Private equity has been an increasingly prevalent part of institutional investors’ portfolios over the past 30 years. No surprise, really; as discussed below, it has typically generated substantially better returns than broad public investment benchmarks.

But, of course, the past is a limited predictor of the future. Some argue that the heyday of private equity (PE) is now past, as money has flooded in to the sector. In the meantime, no one can say they really love the illiquidity, limited transparency, and relatively higher fees that the category often involves. So for those without a PE investment history, is it an attractive option today?

Well, let’s zoom out to some big-picture facts. First, it’s clear there are very few bargains anywhere in the investing universe right now (private transactions included). The global central banks’ very intentional reflation of every sort of asset price has taken care of that. That has led, as we know, to historically high stock and bond valuations, and thus historically low expected real returns on a 60/40 portfolio. All the calculations I’ve seen lately are in the zip code of 2 percent, the lowest since 1900. Not too exciting.

So the profound challenge for investors seeking more substantial returns over the next few years is to find the most reasonably priced investible assets—and, if possible, an investing style that enhances the odds of exiting later at a meaningful profit.

Let’s look at those tasks separately.

First, it stands to reason that the liquid assets should be more expensive than illiquid ones. Given otherwise identical choices, buyers obviously will prefer the liquid option, so that’s where the majority of the money tends to go. Without looking at data we can guess that multiples paid to purchase private companies usually should be lower than those in the public sphere, and indeed, the data do show exactly that.

According to Neuberger Berman, the spread between multiples for public versus private companies is very substantial. Whereas you’re paying about 17 times earnings for a public company, you’re paying more like 10 times for a private one (see figure 1).

Obviously, the lower the purchase price, the more upside to the investment—and the lower the risk. So, even though private company prices aren’t cheap, they remain relatively attractive as compared to their public counterparts.

Moreover, information about private deals is highly asymmetrically distributed through the market, and managers with the best deal flow networks can and do have huge advantages over others—just the kind of advantage that can’t exist in the public markets.

Finally, one simple statistic tells a big story: The number of public companies worldwide is about 65,000 according to Bloomberg, and the number in the United States is only about 3,700 (just half the number that existed in 1996), but the number of private companies in the world is more like 65 million, according to Hoovers. Where would you rather look for opportunity?

So that’s one big argument for PE—it provides better chances to find better investments. But a different one is equally critical. Unlike traditional public equity portfolio managers, PE managers strive to directly add value to each investment position. Even assets that aren’t cheap when you buy them often can have their value improved by this sort of direct involvement, or “intervention,” as the industry calls it.

A quality PE firm delivers more than money to its investments. It provides injection of industry-specific management talent, experience in reducing costs and increasing efficiencies, relationships with potential strategic partners, and the like. And the funds can leverage these advan-

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**Figure 1: Private vs. Public Multiples**

<table>
<thead>
<tr>
<th>Year</th>
<th>U.S. Private</th>
<th>U.S. Public</th>
<th>Europe Private</th>
<th>Europe Public</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>8x</td>
<td>12x</td>
<td>10x</td>
<td>14x</td>
</tr>
<tr>
<td>2010</td>
<td>6x</td>
<td>10x</td>
<td>8x</td>
<td>12x</td>
</tr>
<tr>
<td>2011</td>
<td>4x</td>
<td>8x</td>
<td>6x</td>
<td>10x</td>
</tr>
<tr>
<td>2012</td>
<td>2x</td>
<td>4x</td>
<td>2x</td>
<td>6x</td>
</tr>
<tr>
<td>2013</td>
<td>1x</td>
<td>2x</td>
<td>1x</td>
<td>3x</td>
</tr>
<tr>
<td>2014</td>
<td>0x</td>
<td>1x</td>
<td>0x</td>
<td>2x</td>
</tr>
<tr>
<td>YTD Q3-15</td>
<td>2x</td>
<td>4x</td>
<td>2x</td>
<td>6x</td>
</tr>
</tbody>
</table>
returns have outperformed the S&P 500 Index by 511 basis points and 432 basis points, respectively. This advantage certainly varies over time, but it has quite consistently tilted in favor of PE (see figure 3). (Note that recent comparisons are clouded by the fact that the relevant PE vintages have not harvested all their investments.)

