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# Private Equity Primer

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**This primer describes the asset class commonly known as private equity. It attempts to answer the types of questions institutional investors would be likely to ask when considering an investment in this area.**

**Historically, private equity investments have often been grouped in a larger category of investments called alternative investments. Alternative investments have been defined as any investments other than publicly traded stocks and bonds. In addition to private equity investments, alternatives have often included real estate, infrastructure, natural resources, private debt, and hedge funds.**

**This primer is limited to an overview of private equity and only describes the characteristics of the asset class. It does not suggest a target allocation, nor does it specify how to implement an investment program. These issues are client specific and must be addressed by the decision-makers in each group.**

## What is private equity?

Private equity (i.e., "PE") investments are simply equity investments in privately held companies. Private equity investments are generally structured in the form of partnerships that usually consist of 10 to 20 equity investments in individual companies.

Like investments in publicly traded common stocks, investments in private equity funds provide long-term investors with stakes in generative assets (i.e., equity positions). However, unlike publicly traded stocks, private equity funds are not priced daily by a market. Thus, the apparent price volatility is lower and the interim return correlation to other asset classes is subdued.

The private equity market provides a large arena for investing as private firms far outnumber public companies. In the US, there are approximately 1,000 private companies for every publicly listed company[1], and the number of total public companies has declined significantly since peaking in the late 1990s[2]. The relatively small number of US public companies, though, are estimated to be worth approximately 25 times the assets under management ("AUM") in PE funds today.[3] While many private companies are unlikely private equity targets (approximately 55% of US firms have fewer than five employees),[4] the potential opportunity set in private equity is substantially larger than the amount of capital in the asset class.

[1] Source: United States Census Bureau and JP Morgan: *"Guide to the Markets,"* June 2021.

[2] Source: Bloomberg, *"Where Have All the Public Companies Gone?"* April 9, 2018.

[3] Source: Morgan Stanley, *"Public to Private Equity in the United States: A Long Term Look,"* August 4, 2020. Includes dry powder.

[4] Source: United States Census Bureau, 2019.


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Today, private equity investments come in many forms, including venture capital ("VC") funds, buyout funds, and growth equity funds. All of these strategies produce significantly different returns from traditional investment classes and exhibit different fundamental characteristics from each other.

## Who invests in private equity?

Institutional investors such as pension funds, endowments, and foundations comprise the vast majority of capital allocated to private equity, though high-net-worth individuals also participate. The long-term time horizon of these institutions often makes them more willing to invest some portion of their portfolio in illiquid assets. They may also be seeking higher returns and enhanced equity diversification beyond that available through the public stock market. And they must also be willing to accept greater or different risks than are present with traditional public market assets.

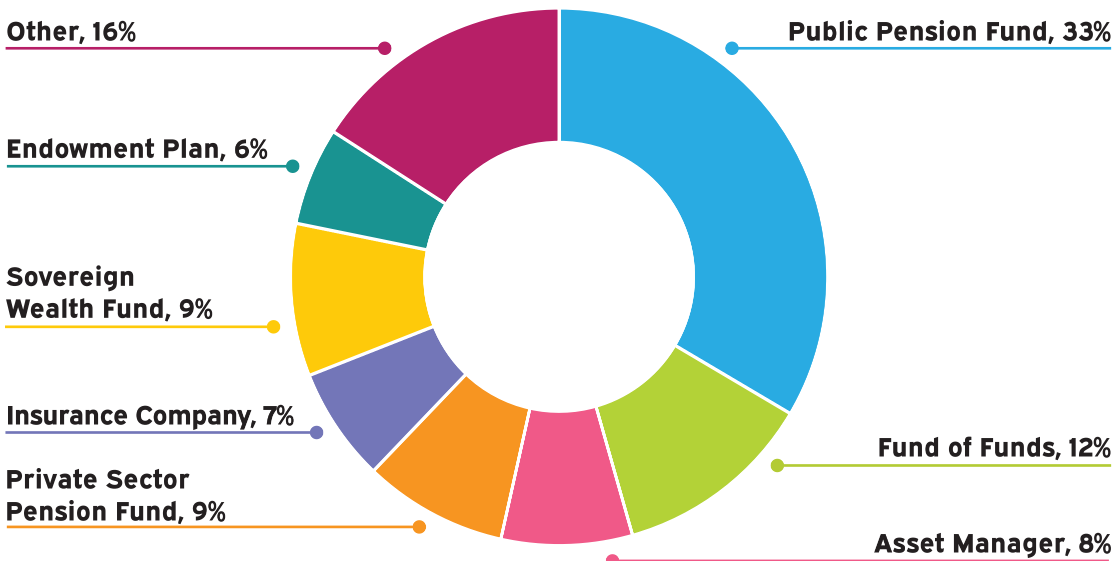


**FIGURE 1**
**Aggregate Amount Invested in Private Equity by Investor Type**
**% of Invested Capital**

Source: Preqin, as of July 2022.

## How large is a typical investment in private equity?

The average target allocation to private equity by endowments, public pension funds, and private pension funds is approximately 11%, ranging from 7% to 16% depending on the type of investor. This represents the target for the entire private equity program, not for an individual investment.


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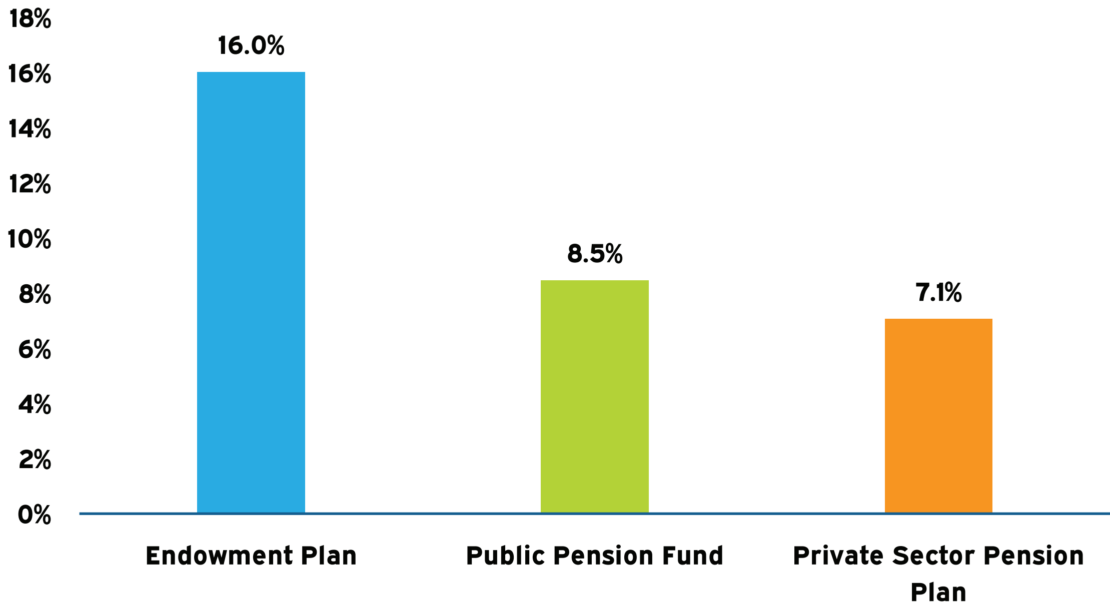


