and investments have faced hurdles. But that may be changing as one PE firm is allowing "investors in one of its funds to hire an independent advisor to monitor the fund's practices."

Under Dodd-Frank legislation, PE firms with more than $150 million in assets must register as investment advisers with the Securities and Exchange Commission (SEC). Since SEC examinations of PE firms began in 2012, few improprieties have been discovered.

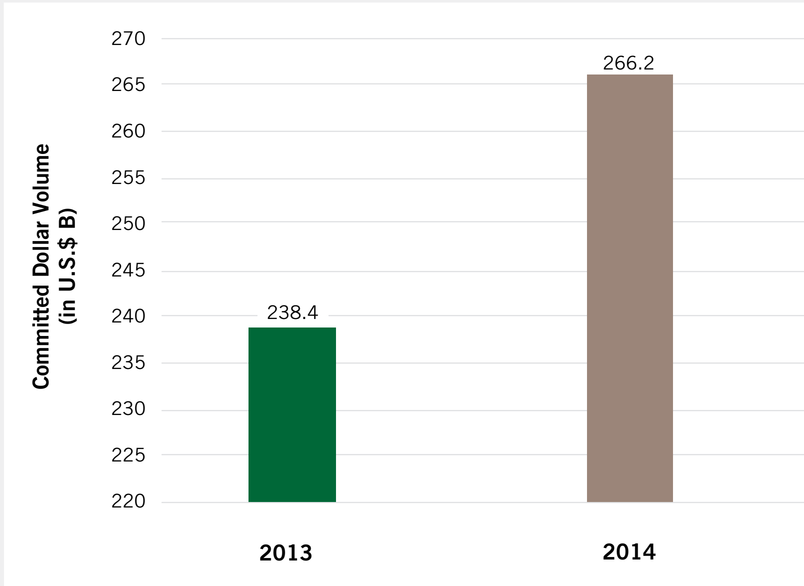
The NYT suggests investors, "be more vigilant about ensuring that the fee-sharing arrangements they have been promised…are actually followed."

Source: *The New York Times*, Dec. 27, 2014. (See Endnotes for additional articles on this topic.)

[1] Investopedia.com

"My experience investing…into direct private equity vehicles…showed we actually did incredibly well." –Philip Read

Exhibit 1: U.S. Private Equity Committed Dollar Volume Rose 11.7% in 2014



Source: Dow Jones LP Source, Private Equity Analyst, January 2015

Philip Read, BIAB member and former Chairman of the British Coal Staff Superannuation Scheme Trustee Board, said, "Many institutional investors have rules that *prevent* them from making leveraged investments in any asset, although they can make an investment in an asset that uses leverage. My experience investing consistently over the long term into direct private equity vehicles, and then measuring the actual cash flow returns compared to other opportunities, showed we actually did incredibly well."

Peter Branner, BIAB member and CEO of SEB Investment Management, agreed. "As someone who invests in private equity, I've seen returns that have consistently and convincingly beaten public equities—net of all fees." He added that most of the evidence used to discredit private equity returns is done by academics, not practitioners. "Some of the criticisms are based on naïve investment theses that don't look at the underlying investment companies during the period of investment."

Other Board members also expressed their high satisfaction levels with the consistently exceptional returns of the private equity managers they've hired, returns that were far better than those of public equity markets. Exhibit 1 shows committed dollar volume for private equity was up 11.7% in the United States in 2014 versus 2013. Though not pictured, the number of funds formed in the United States increased 15.7% last year to 765 from 661 in 2013, according to Dow Jones LP Source's January 2015 *Private Equity Analyst*.

Case countered that returns may be similar to the performance of publicly traded stocks themselves, about half the individual companies outperform a passive portfolio of all companies. He therefore believes that the likelihood of selecting an outperforming private equity manager is no greater than the likelihood of selecting an outperforming individual stock: it's possible, but evidence shows that it can't be done consistently.

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Additional Reasons for Concern

Alongside the advantages of private equity, there are a number of concerns. "People who invest in private equity already know two bad things: they are paying a lot in fees, and they're investing in something illiquid," said Case. "But they think they are getting compensated in three ways. One, they think they're getting really good returns, although it turns out they're not. Second, they think they're getting low volatility; again, it turns out they're not. Third, they think they're getting a big diversification benefit. Once more, it turns out they're not."