Timing
All that said, we’d still rather invest when prices are low, so should we defer investing until the next cycle? Sounds good, but of course no one can foretell when that may be, or indeed whether today’s prices might seem less expensive in retrospect than they do now—a plausible possibility if global central banks hew to ultra-low rates and extraordinary monetary policies for several more years.

So what’s the best answer? Diversification. Vintage year diversification can mitigate
the impact of business and pricing cycles, smoothing returns much as averaging in does with stocks. For example, according to Prequin, 2009 vintage funds are producing an internal rate of return (IRR) of 17.5 percent, while 2005 funds generated an IRR of 6.2 percent (as of April 2015).

Geographic diversification, of course, also helps. Despite the fact that global correlations are rising, they certainly haven’t reached 1.0; and as monetary policies of the global banks diverge (if indeed they do), pricing disparities certainly will increase.

Style diversification is another powerful idea. Midcap buyout funds may well be investing at lower adjusted prices than large-cap funds, vulture funds at lower effective prices than venture funds, and infrastructure funds often will invest in ways that are uncorrelated to the prices of other assets. Table 1 describes key PE style differences.

Taking all this into account, smaller investors may find that a fund of funds is a cost-effective way to obtain exposure to private equity. These can have numerous advantages, including access to the superior managers, efficient portfolio diversification across investment stage, vintage year, industry, and geography continuums; administrative efficiency and consolidated reporting; and dedicated due diligence, legal, accounting, and tax resources.

Manager Selection
One enormous caveat remains: It really matters which PE managers, and which funds, you choose. The best managers get the best deal flow, talent, and terms because the relevant stakeholders are attracted by their track record. In PE, more than any other investment class, nothing succeeds like success. This is especially so in the venture capital subcategory, where nearly all the industry’s returns are captured by a tiny handful of venture capitalists, but it’s also true of the broader world of private equity. If you’re not with a top-quartile manager, don’t bother. Figure 4 tells the tale.

And performance patterns tend to persist. One recent study found that 35 percent of the top-quartile managers delivered top-quartile performance on their next fund, and only 13 percent delivered bottom-quartile results. By contrast, only 19 percent of the managers of bottom-quartile funds delivered top-quartile performance in their next funds, and 36 percent repeated their bottom-quartile performance again.

Fees
If illiquidity is the number one rap on PE investing, number two is that the associated fees are higher than with public market investments. Let’s dig down a bit before critiquing that objection.

Typically, the manager charges the limited partner an annual management fee along with performance fees, or carried interest, which represents a portion of the profits above a stated hurdle rate.

Management fees on direct fund investments typically range 1.5–2.5 percent annually, and are charged on committed capital. Fees should be, and usually are, reduced after the investment phase. Of course, very roughly speaking, these fee levels are relatively comparable to actively managed portfolios of public securities.

Now, to the carry, which can produce very large fees for the manager; actually, that’s precisely the idea. Normally, the manager will earn 5–20 percent of the profits earned by the fund, if those profits exceed a hurdle rate of about 8–15 percent.

In my opinion, this hurdle rate is the key to fair compensation to the managers. If they...
return an investors’ capital plus that sort of hurdle rate, especially in this environment, it’s hard to see why then capturing 5–20 percent of the additional profits is particularly objectionable—those returns are, after all, a direct consequence of the quality of the managers’ intervention. Of course, it is this exact incentive that brings the best managerial talent into the game. Yes, the gross dollars involved can be large, but, frankly, investors should hope they are, because investors’ returns will be so much the larger.

One key distinction to understand is how these incentive fees are calculated. In the U.S. model, it’s deal by deal, and in the European model, the manager gets incentive fees only after the investor’s whole investment, plus the hurdle, is returned. The U.S. model has various clawbacks and other mechanisms that seek to cancel out any unfair consequences of paying incentive fees deal by deal, but still the European version is to be preferred.

The most basic point of all about fees is simply that, as discussed above, PE’s post-fee net returns generally and substantially have outpaced those of public equities. Isn’t that what we really care about?

The Future of PE Investing
What can we say about the future of PE investing? Well, two things, I think. One, some fundamental changes in the global economy will make it an ever more important part of portfolios; and two, it will become easier and more standardized.