**FIGURE 2**
**Average Private Equity Target Allocation by Investor Type (As a % of AUM)**

Source: Preqin, as of July 2022.

## How has institutional investment in private equity changed over time?

Institutional investors' allocation in private equity has been on the rise in the last decade and is projected to continue to increase. The median private equity allocation among public pensions was approximately 5% in 2012 and has since risen to roughly 8.5% in 2022.[5] Furthermore, 50% of polled institutional investors plan to increase their current allocation, while 45% plan to maintain current rates.[6]

[5] Source: Preqin, *"Future of Alternatives 2025: Investors' Inexorable Push to Alternatives,"* November 2020.

[6] Source: Preqin, Alternative Assets Report H1 2022.

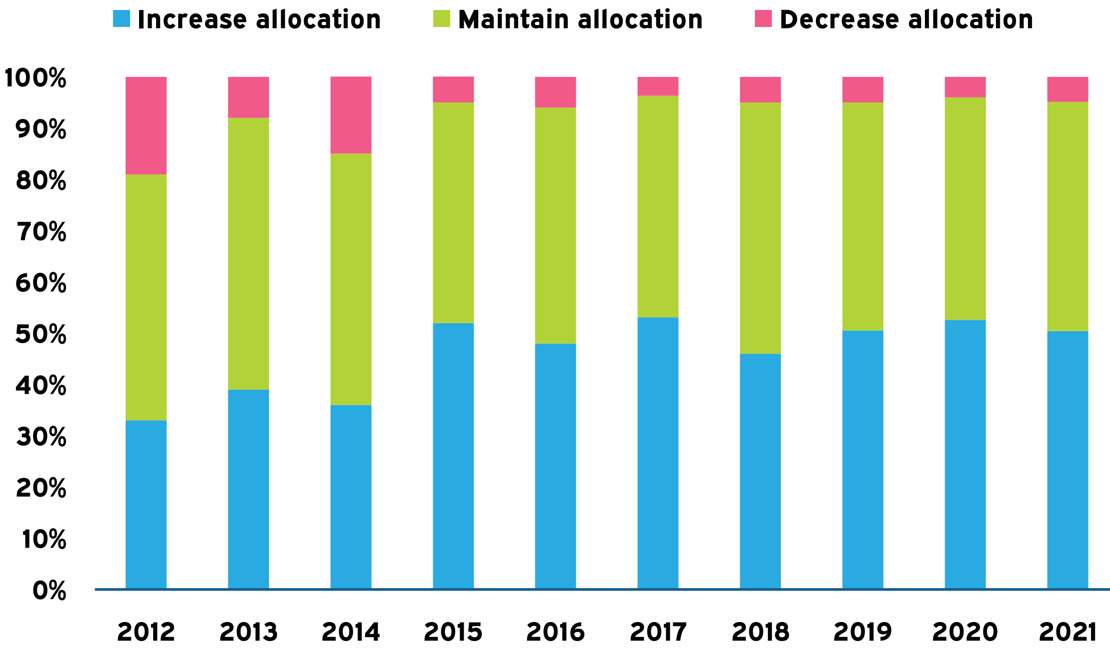


**FIGURE 3**
**Investors' Plans for Private Equity Allocation in the Longer Term**

Source: Preqin, Alternative Assets Report H1 2022.


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## Why invest in private equity?

There are three key reasons why investors tend to invest in private equity. First, adding to private equity should increase the expected return of a portfolio. Second, private equity is an area with the opportunity to generate significant "alpha" via fund/manager selection. Third – though not always readily admitted – an allocation to private equity should also reduce the observed volatility of the portfolio vis-à-vis other ways to increase returns (e.g., increasing the public equity allocation).

### Expected returns

Investors generally assume they will earn more from their private equity portfolio than they will from public equities. This has been the case for the asset class historically, and it is expected to persist in the future.

Private equity has the highest expected return among firms that produce capital markets expectations. Annually, Horizon Actuarial Services publishes a survey of capital market assumptions (see Figure 4) that they collect from various investment advisors. The average expected return is higher for private equity than for any other asset class, both over the 10-year and 20-year horizon.

| Asset Class | 10-Year Average (%) | 20-Year Average (%) |
|---|---|---|
| US Equity | 5.9 | 6.5 |
| Developed Non-US Equity | 6.5 | 7.1 |
| Emerging Non-US Equity | 7.3 | 7.9 |
| Real Estate | 5.4 | 6.0 |
| Hedge Funds | 4.8 | 5.5 |
| **Private Equity** | **9.2** | **9.8** |

FIGURE 4

**Expected Returns for Equity-like Asset Classes**

The survey by Horizon Actuarial Services is published annually and is the most comprehensive survey of capital markets expectations of which we are aware. In the 2022 survey there were 40 respondents. The 10-year horizon included all 40 respondents, and the 20-year horizon included 24 respondents.

### Historical returns

Over the past 20 years, private equity has been the best performing major asset class.

