Verus

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Topic of Interest

Private Equity Return Premium: It’s Not Just Due to Illiquidity

Introduction/overview

— Historically, private assets have produced higher long-term returns compared to publicly traded assets. Investors have attributed the private asset outperformance to their illiquid nature.

— However, illiquidity alone does not guarantee outperformance, and success depends on other factors that investors are encouraged to consider.

— In this Topic of Interest, we discuss the key drivers of successful private investment outcomes: skilled manager selection, best-in-class processes such as portfolio management, and effective and efficient governance.

— Private equity should be viewed as an active "alpha-opportunity" with high dispersion of potential returns, rather than a guaranteed higher-return bet on systemic exposure (or "beta"). The investment performance of private equity portfolios varies greatly, from underperformance to dramatic outperformance, depending on investor approach and experience.

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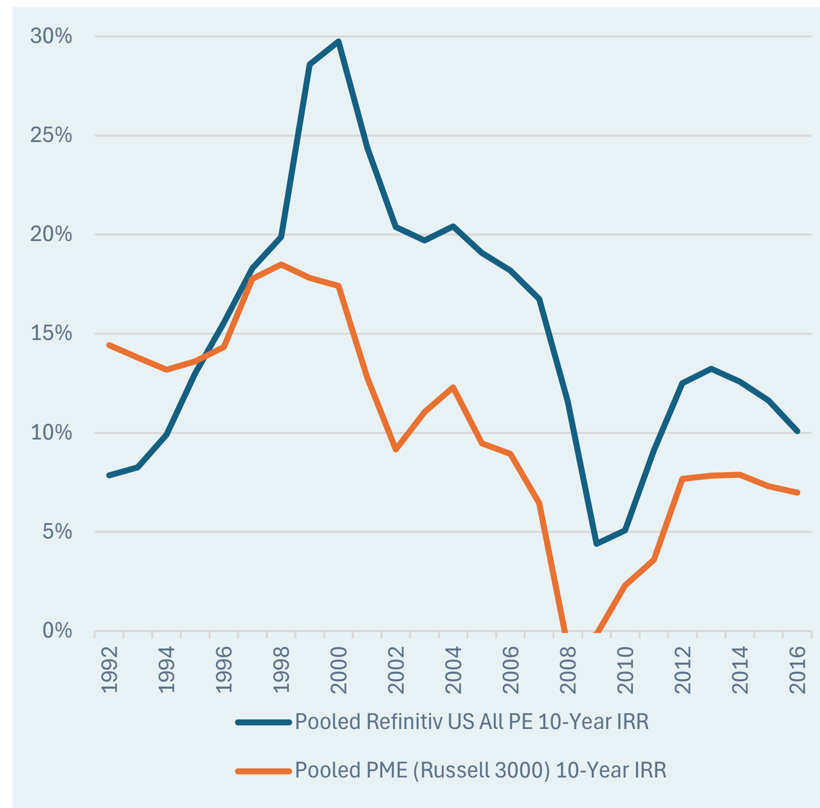
Private markets returns

Benchmark observations

- Private Equity returns have historically outperformed Public Equity (PE) returns over rolling 10-year periods.
  - The graph shows the pooled IRR of all U.S. PE funds tracked in the Refinitiv C|A universe from 1983 to 2016 compared to IRRs had the same cashflows been invested in the Russell 3000 index.
- Long-term investors seeking higher returns have increasingly sought to invest in Private Equity over the last few decades. Their results have been mixed.

U.S. ALL PE* vs. RUSSELL 3000



Source: Refinitiv C|A All U.S. Private Equity universe calendar year-end returns as of December 31, 2022. Funds are shown only since 2016 because vintages beyond 2016 have not yet matured sufficiently to show an accurate IRR.

