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Private Equity in a Portfolio Perspective

The Last Free Lunch?

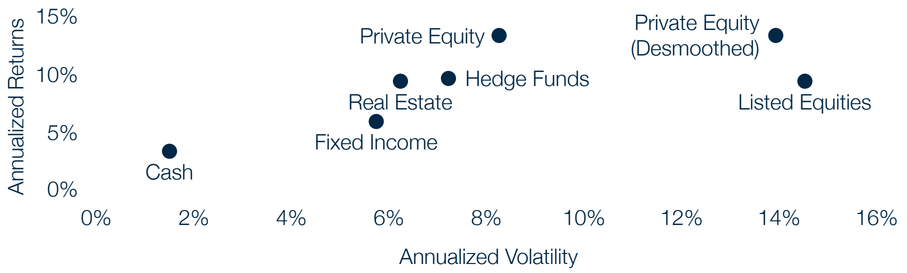
Is Private Equity the last “free lunch”?

Private equity has historically provided one of the most attractive risk-adjusted returns among asset classes.[1] Hence, portfolios allocating to private equity have historically generated a greater return with similar risk as traditionally diversified portfolios.[2]

In its letter of 29th June 2017, Norway’s Finance Ministry asked Norges Bank, the investment manager of the Norwegian Government Pension Fund, controlling over $1 trillion in assets under management[3], to evaluate whether private equity should be included in the investment universe for the world’s largest sovereign wealth fund. Professors Doskeland and Strömberg were assigned to the task and ventured into a paper reviewing the asset class in great depth before providing a final recommendation for the fund. They concluded that including private equity in the fund’s mandate improved the fund’s capacity to optimize risk-adjusted returns, further alluding to the possibility that private equity’s role in global markets could enhance its diversification potential over time[4].

Data from at least the last three decades shows that private equity provided investors with the highest risk-adjusted returns[5] as an asset class. Private equity offered the highest annualized returns among the major asset classes while, exhibiting less volatility than listed equities, even when desmoothing private equity returns[6].

Figure 1: Asset Classes Risk Return Chart[7]



Yet, Sharpe ratios are not prescriptive and asset classes are not assessed by investors in isolation. What is also relevant is an asset class’ diversification potential, since, as Markowitz, the father of Modern Portfolio theory, put it, diversification is “the only free lunch in finance”. The very basis of investment portfolios is to construct them with imperfectly correlated assets in order to take advantage of the principle of diversification. Given the current access to low fee and highly diversified public market portfolios, we suspect that private equity represents the only remaining missing piece for individuals to access the “free lunch” of portfolio diversification.

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1 McKinsey & Company (February 2020). A new decade for private markets. McKinsey Global Private Markets Review 2020.

2 Tutrone, A. (January 2019). Private Equity and Your Portfolio. Neuberger Berman Insights.

3 Norges Bank. (2019). The fund’s development. Retrieved from https://www.nbim.no/en/

4 Doskeland, T., & Strömberg, P. (January 2018). Evaluating Investments in Unlisted Equity For the Norwegian Government Pension Fund Global (GPFG). pg. 22.

5 As measured by the Sharpe ratio (= [period returns – risk-free returns] / [period return deviations]).

6 Desmoothing private equity returns refers to process of using proxy daily volatility figures to adjust for the fact that private equity funds report their performance quarterly and not daily.

7 KKR Global Institute (2019), p. 7. Data as at 1Q86 or earliest available to 4Q17, and de-emphasizing 2008 and 2009 returns at one third the weight, due to the extreme volatility and wide range of performance which skewed results. Source: MSCI AC World Gross USD for Listed Equities; Barclays Global Aggregate Total Return Index Unhedged USD for Fixed Income; Cambridge Associates Global Private Equity for Private Equity; HFRI Fund Weighted Composite Index for Hedge Funds; and Barclays US T-Bills 3-6 Months Unhedged USD for Cash. Desmoothed Private Equity volatility comes from the same dataset and the adjustments performed by Ilmanen (2018), p. 10.

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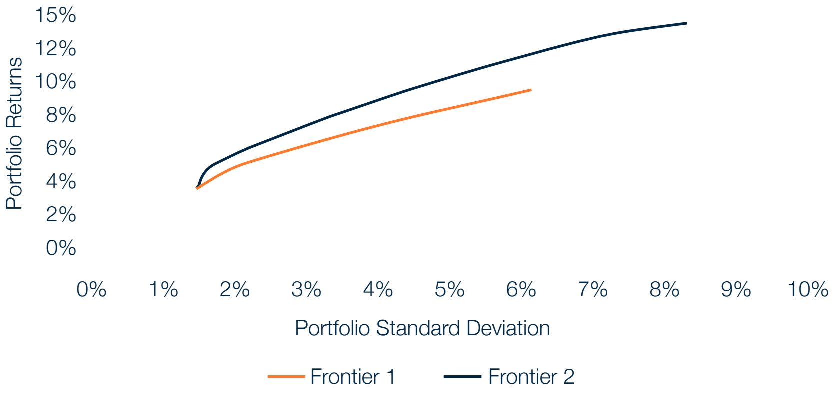
The idea is simple. Just by taking the last 20 years of data and accounting for the historical correlations between the major asset classes[8], we plot in Figure 2 two efficient frontiers.