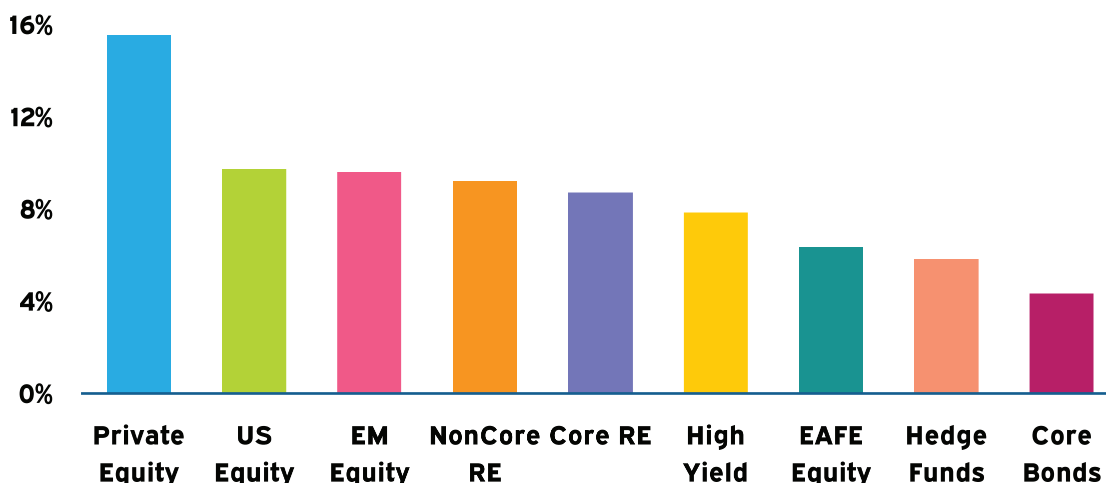


FIGURE 5

**Trailing 20-Year Performance**

Annualized monthly returns as of December 31, 2021. Data sourced from Cambridge Associates via IHS Markit as of August 2022. Indices used: Cambridge PE Composite, Cambridge Non-Core RE, Bloomberg Barclays US Corporate High Yield Bond Index, MSCI EM, Russell 3000, NCREIF Property Index, Bloomberg Barclays US Aggregate Bond Index, HFRI Weighted Composite Index, MSCI EAFE. PE and Non-Core RE values are Pooled IRR. PE, Core RE, and Non-Core RE are annualized quarterly returns. Note that all historical performance presented throughout this document is net of fees.


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Historically, private equity investors have earned 2% to 5% per year more than investors in comparable common stocks (see Figure 6), even after paying substantial management fees and other costs. Over the last decade, excess private equity returns have shrunk, at least relative to US equities (the margin over foreign equities remains quite wide). Potential reasons behind the decline include increasing valuations of private companies and the influx of capital being invested in the space.

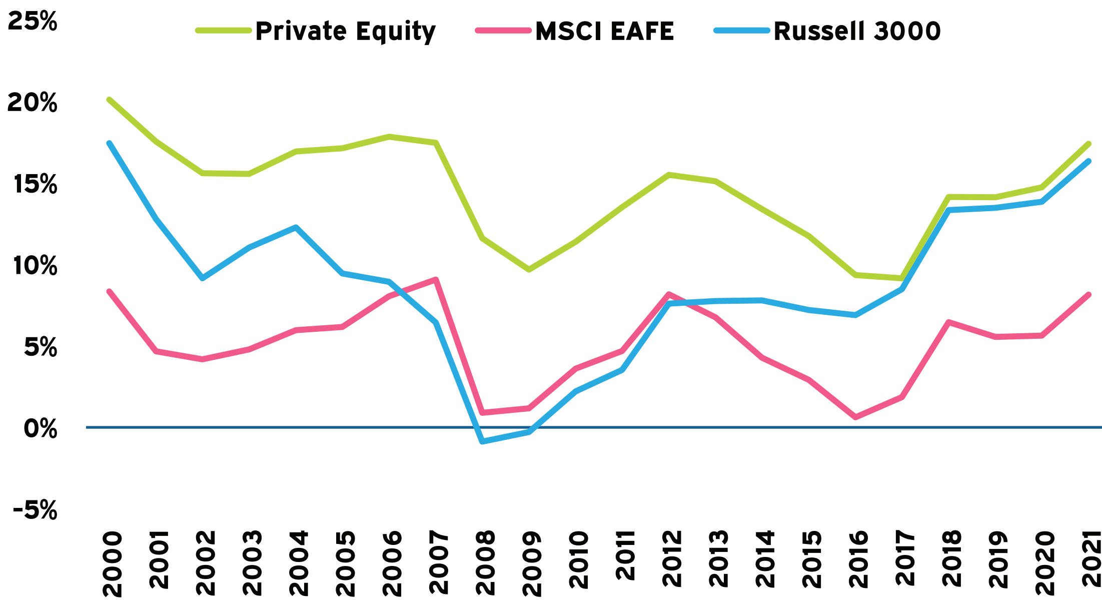


**FIGURE 6**

**Rolling 10-Year Returns**

Rolling 10-Year Annual Returns as of December 2021. Data sourced from Cambridge Associates via IHS Markit as of August 2022. Indices used: Cambridge PE Composite, Russell 3000, MSCI EAFE.

Academics and practitioners have offered a number of explanations for the superior performance of private equity historically.

- → PE investors can "sell" unneeded liquidity to capital-needy businesses. Generally, investors demand a premium for liquidity risk; that is, they expect to earn a higher cumulative return as compensation for giving up liquidity on a short-term basis. The businesses that need the capital are willing to pay this premium for various reasons, including the desire to grow the business, make strategic acquisitions, cash out a founder, etc., all while keeping the enterprise in private hands.

- → General partners ("GPs") can create a better alignment of interests between owners and management. Private owners generally produce better financial results. This is often ascribed to the inherent longer-term approach they take to management and capital expenditures. In contrast, there is an inherent agency problem with most public companies where management and shareholders do not necessarily share identical interests.

- → GPs can improve the value of the asset by being a "control" investor. Most investors in public companies have minimal influence individually over how those companies are run. In contrast, most private equity funds either take a controlling stake or a position where they can exert significant influence over strategic and management


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decisions. Many private equity managers have experienced in-house operations teams and expertise in turning around a struggling business, ramping up growth of a mature business, or accelerating the trajectory of a rapidly growing firm, among other strategies. These teams can assist in and add value to the company's business strategy formation, operational execution, mergers and acquisitions, and capital raising.

→ GPs can take advantage of mispricing opportunities that are larger and more frequent than those in public markets. Information asymmetries in the private markets may allow for PE managers to invest in companies at a discount to fair value. Private companies, especially those in the small/mid-market segment, have historically been valued at significantly lower EV/EBITDA multiples than public companies.

→ GPs can use leverage to a greater extent. Many GPs engage in financial engineering to boost the return of the funds they manage. Adding debt to finance acquisitions or to pay dividends boosts the return to investors in companies for which the gains exceed the cost of borrowing.

