Private Equity for the Masses: The Official End of the Illiquidity Premium

By Bruce Stewart, CAIA®, CIMA®
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Investing in private equity generally is considered a strategy that sophisticated and wealthy individuals, endowments, pensions, and family offices use to earn outsized returns relative to the broad equity markets. These institutional-style investors generally take a different view of their portfolios than the average individual investor, who is used to liquid, transparent, highly regulated, minute-to-minute valuation of investments.

Traditional private equity investors are comfortable taking on illiquidity for 10–12 years to earn a return premium over liquid public markets. The “illiquidity premium” may be 300–700 basis points per annum, which is a core motivation for investing in illiquid markets or private equity relative to long-only or less-liquid hedge fund strategies (see sidebar).

A core source of private equity (PE) performance has been the identification of equity, debt, and other investments that do not exist in the liquid markets. PE firms seek to increase the value of small to midsize private companies in several ways, including but not limited to:

- Enhancing company leadership
- Financial engineering
- Improving operating infrastructure
- Introduction to distribution partners
- Increasing operating scale
- Value creation

PE firms now increasingly are looking to take on more of a consultancy-type role: giving firms in their portfolios the professional expertise they need to thrive. As Stephen Schwarzman, chairman, chief executive officer, and co-founder of Blackstone, one of the oldest PE firms in the business, has commented: “You don’t create value by just buying the S&P on leverage. You actually have to transform the company” (Schooley 2018). It’s no longer just about cutting costs to boost profits—it’s about boosting the long-term viability of the asset via a more fundamental strategic change in direction.

To increase the scope of what is within their ability to control, PE executives increasingly must bring deep strategic expertise to companies in their portfolios, in order to transform those assets’ business strategies, processes, or business models in ways that drive top-line growth. Unlike at a public company, there is no emphasis at these private companies on quarter-to-quarter, short-term results. Instead, the focus is on a company’s longer-term operating efficiencies. This “patient capital” also ensures that investors are committed to a long-term investment strategy and are not swayed by the emotional roller coaster many fall victim to in the liquid markets (i.e., buying and selling based on emotional, short-term views of the market).

Successful investing in PE is highly dependent on the search for and selection of talented general partners (GPs). Access to certain tools, resources, and the best GPs is critical in order to earn outperformance relative to the long-only equity markets, especially when discounting performance for the illiquidity premium. Talented GPs who are able to persistently add value to their portfolio companies while persistently earning high returns for their investors (limited partners or LPs) are in high demand by the largest and most sophisticated institutional investors in the world. These investors often employ teams of analysts, leverage industry relationships, and utilize sophisticated models to

ILLIQUIDITY PREMIUM

The illiquidity premium is generally understood to be the additional return received for the additional risk of tying up capital in a less-liquid asset. Illiquidity becomes a particular concern when markets start to fall; investors may be forced to endure large price drops if they have difficulty selling the asset. Illiquid investments carry more risk than comparatively more liquid investments. This is because holding a single security for a long period of time exposes the investor to several risk factors, such as market volatility, potential default, economic downturns, interest rate fluctuations, risk-free rate fluctuations, etc. When investors tie up their money in a single security, they also incur the opportunity cost of investing in other assets that may outperform the illiquid investment. Due to the additional risks, an investor will demand a higher return, known as an illiquidity premium.
assess and access talented GPs. Their objectives are to identify best-in-class PE managers and to strategically design diversified PE allocations. Building diversified PE solutions can be a complex exercise that requires extensive experience and training (see figure 1).

PE allocations generally are 5–20 percent of an investor’s portfolio but may be as high as 50 percent depending on the sophistication and size of the investor (e.g., Yale’s endowment). Portfolios often are designed around a core–satellite architecture whereby leveraged buyouts are the largest allocation (core) and strategies such as venture capital, debt, real estate, and infrastructure represent the smaller, more esoteric exposures (satellite) (see figure 2).

Many asset allocators have debated the merits of PE being included in the equity asset class or whether it deserves its own asset class. Although there are cogent arguments on both sides, we prefer to stand by the adage, “You can’t manage what you can’t measure.” That is, due to the illiquidity of PE, it cannot be blended into the aggregate client portfolio from a measurement perspective, and therefore it must be removed when applying standard performance and risk measures. Because there are no convenient or generally accepted ways to blend PE performance metrics with long-only (or less-liquid) metrics, PE must, by default, be placed in its own asset class, apart from the measured portfolio.

Some PE marketers have suggested that PE offers a compelling diversification opportunity when added to a multi-asset portfolio. This would be difficult to demonstrate mathematically, however, even though many would agree that there are several benefits to adding PE to such a portfolio.