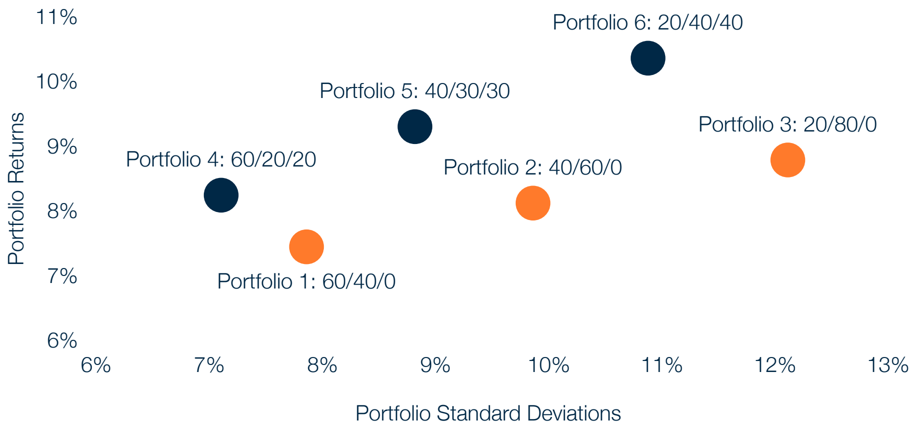
Figure 2: The Free Lunch[9]



For each target volatility level, the return potential is maximized based on historical figures. Frontier 1 is constrained by the four major asset classes, namely cash, bonds, real estate, and stocks. For Frontier 2, we allow for the inclusion of private equity. This shifts the efficient frontier to the left, showing how a portfolio allocating also to private equity taps further into the "free lunch" afforded by diversification, offering higher returns for the same level of risk, as measured by standard deviation.

The hypothetical model portfolios presented in Figure 3 show how a portfolio's standard deviation and return change when changing the asset allocation between bonds, stocks and private equity. To construct the six hypothetical model portfolios the historical returns and volatility levels peer asset class as presented in Figure 1 were used. The correlation between bonds, stocks and private equity has been taken from Swensen's correlation matrix.[8] As exhibited, the portfolio returns increase with an increasing allocation to private equity.

Figure 3: Hypothetical Model Portfolios[10]
Portfolio: Bonds/Stock/PE



Taking a step back, and looking at the question via a normative lens, private equity's capacity to focus on active ownership, operational and strategic improvement, as well as business transformation is a unique source of value creation, one that cannot be imitated in the public markets. This unique and diversified exposure forms the thesis for private equity's prime position in the most successful institutional portfolios, such as in the cases of the Yale Endowment[11] as well as the largest US educational investment endowments.

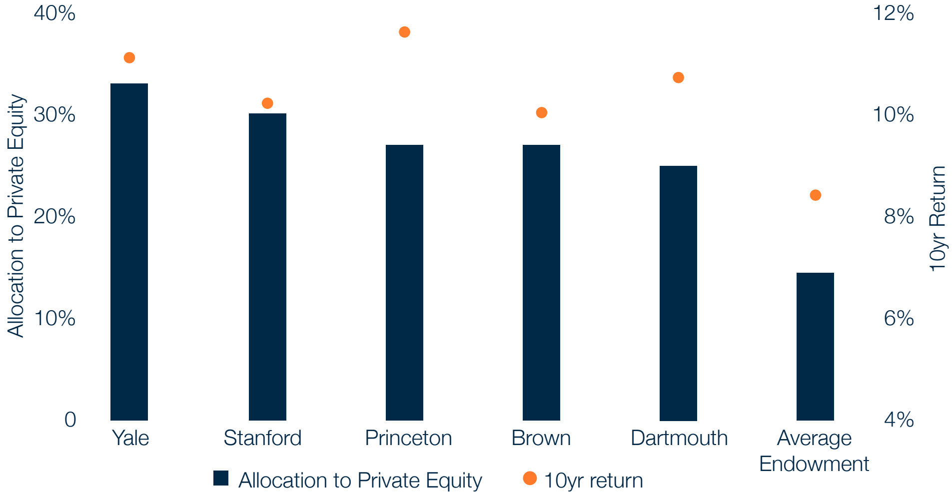
8 The correlation matrices are derived from the modified correlation matrix in Swensen, D. F. (2009). Pioneering portfolio management: An unconventional approach to institutional investment. New York: Free Press.

9 The efficient frontier is a set of portfolios that offer the highest expected return for a given level of risk, as defined by standard deviation/volatility. The expected returns as well as expected volatility of the portfolios were taken from McVey, H., H. (2018). Rethinking Asset Allocation (Rep.). New York: KKR Global Institute. The correlation coefficients were taken from Swensen, D. F. (2009). Pioneering portfolio management: An unconventional approach to institutional investment. New York: Free Press. The efficient frontier is constructed in a way that weights are allocated to different portfolios so that the resulting combination offers the best returns for a defined level of risk.

10 Data as at September 30, 2018. Source: KKR Global Macro & Asset Allocation analysis.

11 The Yale Endowment. (2019). 2019 (Rep.). New Haven, Connecticut: Yale University.

Figure 4: US Endowments Allocation to Private Equity and Average 10yr Annualized Return[12]



The increased relative cost of maintaining a public listing and the healthy supply of private equity capital have led to firms staying private for longer. Thus, legacy public market investment managers, such as Fidelity, have started shifting their mutual fund strategies to also include allocations to private markets[13]. The rationale is that by the time companies list on the public markets, most of their profit potential has been harvested by private market investors.

The opportunity set is such, that even though only a limited portion of companies in the world are listed, private equity represents a total investable market of $2.4 trillion[14], just a fraction of the $55 trillion global stock market's capitalization. Private equity is growing rapidly and no longer just a privilege for large institutional investors. At Moonfare, we are committed to providing you the free lunch for your portfolio.

References

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12 NACUBO (2019). Based on FY 2018 data. Private Capital includes Private Equity, Venture Capital, Private Equity Real Estate, and Private Deb

13 Reuters, 2015.

14 Doskeland and Stromberg (2018), p. 121.

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