### The importance of manager selection

Private equity asset classes such as buyouts, growth equity, and venture capital show considerably higher performance dispersion as measured by interquartile spreads (see Figure 7). These interquartile spreads can be interpreted as how much potential value lies in selecting superior active managers within each asset class. When comparing interquartile spreads between private and public markets managers, it is worth noting that the private market databases are often smaller, and with more limited history, than public market counterparts. Private equity funds also tend to have more concentrated portfolios; hence, more dispersion should be expected among private equity funds.

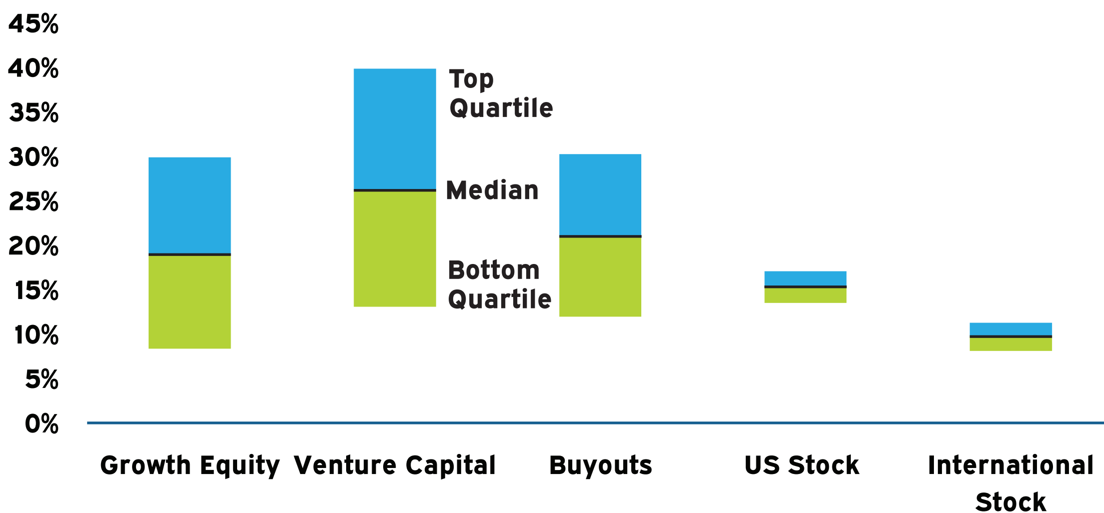


FIGURE 7
**Quartile Returns, Last 10 Years**

Data sourced from Cambridge Associates via IHS Markit and eVestment. Data for PE funds raised from 2012 through December 2021 and public equity managers for the trailing 10 years, as of December 2021. All data sourced in August 2022.


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Several of the factors that explain the relative outperformance of private equity also help explain the large dispersion of returns among private equity funds. For example, because of both the vast number of investable firms and the lower amount of readily-available financial and operational information about such firms, private equity is a much more inefficient asset class than public equity. This means that skilled investment managers should be able to take advantage of the larger mispricing opportunities to add value. Likewise, managers who are more skilled at growing or turning around a business are more likely to add value relative to their peers.

Furthermore, direct exposure to private equity is not available via passive vehicles but only through active managers. Since investors cannot "fall back" on mimicking the returns of a private equity index, and since there is much potential value to be gained from picking an above-average manager (or to be lost from picking one that is below average), manager selection is critical. There can be so much demand for managers with top historical performance records that access to their funds is often quite limited. Access to these top funds is often a critical component for investors whose private equity programs outperform their peers.

### Lower observed volatility

Private equity returns have exhibited much less volatility than have public equities (see Figure 8). This is because, unlike public market securities, private equity assets are not priced daily. Rather, they are valued quarterly, and managers have fairly wide latitude in applying valuation methodologies.

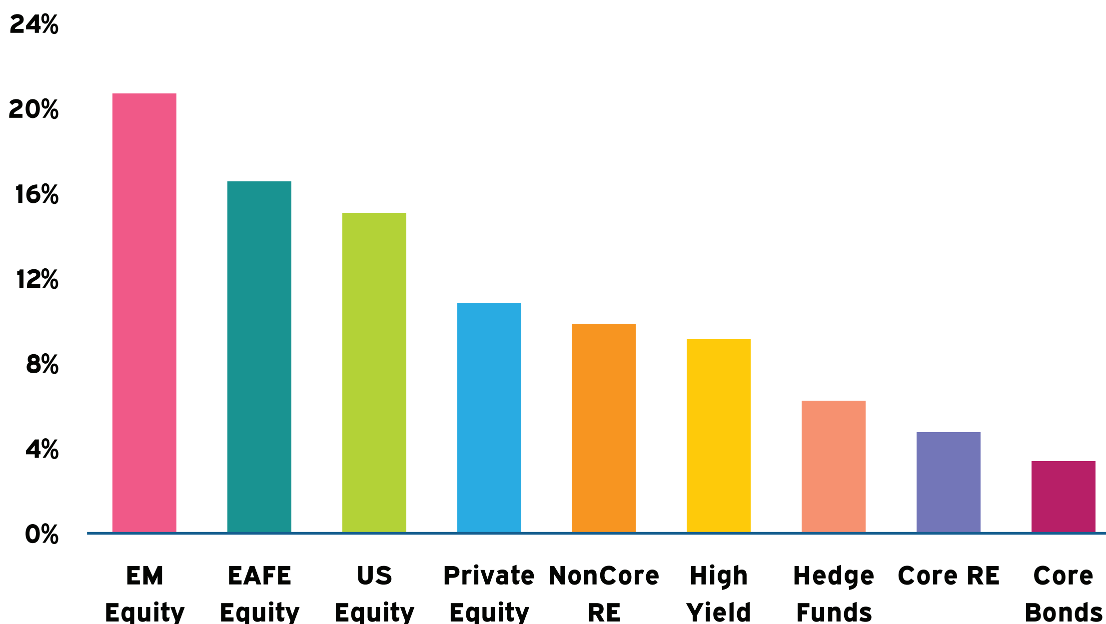


**FIGURE 8**
**Trailing 20-Year Volatility**

Annualized monthly standard deviation as of December 31, 2021. Data sourced from Cambridge Associates via IHS Markit as of August 2022. Indices used: Cambridge PE Composite, Cambridge Non-Core RE, Bloomberg Barclays US Corporate High Yield Bond Index, MSCI EM, Russell 3000, NCREIF Property Index, Bloomberg Barclays US Aggregate Bond Index, HFRI Weighted Composite Index, MSCI EAFE. PE and Non-Core RE values are Pooled IRR. PE, Core RE, and Non-Core RE are annualized quarterly returns. Note that all historical performance presented throughout this document is net of fees.

