

The Private Equity Market

Overview: This article defines private equity and discusses how investors in this market have fared over the past two decades. According to several studies, it appears that, on average, the returns that private equity investors received were not commensurate with the significant incremental risks they incurred.

Introduction

Similar to hedge funds, investing in private equity appeals to certain investors because of its exclusive nature. It also offers the possibility of superior returns. Although they share some of the same characteristics, private-equity funds are not hedge funds (or mutual funds). “Private equity is a catchall term for money used to invest in any private company, with the potential for big returns if and when the company goes public or is bought out.”¹

In 1980, investors committed approximately \$5 billion to private equity. By 2004, that figure had reached nearly \$300 billion.² High-net-worth investors may be attracted to such opportunities; in some cases, the minimum needed to participate could be as much as \$10 million. Recently, some private equity funds have followed the lead of many firms in the hedge fund industry, lowering their minimums. It seems reasonable to assume that high-risk, illiquid investments such as these would be priced to deliver higher expected returns than publicly traded securities. But does the reality match the expectation?

Comparing Private Equity Returns to Publicly Traded Stock Benchmarks

According to Thomson Venture Economics and the National Venture Capital Association, the private equity market returned 13.8 percent annualized for the 20-year period ending June 30, 2005.³ We cannot know if the data contains any biases, such as survivorship or self-selection bias, that might make the returns appear better than they actually were. With this caveat, we can still compare that figure with returns of equity asset classes.

Comparing Annualized Returns of Private Equity to Publicly Traded Stock Benchmarks (For the 20-Year Period Ending June 30, 2005)	
Private Equity (as noted above)	13.8%
S&P 500 Index	12.3%
Fama-French Large-Cap Value Index	13.0%
CRSP 9-10 (micro-cap stocks)	12.1%
Fama-French Small-Cap Value Index	16.8%

Source: Venture Economics/Dimensional Fund Advisors Returns®

Although private equity outperformed the S&P 500 Index and micro-cap stocks, its returns were well below those of small-cap value stocks. Micro-cap and small-cap value stocks are generally considered more appropriate benchmarks for private equity.

For example, in a January 2005 paper published in the *Journal of Financial Economics*, University of Chicago Professor John Cochrane concluded that the risks and returns to venture capital (a segment

of the private equity market) were similar to those of the smallest NASDAQ stocks (thinly traded, illiquid stocks with very small market capitalization).⁴

Comparing Segment Returns from within the Private Equity Market

With additional data from Venture Economics, we can also discuss the returns of three segments of the private equity market: venture capital (overall, early and later stage), leveraged buyouts (LBOs) and mezzanine financing.

Comparing Returns of Segments of the Private Equity Market (For the 20-Year Period Ending June 30, 2005)	
Segment	Annualized Return
S&P 500 Index	12.3%
Fama-French Small-Cap Value Index	16.8%
Venture Capital (overall)	16.0%
Seed Venture Capital/Early Stage Funds	20.2%
Later Stage Venture Capital	13.8%
Leveraged Buyouts	13.8%
Mezzanine Financing	9.1%

Source: Dimensional Fund Advisors Returns®/Venture Economics

Venture capital nearly matched the 16.8 percent return of small-cap value stocks overall. Seed venture capital and early stage funds provided the highest return within that segment: 20.2 percent. This type of private equity consists of initial investments made in start-up companies and businesses through the first few rounds of funding. In recent years, funding for companies that fall into this category has declined, partly due to investor fears about potential losses. “Rather than laying risky wagers on unproven startups, they’re placing safer bets on growing mid- and late-stage companies.”⁵

According to Venture Economics, later stage venture capital returned 13.8 percent, underperforming the returns of small-cap value public equities by 3.0 percent. However, late stage deals have received most of the venture capital investments in 2005.⁶ Leveraged buyouts, which employ strategies to acquire companies with loans or bonds instead of cash, returned 13.8 percent. Mezzanine financing, a type of financing that uses debt and equity, returned 9.1 percent.