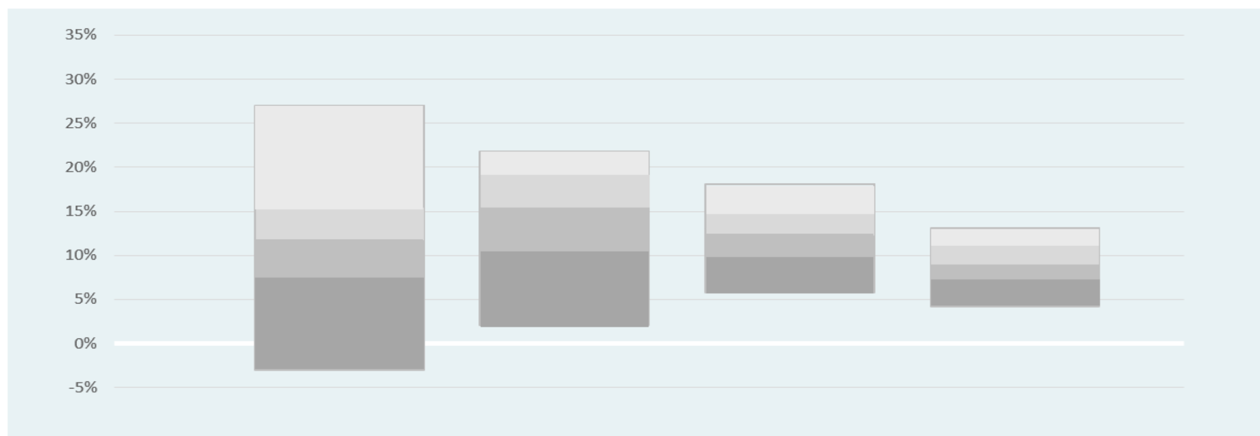
**Buyout, Fund of Funds, Growth Equity, Secondary Funds, Venture Capital*

The 10-year average return of Private Equity outperformed Public Equity by 3% or more a year some 68% of the time since 1992, and 94% of time since 1999.

Private markets returns

Institutional investor experience

RETURNS COMPARISON: INSTITUTIONAL PRIVATE EQUITY PORTFOLIOS VERSUS PUBLIC EQUITY



	3 YEAR		5 YEAR		10 YEAR		15 YEAR	
5th Percentile	27.0%		21.8%		18.1%		13.1%	
Top Quartile	21.9%		18.8%		15.0%		11.0%	
Median Quartile	17.3%		15.3%		13.1%		9.2%	
Lower Quartile	12.0%		10.4%		9.7%		7.4%	
95th Percentile	-3.0%		2.1%		5.8%		4.2%	
# of Portfolios	125		106		67		36	
	Return	Rank	Return	Rank	Return	Rank	Return	Rank
MSCI World IMI Index	4.7%	92	5.8%	90	8.8%	81	5.5%	86
Russell 3000 Index	7.1%	88	8.8%	82	12.1%	57	8.7%	60

Source: InvMetrics Trust Funds Private Equity (Net) Time-weighted Return Universe as of December 31, 2022.
**Time-weighted return is not the best measure for private investments.*

- Top- vs. Bottom-quartile PE portfolios: 5.3% / year over the 10-year period.
- Bottom-quartile portfolio returned 9.7% vs. 8.8% by MSCI World IMI. 0.9% outperformance falls below most expectations.

Implementation

Key portfolio return drivers

— Manager / fund selection is a key return driver

  - Private funds exhibit high dispersion of returns. On average from 1986 to 2016, the dispersion of returns between top- and bottom-quartile funds:
    - Buyout funds: 14.1%
    - Venture and Growth Equity funds: 18.4%
  - Skilled investors constructing portfolios of better performing funds have better portfolio returns than their counterparts.

— Avoid timing the market

  - Some of the worst performing macro calendar years have turned out as the best vintage years to commit to new private equity funds
  - Conducting pacing studies regularly to determine prudent levels of commitment is a best practice

— Consider incorporating the following if existing skills and capabilities, manager access, size, governance models and compensation structures are adequately aligned:

  - Co-investments
  - Active participation in secondary markets

Concluding thoughts

Steady hands are needed

Patience can be a virtue in investing, and it is often a requirement in private markets wherein strategies take years to execute. Prior to allocating to any private market asset class, investors need to determine their maximum need for liquidity and set comfortable limits to support illiquid portfolios over the long haul.

Second, they need to select the appropriate implementation model with a full understanding of the options available for effective implementation, including the costs between in-house versus outsourced models over the entire lifecycle of investments, as they can be quite significant.

Lastly, trustees need to appreciate the long-term nature of the asset class, and the need to learn new concepts and adjust roles and governance models as required to succeed in what might be a new universe of investments. These adjustments are prudent to start slow and build into a more significant private markets exposure over time.

For more information regarding our experience and expertise in building private markets programs, please reach out to your Verus consultants.

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