When asked how an executive at NAREIT knows so much about private equity, Case said he has compared private equity real estate with listed REITs. "As it turns out, what really damns real estate private equity also damns other forms of private equity," he added.

Case cited his extensive research and presentations comparing private real estate investing with publicly traded REITs. He acknowledged investors need to be aware that modern-day REITs can include non-traditional property types such as cell phone towers, pipelines, car dealerships, gas stations and bank branches. But the types of assets available through REITs are very similar to those accessible via private real estate investing.

A survey by Preqin notes that in June 2014, 63% of investors believed private equity fund and investor interests are aligned. At the same time, 10% "strongly disagreed" that interests are aligned, up from just 1% in 2013.

The 2014 Preqin Private Equity Fund Terms Advisor: A Comprehensive Guide to Private Equity Fund Terms and Conditions. https://www.preqin.com/docs/samples/2014-Preqin-Private-Equity-Fund-Terms-Advisor-Sample-Pages.pdf

Questions on Performance

Case also claimed that private equity returns are difficult to benchmark and difficult for investors to discern their accuracy—even if they meet Global Investment Performance Standards (GIPS). Reflecting his distrust of performance reporting and supposed diversification benefits, Case called published private equity data "fake." He shared a number of academic studies that support planks of his argument. (A truncated, annotated bibliography Case provided is available at the end of this article.)

Read acknowledged academics find it "difficult to come up with the appropriate measure for private equity performance in trying to construct or compare with some kind of index." However, he remains a proponent of the asset class.

A *Reuters* report stated, "The U.S. Securities and Exchange Commission is examining how private equity firms report a key metric of their past performance when they market new funds to investors, as the regulator boosts its scrutiny of the industry. . . . At issue is how private equity firms report how they calculate average net returns in past funds in their marketing materials. . . . Net returns, also known as the net internal rate of return (IRR) and an indicator of investors' actual profits, deduct private equity fund investors' fees and expenses from a fund's gross profits. Private equity fees are not standard, and different investors in the same fund can pay different fees."[2]

[2]Roumeliotis, Greg. "Exclusive: SEC probing private equity performance figures – sources." Reuters, Oct 29, 2014, http://www.reuters.com/article/2014/10/29/us-sec-privateequity-idUSKBN0II08K20141029

"Have you ever spoken to somebody who invests in private equity and got anything less than top-quartile returns?" –Brad Case

Case also was wary of consultant recommendations for private equity. "Have you ever spoken to somebody who invests in private equity and got anything *less* than top-quartile returns?" he asked. "There are so many different ways of measuring returns that 60% of private equity funds can legitimately be called top quartile by one of the available measures. So knowing you are in a top-quartile fund doesn't mean a thing."

"During my time as Managing Director at Scotiabank's pension fund, we chose REITs over private equity," said BIAB member Bruce Grantier. "We too believed we needed to get top-quartile managers to perform well. We managed over $5 billion in assets yet, due to the difficulty of choosing private equity managers and a lack of sufficient resources, we avoided private equity."

Grantier went on to say that Scotiabank also preferred U.S. small-cap value stocks to private equity, noting that, "Historically, U.S. small caps beat large caps by about 2.0% per year. We had a 3.0% manager outperformance objective for small caps over the Russell 2000 Index over 3-4 year periods—and generally met that." He added, "So the total of active small-cap value over large caps was 5.0%, which is about what private equity investors expect as a premium."

The tendency of top firms to replicate their performance across funds is not nearly as strong as it once was, according to McKinsey & Co. "Until 2000 or so, private-equity firms that had delivered top-quartile returns in one fund were highly likely to do so again in subsequent funds. Knowing that yesterday's winners were likely to excel again today enabled limited partners to focus their due diligence on identifying top-quartile funds."[3] Since the 2000 fund vintage, however, this persistence has fallen considerably.[4] "These shifts are forcing limited partners to develop new means of predicting tomorrow's winners. Meanwhile, returns remain widely dispersed: the best funds in any vintage generate returns of about 50 percent, while bottom funds lose up to 30 percent of their investment. With persistence waning and dispersion still significant, selection risk remains as high as it was in the 1990s, but it has become tougher to predict which firms will deliver top-performing funds," the report stated.[5]

What About Diversification Benefits?

