Private Equity: Viable Alternative Investment or Empty Promise?

Summary
In a lively roundtable debate, members of the Brandes Institute Advisory Board (BIAB) and guest speaker 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 Pros and Cons
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.”

Peter Branner, BIAB member and CEO of SEB Investment Management, countered, “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.”

Potential Performance Issues
Case 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.”
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”.

Questions to Ask About Private Equity & 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?

To read the full roundtable discussion, visit the Brandes Institute at www.brandes.com/institute.

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.”

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