THE IMPORTANCE OF ILLIQUIDITY IN PRIVATE EQUITY
An asset’s liquidity depends on the ease with which the security can (or cannot) be traded. A PE fund is an illiquid investment because of the time it takes to exit the fund’s positions. Further, most funds are organized as LPs, a construct that makes it difficult to achieve liquidity before a manager begins to sell investments in the fund’s
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as return enhancements, many manag-
ers were unable to deliver persistent

performance as capital overflowed into

the asset class, increasing effi-
ciency and driving down average

performance. As performance pressure

mounted, hedge fund marketers

suggested that less-liquid strategies

could represent diversification

risks. In effect, this increased efficiency

and

overall, semiannual, or annual redemp-
tions (with notice required), capital
generally is locked for a much shorter
amount of time than for PE funds,
making hedge funds more-liquid
alternative investments than PE.

PE’s appeal has been that investors, by
accepting illiquidity, may be rewarded by
earning more than they could earn in the
public markets. By allocating capital to
investments that trade infrequently, have
little price transparency, and provide
scant public information, investors expect
a superior return for investing with man-
agers capable of negotiating an unfamil-
 iar environment. Historically, talented
investment managers have exploited
inefficiencies and may persistently out-
perform the broad public markets. This
philosophy has evolved across various
asset classes and stipulates that, within
inefficient classes, there is a higher prob-
ability that proven managers can outper-
form their peer groups, as well as the
public markets, persistently.

Several metrics can gauge
performance, but it’s less
clear whether investors are
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RECENT DEVELOPMENTS

Significant capital inflows mixed with
the proliferation of the internet have had
pronounced implications in raising the
efficiency of both liquid (public) markets
and less-liquid (e.g., hedge fund) strate-
gies. In effect, this increased efficiency
has removed the information advantage
(via price discovery) that once afforded
active managers the ability to deliver
outsized relative returns. Due to market
efficiencies and lowered performance
expectations, investors are turning to a
new source of portfolio return that once
only select investors could access. PE

represents, to many investors, the last
truly inefficient asset class whereby:

- Sources of risk and return are distin-
guished from liquid markets (differen-
tiated factors)
- PE returns may persistently exceed
the public markets

However, it is noteworthy that over the
past five to eight years, the largest por-
tion of the PE market (buyout) has expe-
rienced significant capital inflows to the
point where performance expectations
have been lowered from 20–percent* target returns to a more manageable
14–16 percent internal rate of return
(IRR). Interestingly, though perhaps unsurprisingly, the market has adapted
with the surge in additional demand.
A growing secondaries market now
exists, allowing some PE funds the
opportunity to exit or reduce positions
earlier than expected, for tactical rea-
sons, and simultaneously offer other
funds the opportunity to put excess
capital to work when initial investment
opportunities dry up. Another growing
trend is the proliferation of co-investment
funds, which are particularly attractive
to family offices and endowments
and allow them to invest in smaller,
less-diversified investments that they
believe may offer better opportunities.

PERFORMANCE ANXIETY

Several metrics can gauge performance, but it’s less clear whether investors are
adequately compensated for illiquidity. According to Harris et al. (2012), the
average U.S. buyout fund has outper-
formed the public markets significantly
for most vintages over an extended
period of time (the dataset extended over
three decades and comprised data from
three different sources). Harris et al.
(2012) assert that buyout fund outper-
formance compared to the S&P 500 aver-
ages 20–27 percent better over the life of
a fund, representing alpha of 3–4 percent
annualized. Venture capital funds signifi-
cantly outperformed the public market in
the 1990s during the dot-com boom but
sharply underperformed during the
2000s. Ghai et al. (2014), in a McKinsey
analysis for the World Economic Forum,
arrived at a similar conclusion, reporting
that funds created since 1995 have mean-
ingfully outperformed large-cap stocks.

However, returns net of fees show that
investors are not persistently rewarded
with earnings superior to those of the
S&P 500 Index. Sorensen et al. (2013)
assert that PE firms’ returns are misleading. The study showed that a 20–27-percent premium over the public market is merely break-even due to management fees and carried interest, as well as the risks and opportunity costs associated with PE investments. Several other credible studies affirm that the asset class routinely does not outperform to the extent that common lore suggests. Two other studies show that PE firms charge an average of 7 percent in annual fees by liquidation and payout, whereas the S&P 500 Index has significantly lower fees that amount to about 15 basis points (or less) (Franzoni et al. 2012; Szala 2020).

Although PE funds yield superior gross-of-fees returns, the authors argue that the significant fee impact results in an alpha near zero. Likewise, Franzoni et al. (2012) find that, when considering the significant liquidity risk premium inherent in PE investments (along with other factors), alpha is effectively reduced “to zero.” Although the McKinsey analysis (Ghai et al. 2014) asserts that private equity has outperformed listed equities in the past, it recognizes the inability of top PE managers to consistently produce successful funds (or follow-on vehicles), primarily due to a massive flood of capital to the PE universe (see figure 3).