"In regards to correlation, the story is much the same," Case claimed. "There is no reason to believe a measured correlation of a private equity asset should be any different than that of the same publicly listed asset. When the returns data reported by private equity investment managers are used to compute correlations with other asset classes, it makes private equity look like it has a diversification benefit that it doesn't really have."

McKinsey & Co. noted, "Several researchers concluded in the mid-2000s that, on average, buyout funds underperformed the S&P 500 on a risk-adjusted basis; only about a quarter of firms consistently beat the index. Other research has found that private-equity returns have become highly correlated with public markets."[6]

[3]McKinsey & Co., April 2014: http://www.mckinsey.com/insights/financial_services/private_equity_changing_perceptions_and_new_realities

[4]Vintage year: The year in which the first influx of investment capital is delivered to a project or company. This marks when capital is contributed by venture capital, private equity fund or a partnership drawing down from its investors. Source: Investopedia.com

[5]McKinsey & Co., April 2014: http://www.mckinsey.com/insights/financial_services/private_equity_changing_perceptions_and_new_realities

[6]McKinsey & Co., April 2014: http://www.mckinsey.com/insights/financial_services/private_equity_changing_perceptions_and_new_realities

High Fees

"As the perception of private equity's differentiation has waned, the fees that the industry charges investors, already under pressure, have come to seem especially exorbitant to some,"[7] according to McKinsey & Co.

Deploying Capital

Case also shared concerns with the private equity business model. He contrasted investing in publicly traded companies and private equity funds, saying the latter are pressured to put money to work—regardless of whether there are good opportunities available.

"There is so much evidence that companies sitting around with a pile of cash tend to waste it," Case said. "And with private equity, that's the business model: form a pile of cash and then look around for something to do with it. By comparison, REITs don't have a pile of cash because they're not allowed to. Capital market discipline makes all the difference between one investment and another. And by discipline, I mean things like market access, compensation structure and transparency. You won't do well if your investments don't have these qualities."

Branner disagreed. "Most private equity funds try to deploy capital both at speeds and into assets which are best for the clients they serve," he said. "If the manager is unable to deploy the capital fast enough, they launch a new vehicle the following year and offer clients to roll over unused funds for future deployment. Credible private equity funds are consistently raising money. Despite constant inflows of capital what we see is when good investments are not available, they are not used and instead a new vehicle is created. Most credible private equity houses run their businesses like this."

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–Peter Branner

Illiquidity Premium

The conversation also included the issue of illiquidity and a renewed debate on whether private equity funds provided an illiquidity premium—or any premium at all—over publicly traded equities.

Barry Gillman, Research Director, BIAB, shared an interesting angle on a potential benefit of illiquidity.

"All too often, people suffer from behavioral pitfalls that result in emotional and irrational decisions which, in turn, hurt investment returns," Gillman said. "Many institutional investors do a disservice to themselves when they churn through managers too quickly, usually due to performance panic. With private equity, people can panic, but because of lock-up periods, they can't panic out."

Bill Raver, a BIAB member who serves as an advisor or fiduciary to a number of investment funds, says a typical institutional investor sets high nominal and risk-adjusted, net-of-fee return objectives for private equity. According to Raver, "This is largely to compensate for the illiquidity, but also to cover for a lack of transparency as well as a lack of control over portfolio construction within the PE fund."

[7]McKinsey & Co., April 2014: http://www.mckinsey.com/insights/financial_services/private_equity_changing_perceptions_and_new_realities

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Private equity requires a thorough understanding of the risks relative to the potential rewards.

Conclusion

Private equity may be best used as part of a diverse portfolio. Investing in private equity, like any other investment, requires a thorough understanding of the risks relative to the potential rewards it promises. Retail and institutional investors may be best served to know what they're getting into by considering the pros and cons of private equity, as well as the gray areas in between.

Questions to Ask Regarding Private Equity and Private Equity Funds

1. What are the specific investment goals for a private equity allocation, how can they be accurately measured and how can progress toward these goals be monitored?