Three reasons augur an increasingly important role for PE investing. The most subtle, and possibly most important, is the rise of the digital economy. At first, this may seem irrelevant to the question of public versus private investments. After all, Google and Apple are both public and big beneficiaries of the trend. But Uber and Airbnb are better examples of the future, the way successful young companies will play the public markets game—meaning, they won’t (at least until somebody needs a really big cash-out event). Digital companies don’t require an initial public offering (IPO) to acquire the funds needed to build their franchises, and whatever cash they do require is readily available through massive pools of capital controlled by venture capitalists and corporate strategic partners.

In this day and age of regulation and litigation, if you don’t need to go public, why would you? Indeed, Nasdaq already has developed Nasdaq Private Market (NPM), a platform that provides a variety of services to pre-public companies, precisely because many of them may stay private indefinitely. For most of the IPOs that do come to market, the companies have long since passed the sweet spot of their growth curve, so the stock may still do fine, but the real pop already has been heard.

The bottom line is that public investors are beneficiaries of an ever-decreasing proportion of the value newer companies are creating.

This phenomenon is actually more pernicious than it at first appears, for it’s not just that new companies are going public less frequently; it’s that those private concerns are rapidly sucking value away from today’s listed companies. Look at automobiles, a mainstay of the U.S. economy for many decades. As advanced technologies become a more important portion of their value, that value is more likely to be added by new companies with technology advances that are nearly impossible to create through internal research and development. The component manufacturers will capture more of the value of new vehicles, at the expense of the assemblers, much as occurred in the personal computer world.

Another change in the global economy that increases the importance of private investing is the increasing share of worldwide gross domestic product generated in developing economies. The U.S. share has fallen by roughly half since 2000, and emerging country share has increased to 57 percent. But most of those countries lack sophisticated capital markets through which investment is plausible (even in India, only a few companies are really large and stable enough to be considered investible by usual U.S. standards). Instead, accessing that growth often will entail private investment, where direct control can be exerted.

Finally, the one non-digital area certain to grow in the developed countries is infrastructure investment. Again, private investment often will be the preferable (or only) way to participate.

My conclusion is that investible growth opportunities increasingly will present themselves in the private sphere.

Coming Soon: Nasdaq Private Market for Alternative Funds
As mentioned, the most often-cited reason to avoid private equity is its illiquidity. In an effort to address that problem (and several others, including the long-term obligations created by capital calls), Nasdaq Private Market, a wholly owned subsidiary of Nasdaq, plans to introduce an important innovation for PE investors in 2016—
THE RATIONALE FOR PRIVATE EQUITY

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a new marketplace for certain types of PE investment securities, designed to provide regular liquidity options for investors.

NPM’s platform will be available to a special kind of mutual fund, sometimes known as an “interval-like” fund. Investors will be given the opportunity to sell interests in monthly auctions through a process designed to generate robust activity and fair pricing.

All funds traded through NPM’s platform will be Investment Company Act of 1940 registered, and thus subject to Securities and Exchange Commission oversight and regulation. The funds also must have elected tax treatment as a regulated investment company, meaning that tax reporting occurs through a Form 1099 and, therefore, that the fund does not generate unrelated business income and is not subject to Employee Retirement Income Security Act of 1974 plan assets issues. All buyers of fund interests on the NPM platform must be accredited investors.

NPM expects to launch its new marketplace later in 2016, a significant step forward for investors seeking liquidity of positions in private equity investments.

Conclusion

There are no bargains out there these days, and no easy answers for robust portfolio growth over the next many years. But, overall, valuations are lower in private market transactions than they are in public securities, and manager intervention offers a better chance of exiting positions at a profit than does passive security selection. I think the comparative returns of the past will hold up going forward (for structural reasons), and I also think that an ever greater percentage of new economic value creation will occur on the private side.

So, yes, for those not already invested in PE, it is indeed time for a serious look.

Bob Rice is managing partner at Tangent Capital, a contributor to Fox News and InvestmentNews, and author of The Alternative Answer, a Wall Street Journal bestseller. Contact him at bob@tangentcapital.com.

Endnotes