Franzoni et al. (2012) confirmed McKinsey’s claim (Ghai et al. 2014) that PE funds are not outperforming the benchmarks at past rates. Higson and Stucke (2012) and Korteweg and Sorensen (2015) reported the decline in PE returns. Likely culprits include managers’ performance reversion to the mean, an asset class flooded with investors chasing returns, and an increased supply of presumably inferior managers—and vehicles—seeking unique deals. This clearly demonstrates that the broad PE landscape is not immune from general equity market behavior and that it may not deliver the perceived diversification benefits it once did.

Recent studies have confirmed that average PE fund performance has fallen from its historic average. This may be due in part to the asset class becoming more efficient as more non-institutional capital has flowed into the PE arena seeking to replicate the early successes many institutional investors earned in the 1980s and 90s. PE investing is often positioned as a low-correlation, high-return, low-volatility strategy. In reality, the smoothed returns have resulted in underreported risk and correlation while overstating risk-adjusted returns and diversification benefits.

On the other hand, it is also clear that PE may offer unique factor exposures that are available only via illiquid markets. These unique factor exposures offer return opportunities and diversification benefits that typically are not available in the long-only markets. However, it is important to note that access matters as much as high-quality manager due diligence and selection. If an investor can access top-quartile strategies within more specialized PE sub-asset classes, persistent outperformance may be found, i.e., small buyout (see figure 4). It is noteworthy that strong performing managers often are oversubscribed and have loyal, longtime investors that may preclude new investors from participating; thus, relationships matter in acquiring access to this sometimes by-invitation-only asset class.

TODAY’S CONUNDRUM: PRIVATE EQUITY FOR EVERYONE?

Many in the financial and political press have suggested that there needs to be a democratized and retailized delivery of private equity to all investors, not just...
sophisticated, wealthy, institutional investors (Szala 2020).

In June 2020, the U.S. Department of Labor (DOL) issued a feasible way for most Americans to make their first significant investments in PE via liquid, multi-asset vehicles that invest in a range of different securities, including stocks, bonds, and the shares of PE funds. It’s the first shot across the bow in a revolution that has the potential to fundamentally alter how individuals throughout the world invest and how the PE industry operates. The DOL guidance, provided in Information Letter 06-03-2020, written with the collaboration and support of the Securities and Exchange Commission, the key financial markets regulator in the United States, is in effect a ruling that sets out the investment structures that must be used and the fiduciary and regulatory responsibilities that must be met for fund management groups to offer private equity to individuals.1

Among other key DOL requirements, asset allocation funds must have sufficient liquid investments in the form of stocks, bonds, and money market instruments to handle daily redemption requests, in particular for the portion invested in PE; they must have a transparent and comprehensible mechanism for valuing PE fund investments on a daily basis—one that meets generally accepted accounting standards; they are obliged to cap allocation to the PE portion of the fund at a specified percentage of the overall portfolio, to ensure asset category diversity; and they must engage in risk-benefit analysis to validate the thesis that any prospective investment in a PE fund is likely to reinforce the vehicle’s ability to provide an acceptably high level of return for a targeted level of risk and a set level of fees. Further, the asset allocation’s funds must ensure that investors are aware of all costs. The classic PE fund has a 2–percent annual management fee and takes a 20–percent share of profit once a preferred annualized return for investors—typically 8 percent—has been achieved. That’s much higher than fees charged by stock and bond funds and easily could give pause to individuals considering adding PE to their investments.

**WELL-INTENDED CONSEQUENCES, ADVERSE IMPLICATIONS**

The desire to retailize PE comes at a time when the asset class is already under significant performance pressure. Democratizing the PE industry effectively increases the liquidity of the asset class, thus lowering its inefficiency and ability to outperform long-only equity asset classes. Opening the asset class to millions more U.S. investors could have significant and long-term adverse implications that could include but are not limited to the following:

1. Inexperienced investors misunderstanding the PE asset class, specifically:
   - performance expectations
   - risk
   - fees
   - risk-adjusted returns (illiquidity premium)
   - incentive structure
   - composition of underlying investments
   - strategy execution
2. Accelerated PE efficiency
3. Diminished illiquidity premium
4. Inability to access liquidity when needed
5. Limited ability to rebalance
6. Nonstandard performance reporting—difficulty in measuring aggregated performance, risk, or diversification
7. Difficulty in accessing top–quartile GPs

Hedge funds were once return–enhancement solutions but today are marketed as diversification products, and this also may be happening now in the PE space. Suggesting that PE offers superior risk–adjusted returns and diversification benefits is a tall order to prove mathematically to an investment committee, but it’s perhaps even harder to prove to the average, nonprofessional investor.

Other important considerations could include the quality of PE products that retail investors will have access to. High–performing, top–quartile managers unlikely will offer access to retail investors because they will be closed, i.e., by invitation only. Oaktree Capital Management Co-Chairman Howard Marks noted some time ago that there is no easy way to evaluate PE (McSwain 2019).

Marks and other accredited, sophisticated investors have the background and the resources to conduct such analyses. Are retail investors, who may soon have expanded PE access, similarly equipped? For that matter, are their advisors?  

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Globalization in Transition: The Future
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