2. What specific risks would an investor assume with a commitment to private equity, and is there adequate compensation for these risks?

3. What process can successfully and consistently identify top-tier private equity managers that are open to new business?

4. What incentives for capital raising and deployment would best align private equity managers with their investors' interests?

5. What are the fees associated with investing in a private equity fund? And are the fees justified?

6. What fiduciary duties and obligations are outlined in an agreement between investors and a private equity fund? What recourse do investors have if those duties are not fulfilled?

7. How does the fund plan to draw on committed capital, and what are its planned exit strategies?

Lifting Curtain of Secrecy: Additional Articles

Morgensen, Gretchen. "Behind Private Equity's Curtain." *The New York Times*. Oct. 18, 2014.
http://www.nytimes.com/2014/10/19/business/retirement/behind-private-equitys-curtain.html?_r=1

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Siedle, Edward "Ted." "KKR Warns 'Leading Fiduciaries' It's No Fiduciary." *Forbes*. Aug. 18, 2014.
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Annotated Bibliography

Ang, Andrew and Morton Sorensen. "Risks, Returns and Optimal Holdings of Private Equity: A Survey of Existing Approaches." ssrn.com, July 30, 2012.
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2119849

> *"Studies using company-level data that account for selection bias find high alphas for private equity investments only during the late 1990s, but negative alphas post-2000. The positive alpha estimates are hard to interpret in terms of arithmetic returns, however, because of the very high volatility. Estimates of betas vary substantially, ranging as high as 3.6 for venture capital investments; generally, however, private equity betas are well above one."*

Kaplan, Steven N., and Per Stromberg. 2009. "Leveraged Buyouts and Private Equity." Journal of Economic Perspectives, 23(1): 121-46. http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.23.1.121

> *"It is plausible that some of the transactions undertaken during the boom were less driven by the potential of operating and governance improvements, and more driven by the availability of debt financing, which also implies that the returns on these deals will be disappointing."*

Jenkinson, Tim, Miguel Sousa and Rudiger Stucke. "How Fair are the Valuations of Private Equity Funds?" February 27, 2013. ssrn.com. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2229547

"We find a distinctive pattern of abnormal valuations which matches quite closely the period up to the first close of the follow on fund. It is hard to rationalize the pattern we observed except as a positive bias in valuation during fundraising."

Phalippou, Ludovic. "Performance of Buyout Funds Revisited?" University of Oxford. November 2012. ssrn.com. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1969101

"Adjusting for the size premium brings the average buyout fund return in line with small cap indices and with the oldest small-cap passive mutual fund. If the benchmark is changed to small and value indices, and is levered up, the average buyout fund underperforms by -3.1% per annum."

Welch, Kyle Travis. "Private Equity's Diversification Illusion: Economic Comovement and Fair Value Reporting." March 11, 2014. ssrn.com. http://ssrn.com/abstract=2379170

"I show that returns provided by private equity firms understate the economic comovement between private equity and market returns, creating a diversification illusion."

Brandes Institute Members Featured in this Article

- **Peter Branner**
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- **Barry M. Gillman, CFA**
  Research Director, Brandes Institute Advisory Board

- **Bruce J. Grantier, CFA, CAIA**
  Former Managing Director, Scotiabank

- **William J. Raver**
  Managing Director, Alban Row Investments, LLC

- **Philip E. Read**
  Former Chairman of the British Coal Staff Superannuation Scheme Trustee Board

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Alpha: Alpha measures the difference between a portfolio's actual and expected returns given its risk level as measured by its beta. A positive alpha indicates the portfolio has performed better than its beta would predict, while a negative alpha indicates a portfolio has underperformed given the expectations established by its beta.

Correlation: Correlation measures how the price of a security or portfolio moves relative to another; it is expressed as a correlation coefficient with a range between 1.0 and -1.0. A correlation coefficient of 1.0 suggests prices move in lockstep, -1.0 suggests moves that are completely opposite and zero suggests no relationship.

Russell 2000 Index: The Russell 2000 Index with gross dividends measures the performance of the small-capitalization segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index.

S&P 500 Index: The S&P 500 Index with gross dividends measures equity performance of 500 leading companies in industries of the U.S. economy.

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