These figures are consistent with the findings of an August 2005 paper published in the *Journal of Finance* by University of Chicago professor Steven Kaplan and MIT associate professor Antoinette Schoar. For the sample period 1980–1997, they found that within the overall category of private equity, leveraged buyout funds underperformed the S&P 500 Index, and an equal weighted investment in venture capital would also have underperformed net of fees (though a dollar weighted investment would have outperformed).⁷

The samples analyzed in the two aforementioned papers covered a period that included one of the greatest venture capital booms in history — the Internet/dot.com era. Because of this, it might be useful to discuss the returns from a different sample that excludes this period. Several authors have referred to findings by authors William Bygrave and Jeffrey Timmons mentioned in their 1992 book, *Venture Capital at the Crossroads*. Bygrave and Timmons found that for the period 1974–1989, the average internal rate of return to venture capital funds was 13.5 percent.⁸ This figure is practically identical to the 13.3 percent return to the S&P 500 Index for that period. However, it is significantly below the return to the three other benchmarks we have used in this paper. For the same period,

micro-cap stocks returned 17.3 percent; large-cap value stocks returned 17.9 percent; and small-cap value stocks returned 23.8 percent.

Private equity investors forgo the benefits of liquidity and access to daily pricing information that mutual fund investors enjoy because of the way in which most private equity deals are conducted. Keep in mind that private equity investments typically have very long lockup periods during which investors cannot access their capital. Thus, while private equity strategies generally performed well, there is a compelling argument that the returns were not commensurate with the risks involved.

Biases in the Data

Much of the data contained in the studies mentioned above is likely to contain an upward bias. In the September 2005 working paper, “Performance of Private Equity Funds: Another Puzzle?” the authors attempted to correct this bias.⁹ Poorly performing funds have an incentive to postpone liquidation to artificially raise their reported return. Thus, the authors suggested that residual value (the accounting value, which may not reflect market value) is overstated and should likely be written off. They also proposed that studies such as the one by Kaplan and Schoar, which include only liquidated funds, have a “winner’s” bias.

In the paper, “Performance of Private Equity Funds: Another Puzzle?” the authors corrected for this bias and found the return of private equity funds raised between 1980 and 1996 lagged the return of the S&P 500 Index by 3.3 percent per annum. They also found that about one-quarter of the funds had negative internal rates of return.

Pension Fund Investments in Private Equity

In 1996, the California Public Employees’ Retirement System (CalPERS) invested in the Beacon Group III-Focus Value Fund. As of year-end 2004, the fund was down almost 30 percent. CalPERS also invested in Inroads Capital Partners 1995 Fund. It produced a loss of almost 25 percent through 2004.¹⁰

CalPERS was probably able to diversify its exposure to venture capital across many funds. However, it is likely that most individual investors would be unable to achieve the same level of diversification, and thus would be exposing themselves to even greater risk — the risk that the only funds they invested in might be the ones with very poor results.

Whether they are investing in one or many private equity funds, investors who seek premium returns via private equity investing are exposed to uncompensated risk; their investments are based on taking risks that could otherwise be diversified away. We advise investors to only accept the type of risk that remains after diversification is achieved via a globally diversified portfolio of passive asset class or index funds. These types of funds capture an entire asset class and/or index, thus removing the uncompensated risk of holding only one or a few equities within that asset class.

Conclusion

While venture capital investing appears to carry higher risk and higher expected return, the returns investors have realized do not appear to be commensurate with the incremental risks. The more prudent strategy is to take equity risks by building a globally diversified portfolio of passive asset class funds.

- ¹ Erin Arvedlund, **Private-Equity Funds Lower the Bar**. *Wall Street Journal*, August 2, 2005.
- ² Josh Lerner, Felda Hardyman and Ann Leamon, **Venture Capital and Private Equity: A Casebook**. John Wiley & Sons, 2005.
- ³ **Venture Capital Short Term Performance Improves in Q2 2005**. Thomson Venture Economics/National Venture Capital Association, October 31, 2005.
- ⁴ John H. Cochrane, **The Risk and Return of Venture Capital**. *Journal of Financial Economics*, January 2005.
- ⁵ Eric Hellweg, **Hedge Funds Raise the Pirate Flag**. *Business 2.0*, October 2005.
- ⁶ Ann Grimes, **Trends (A Special Report): Venture Capital; Where the Bets Are**. *Wall Street Journal*, November 21, 2005.
- ⁷ Steven N. Kaplan and Antoinette Schoar, **Private Equity Performance: Returns, Persistence, and Capital Flows**. *Journal of Finance*, August 2005.
- ⁸ John H. Cochrane.
- ⁹ Ludovic Phalippou and Maurizio Zollo, **Performance of Private Equity Funds: Another Puzzle?** Working Paper, University of Amsterdam, September 2005.
- ¹⁰ Erin Arvedlund.

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