Moreover, price changes tend to be reflected on a lagged basis in reporting, perhaps taking as long as two quarters to reflect equivalent changes in public securities. The result is a "smoothing" of the returns experienced by private equity investors (see Figure 9).


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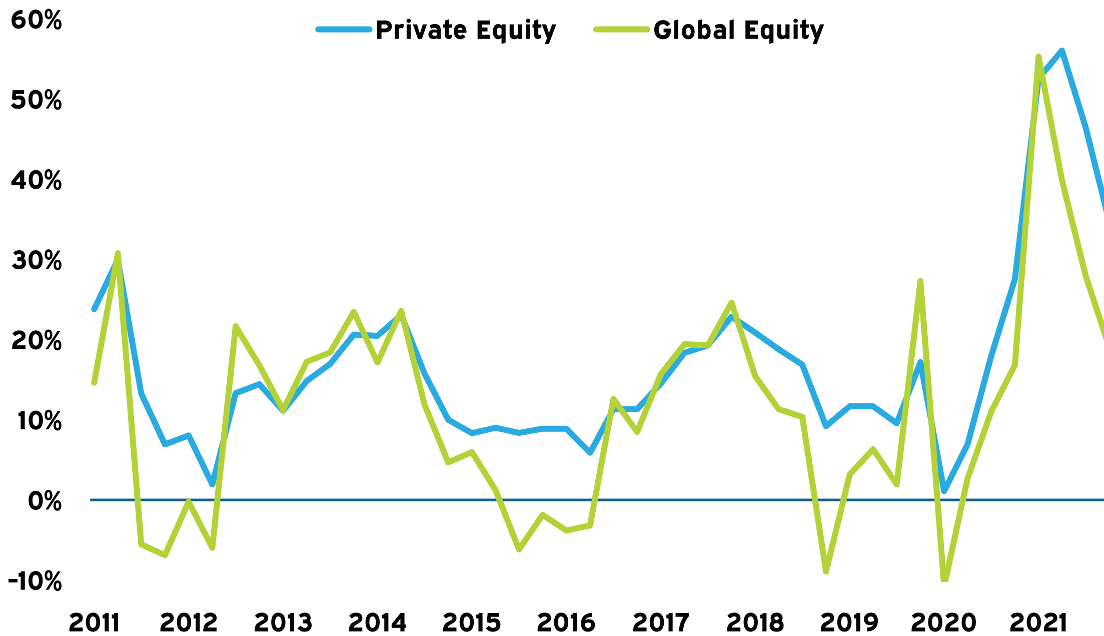


**FIGURE 9**

**Rolling 1-Year Returns**

Annualized quarterly Pooled IRR as of December 31, 2021. Data sourced from Cambridge Associates via IHS Markit as of August 2022. Indices used: Cambridge PE Composite, MSCI ACWI Index.

However, this lower observed volatility does not mean that private equity is less risky. It is often quite the contrary. Private equity portfolios tend to be more concentrated and the underlying companies more highly leveraged (in the case of buyout funds) with less diverse revenue streams than their public market counterparts. That said, the perception of lower risk (from smoothed returns and – arguably – a more rational valuation process) does have a real-world effect on investors maintaining consistent exposure to this risky asset class.

## What risks can investors expect?

In order to obtain the higher returns that private equity investors are looking for, they often must also take on additional risks. One of the most notable risks is the lack of liquidity since investors are generally unable to pull capital from a fund once it has been invested. Too much in illiquid assets may inhibit an investor's ability to meet its obligations in a worst-case scenario. Further, illiquid assets cannot be rebalanced in the interim, which can lead to unintended deviations from a policy benchmark.

Venture capital fund investors are also subject to the risk that results from investing in early-stage companies, which are much more likely to fail relative to mature businesses. Buyout fund investors face a somewhat similar risk by generally targeting micro- or small-cap companies, which are more susceptible to economic downturns and other exogenous events than the large-, and mega-cap companies comprising the majority of public equity exposure. Additionally, buyout funds often employ above-average leverage (relative to public companies), leading to a potentially higher risk of insolvency. The success of many distressed, turnaround, and buy and build strategies are predicated on significant operational improvements.


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The different sectors of the private equity market have produced different returns historically (see Figure 10). Over the full 1987-2021 period, venture capital has proved (unsurprisingly) to be the riskiest segment of private equity, exhibiting a higher volatility and maximum drawdown than public equities, primarily due to the dot-com bubble and subsequent burst in the early 2000s. Since 2003, venture capital returns have been strong, at 14.3%, while standard deviation and max drawdown over that period have dropped to 10.3% and -19.2%, respectively[7].

[7] Annualized quarterly Pooled IRR, as of December 2021. Data sourced from Cambridge Associates via IHS Markit as of August 2022. Index used: Cambridge Venture Capital Composite.

| January 1987 – December 2021 | Venture Capital (%) | Buyout (%) | Growth Equity (%) | MSCI EAFE (%) | Russell 3000 (%) |
|---|---|---|---|---|---|
| Annual Return | 16.0 | 14.7 | 16.8 | 6.1 | 11.2 |
| Annual Standard Deviation | 20.0 | 9.9 | 14.5 | 18.4 | 16.8 |
| Cumulative Maximum Drawdown | -68.8 | -33.4 | -36.5 | -52.1 | -45.9 |

**FIGURE 10**
**Private Equity Returns from January 1987 through December 2021**

Annualized quarterly Pooled IRR, as of December 2021. Data sourced from Cambridge Associates via IHS Markit as of August 2022. Indices used: Cambridge Venture Capital Composite, Cambridge Buyout Composite, Cambridge Growth Equity Composite, Russell 3000, MSCI EAFE.

An important but often overlooked risk is that “alpha” can be negative and at a greater magnitude than in public markets. Looking back to Figure 7, even though the median private equity fund had outperformed the median public equity manager historically, the bottom quartile manager of the venture, growth, and buyout universes underperformed the bottom quartile manager in US equities.

There is also the potential for poor vintage year timing when structuring a private equity program. Missing out on a particularly good year or overcommitting to a particularly bad one will harm performance. Finally, the general lack of transparency makes it harder to conduct due diligence on managers.

