Key Questions

February 27, 2024

Why Should I Invest in Private Equity?

Sean Poe, Senior Research Analyst

The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Passive investing, or investing in funds designed to replicate the return of a specific index, has been on a tear lately. The S&P 500 Index ended 2023 up almost 26.3%, and, incredibly, you could access this return through an exchange-traded fund (ETF) with an expense ratio of just 3 basis points (0.03%), seemingly making 2023 the ultimate year to set it, forget it, and wake up wealthier on January 1, 2024.

Given that, why should investors look anywhere else for their equity exposure? Indeed, one private equity fund returned just 7.3% in the four quarters ending September 30, 2023[1], and it is unquestionably more difficult to get invested in private equity than it is to simply buy an index ETF. The answer to the question in the title, as I will lay out below, is that private equity has historically significantly generated greater returns.

What is private equity?

Before I dive into detail, let's start with the basics: what exactly is private equity?

Private equity, in its simplest form, is ownership in any equity that does not trade publicly on an exchange. This is most often manifested in a fund that takes controlling stakes in privately held companies, improves them, and sells them. Relative to public equities, the key element is the control of the company; rather than buying IBM stock and trusting management to make the right calls, private equity firms have the ability to add value above and beyond public equity returns (more on that below).

There are several forms of private equity: venture capital, growth equity, leveraged buyouts, distressed, and secondaries. Venture capital invests in early-stage (and commonly profitless) companies; growth equity invests in growing but pre-IPO companies; and leveraged buyouts are focused on purchasing established businesses. Of these categories, a leveraged buyout is the most traditional form of private equity, though venture capital has certainly generated headlines over the past several years.

How does private equity generate value?

As mentioned above, it is the control element of private equity investing that drives most of the value creation beyond public equity returns. With this control, private equity owners can upgrade management, introduce new products or services, enter new markets, rationalize costs, or engage in strategic mergers and acquisitions (M&A) activity.

Importantly, private equity firms can pull these levers over time without facing the pressures of publicly reporting quarterly results or being subjected to short-term market gyrations completely unrelated to the company and its financial performance. This allows for a patient approach and the realization of multiple value creation initiatives, such that the company sold after being owned by private equity is typically a dramatically improved version of the original company.

This allows for value creation evidenced in several areas: higher revenue, higher margins, and higher exit valuations, all boosted by the financial leverage typically employed by a private equity firm.

How can I invest in private equity?

It is important to recognize that private equity is still equity at heart; therefore, it should be thought of as a portion of your equity allocation. If equity is targeted to be 60% of a portfolio, private equity could perhaps be equal to 20% of the equity basket, or 12% of the total portfolio. Some investors with long time horizons, such as endowments or family offices, have between 25% and 40% of their capital invested in private equity.

Ideally, over time, a proper private equity allocation is not just one investment at one point in time. In order to achieve the benefits of diversification, it is best to build a portfolio that employs different private equity strategies (venture, leveraged buyout, etc.) across different geographies and different vintages (the year that the fund was originally raised).

Important Considerations

Like any asset class, there are a few key characteristics of private equity to keep in mind. The first is that private equity managers typically raise money before deciding exactly what they will buy. This means that, unlike an ETF, an investor doesn't know a priori what the portfolio holdings will be (though, worth noting, this is also the case with any active mutual fund, as managers frequently buy and sell investments only to inform their investors after the fact). This opacity, however, is not necessarily a bad thing; it simply means that manager selection is of the utmost importance. The focus should be on finding a manager with a consistent process, a strong track record, steady leadership, a strong alignment between the fund manager and her/his investors, and an attractive fee structure.

The other key consideration with private equity is that the investments are illiquid. The typical private equity fund is a multi-year commitment, due to the same control elements outlined above that enable enhanced value creation. Again, this isn't necessarily a bad thing, but it is a factor that needs to be managed within the construct of a total portfolio and any forecasted portfolio cash flows. In fact, this illiquidity can be a very positive psychological element in that it can prevent panic selling when markets are in turmoil, such as March 2020. Private equity forces a patient, long-term investment mindset.

Conclusion

Private equity can be a valuable return enhancer in a portfolio. The control characteristics of the investment type have historically allowed for more than 500 basis points annually of outperformance relative to public equities[1]. To get the full benefits of a private equity allocation, it is best to build a diversified portfolio of funds across strategies, geographies, and vintages.

---

[1]Cambridge Associates LLC US Private Equity Index Returns. (30 September, 2023). Retrieved from https://www.cambridgeassociates.com/wp-content/uploads/2024/02/WEB-2023-Q3-USPE-Benchmark-Book-1.pdf.

For more information, please contact your advisor.

230720-2172668-1269351182