## What are the criticisms?

In recent years, a number of academics and industry participants have questioned if private equity actually lives up to the expectations of many institutional investors. The bold bullet points below list several primary concerns followed by commentary addressing the mitigating factors related to each criticism.

→ **Private equity’s outperformance relative to public equity has declined over time.**

Private equity’s outperformance relative to US equities has been lower in recent years than it has been historically. Some of this is obviously driven by the post-Global Financial Crisis (“GFC”) bull market for US stocks. When compared to an opportunity set that more closely resembles that of most PE investors (i.e., a benchmark that includes non-US companies), the margin has not decreased to quite the same degree. Moreover, there is still strong evidence that private equity investors have continued to generate attractive absolute returns while outperforming public market equivalents (see Figures 4, 5, 6, and 10).


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→ **Private equity asset valuations are frothy and are near all-time highs. Research shows that forward private equity returns tend to be lower when starting valuations are high.**

Prices are elevated across all asset classes, including private equity. This argues for lower absolute private equity returns than those experienced in the past, but not necessarily for lower relative returns (i.e., private equity does not appear to be any more expensive to its own history than public equities do).

→ **Benchmarking private equity performance is challenging because it does not conform to the standard approaches used in public market asset classes.**

It is true that measuring performance for private markets assets is not as straight-forward as it is for public equities. However, that should not preclude investment by institutions. Valuable performance analysis can often be performed by comparing aggregate returns to a peer and/or public market equivalent (i.e., "PME") benchmark in combination with a more granular analysis of historical exposure and return drivers.

→ **Private equity managers charge high fees, including a long-time industry standard "2 and 20" fee structure.**

The fees charged by GPs for their private equity funds are often among the highest in the investment industry. Despite these high fees, private equity has produced strong absolute and relative returns on a net basis. Some (mostly larger) investors mitigate the fees by deploying a portion of their PE capital into lower-fee private equity investments like co-investments and direct investments.

→ **For very large investors, there are some limits on their ability to deploy a meaningful amount of capital in private markets.**

Deploying into the private markets at scale brings challenges. However, these challenges can usually be addressed. Gradual increases in program size and thoughtful pacing allow for measured deployment of capital. Investors can set up separately managed accounts ("SMAs") with advisors to create separate portfolios of VC or small buyout exposure fills in some of the gaps. Investors can also build co-investment programs that rely on relationships with very large managers to get better co-invest access, relationship pricing, special SMAs, etc.

**There can be headline risk, particularly for institutions or assets that are in the public spotlight.**

Private equity firms are often control-owners of companies. As such, they are seen as accountable for a number of business practices that - while possibly within industry norms - are not universally appreciated by society (e.g., layoffs, bankruptcies). However, there is evidence that private equity-owned businesses exhibited better job growth statistics than publicly-owned corporations and that PE has a positive effect on productivity and job growth in the US.[8]

[8] Sources: "Economic contribution of the US private equity sector in 2020," May 2021, prepared by Ernst & Young prepared for the American Investment Council; "The Impact of Private Equity Buyouts on Productivity and Jobs," August 2020, prepared by the Committee on Capital Markets Regulation.


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## How large is the private equity universe?

The private equity marketplace has become increasingly developed and sophisticated, attracting institutional investors of all types. It has reached a size at which it should not be ignored by institutional investors of sufficient scale.

While annual commitments to private equity declined in the wake of the GFC, they have since been on a steady rise and have surpassed pre-GFC levels in recent years.

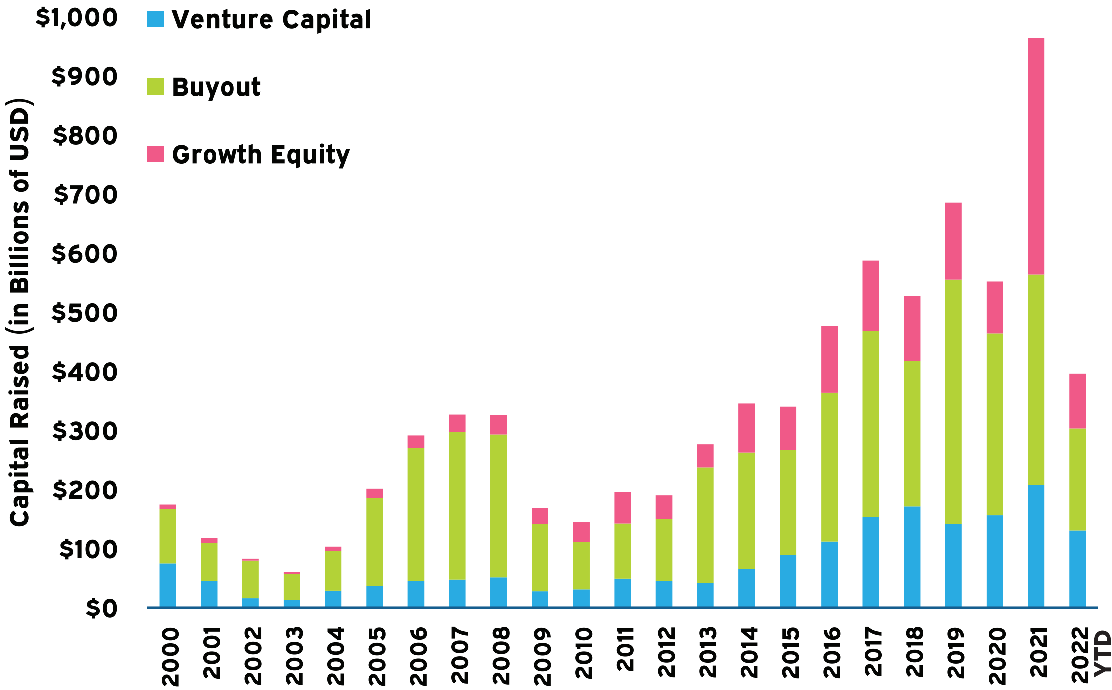


**FIGURE 11**
**Aggregate Capital Raised Globally by Vintage Year**

Source: Preqin, as of July 2022.

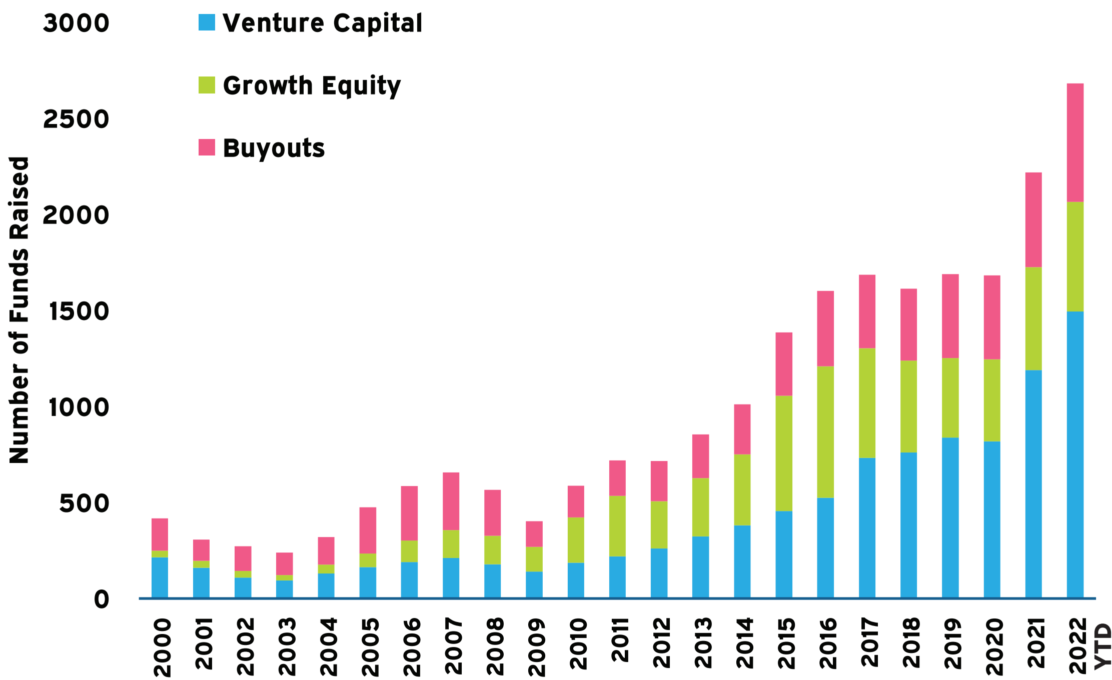


**FIGURE 12**
**Number of Funds Raised Globally by Vintage Year**

Source: Preqin, as of July 2022.



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## How do private equity partnerships work?

The legal structure through which most institutions invest in private equity is a partnership. First, a general partner creates the legal framework of the partnership, prepares a private placement memorandum ("PPM"), and raises commitments from institutional investors who become the limited partners. Each partnership agreement specifies a legal "term," by the end of which all of the investments must be liquidated and the proceeds returned to the investors.

A PPM describes the types of investments the general partner intends to make but does not specify the actual investments, since they have not yet been made. As a result of this uncertainty, such a partnership is known as a "blind pool." Most private equity partnerships begin as blind pools, though some may have "seed assets" that new investors can gain exposure to at cost.

When enough capital has been committed (but not yet invested), the general partner "closes" the partnership and begins making investments. The usual three-to-five-year period during which the general partner makes its investments is known as the investment period. Over the course of the investment period, the general partner may purchase stakes in 10 to 20 different underlying firms. Thus, each partnership is actually a collection, or portfolio, of individual company investments, not a single investment.

At the beginning, the investments are generally carried at cost, and the investors might experience a small negative return, calculated as their initial investment minus the associated organizational expenses and management fees. Because of these initial negative returns, which typically turn positive, a graph of returns is usually J-shaped. This so-called "J-curve" is normal, and limited partners should expect this early in the partnership's lifetime.

By the middle of the partnership period, some early investments may already have matured, been sold, taken public through an IPO, or otherwise liquidated. The proceeds from these liquidations are generally *not* reinvested in the other investments but are distributed immediately to the limited partners as specified in the terms of the partnership agreement. As the end of the partnership's term approaches, most of the underlying assets will have been sold. Thus, all private equity partnerships are self-liquidating, generally over a period of about eight to twelve years.

Note that private equity partnerships are usually not SEC-registered, and that the general partner does not accept the role of a fiduciary as defined by ERISA. However, many plan sponsors use an investment advisor who does serve as a fiduciary to select these partnerships.


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## What is the difference between committed and invested capital?

Private equity partnerships require an advance commitment of capital; unlike liquid investments, these funds do not need to be sourced all at once when this legally-binding commitment is made. The majority of the commitment is drawn down ("called") by the general partner over a period of usually three to five years, during which time the cumulative invested capital is *less* than the committed amount. Normally, the general partner will hold a portion of the commitment as "reserves" for the future financing of the portfolio companies acquired during the investment period. While one commitment is being drawn down, other partnerships may be paying off, effectively reducing exposure to the asset class.

Therefore, to maintain a fixed level of exposure to private equity, it is often necessary to make a greater commitment than the targeted increase in allocation. Additionally, because committed capital is called only gradually, it takes a number of years for private investments to ramp up to their target allocation. This is in contrast to liquid investments, which can be entered and exited swiftly.

## What are vintage years?

To remain prudently invested, both public and private equity portfolios must be diversified across many different individual investments. In both cases, this means investments in companies of different sizes, situated in different geographic areas, and involved in different business activities.

However, unlike public equity portfolios, private equity investments should be diversified across time as well. Since individual partnerships have finite life spans, new partnerships are created every year. The year in which a partnership makes its first investment is known as its "vintage year." Depending upon macro-economic events and available opportunities, some vintage years have better performance than others. Therefore, it is essential to structure investments and plan cash flows to ensure diversification across multiple vintage years.

## What about short-term liquidity?

Private equity partnership interests are not traded on a short-term basis. Until the early 1990s, there was virtually no secondary market through which an investor could sell a partnership interest prior to final maturity. This lack of short-term liquidity was a deterrent to some investors and perhaps limited the growth of the asset class.

Many private equity investors have a limited need for short-term liquidity. However, during and in the aftermath of the GFC, many institutional investors sought liquidity for private equity positions. As private equity values declined, distributions fell considerably while there was a less significant drop in capital calls, and so, liquidity was needed to help rebalance portfolios.


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This secondary market creates liquidity for existing investors, but it also comes at a price, as most buyers of partnership interests will expect to purchase the assets at a discount to their net asset value ("NAV").

The secondary market offers new investors in private equity the opportunity to "buy into" seasoned, existing funds, thus accelerating an otherwise lengthy startup period. The secondary market has become more prominent in the past decade as performance has increased. As of 2021, AUM in the global secondary market had grown by over 7x since 2008.[9]

[9] Source: Preqin, as of September 2022.

## How does an allocator invest prudently in private equity?

Private equity funds should be selected by professionals and carefully structured and monitored. Working closely with their private equity manager(s), trustees should take the following steps:

→ Specify in advance their program's long-term allocation to private equity investments, being mindful of their tolerance for illiquidity in a portion of its assets.

→ Develop an investment policy and set of investment guidelines, including targets for performance and diversification (e.g., by geography and partnership type).

→ Conduct a cash flow analysis to plan how the target allocation will be achieved and maintained.

→ Source individual private equity funds that are consistent with these objectives.

→ Scrutinize each fund closely, to identify its unique characteristics and risks. Note that the analysis, due diligence, and legal review of these partnerships are often significantly more complex and comprehensive than that entailed in public equity manager searches.

→ Monitor all private equity funds, to confirm that assets are invested prudently and as intended.

## How does a fund stay invested?

Unlike public equity funds, private equity partnerships are typically self-liquidating. Thus, if assets are committed to private equity in a single partnership, and if the lifetime of that partnership is 10 years, then a fund will generally be liquidated within a few years of that time frame.

While the approximate length of each partnership's life span is known in advance,[10] the actual pattern of interim cash flows cannot be predicted precisely. In some cases, a

[10] Although fund terms may be extended through approved revisions to Limited Partnership Agreements.


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partnership may make a number of early dispositions, causing much of the original commitment to be returned to the limited partners sooner than expected. In other situations, however, private equity funds can take longer than expected to return capital, potentially causing limited partners to become over-allocated to private equity.

It has become increasingly common for private equity funds to take longer than their typical terms of 10 to 12 years to be fully liquidated. The average time to liquidation has been rising across all areas of private equity, while annual distribution rates (as a percentage of unrealized value) have been falling.[11]

[11] Source: Hamilton Lane, "Acceleration of Trends: SPACs, GP-Leds, and the Case of the Longer Hold," April 2021.

The experience of many institutional investors has demonstrated that an intensive, ongoing monitoring and rebalancing program is necessary with private equity to maintain a specified target allocation. When distributions occur earlier than anticipated, private equity investors must seek new partnerships to reinvest the liquidation proceeds. When distributions take longer than expected, private equity investors may need to taper future commitments somewhat or even consider secondary sales of their LP stakes. These processes are complicated by the unpredictable timing of both liquidations and new capital calls.

## How are costs and fees structured?

Private equity investment programs are much more complicated to create and administer than public equity programs. Private equity involves long-term planning, adjusting to liquidity constraints, complicated accounting procedures, and extensive legal review of individual partnership investments.

There are two generic types of fees associated with private equity investing. The first is a fee for professional portfolio management. This fee can vary across fund types, fund sizes, etc., but typically ranges from 1.8% to 2.1% per year. The management fee is generally applied to a limited partner's aggregate commitment amount during the investment period and on net invested capital (invested capital less cost of realized investments and write-offs) thereafter.

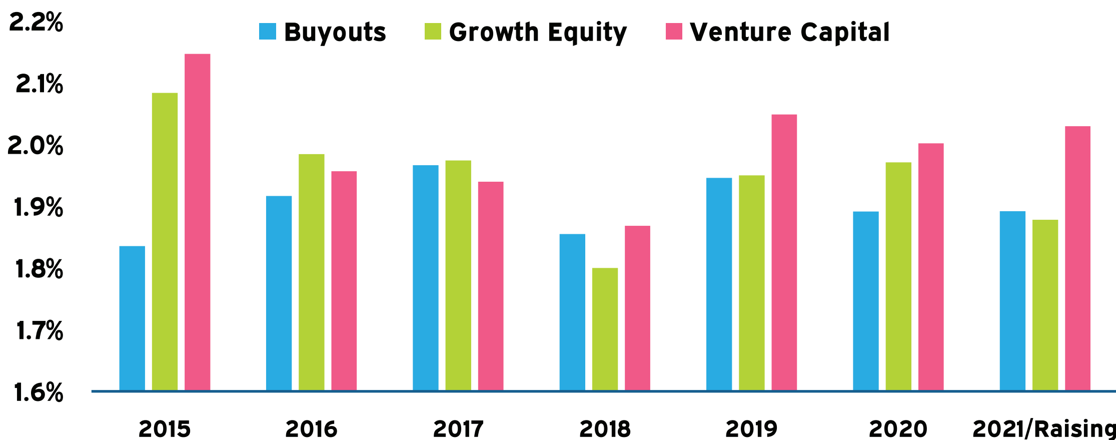


**FIGURE 13**
**Mean Management Fee by Fund Type**

Source: Preqin "The 2021 Preqin Private Capital Fund Terms Advisor," September 2021.


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The second type of fee is called "carried interest," which represents a type of performance incentive fee for the general partner and is typically set at 20% (though top-tier VC funds often charge 30%). Once the general partner has produced a baseline annual net return for the limited partners (called a "preferred return"), all future profits are divided between the general partner and the limited partners. Buyout funds typically have an 8% preferred return while many venture capital funds have no return hurdle. Funds with a preferred return often implement a "GP catch-up" where the GP takes a larger share of the profits (usually 50%-100%) until receiving a proportion of profits equal to its carried interest.

The transaction costs and management fees associated with private equity funds are often substantially higher than for public equity funds. Any investor in private equity must consider these costs carefully. Fortunately, the higher fees can often be offset by the higher potential returns.

## How is private equity different administratively?

The administration of private equity investments differs substantially from that of public market investments in three important areas: maintaining target allocations, management of cash flows, and performance reporting.

Due to their illiquid nature, private equity investments cannot be bought or sold easily. As a result, unlike public market investments, an allocation to private equity investments cannot be finely tuned through periodic rebalancing. The potential therefore exists for regular deviations from a fund's private equity target allocation as a result of uncertain private equity cash flows and performance differentials across asset classes.

The cash flows associated with private equity investments are frequent and unpredictable. Generally, there is little advance notice of capital calls, distributions of cash proceeds, or the receipt of securities in-kind. Fund administrators must have procedures in place to accommodate these cash flows reliably and efficiently.

Finally, no market valuation mechanism exists for private equity investments. Typically, private equity investments exhibit modest changes in value until a formal transaction (i.e., additional financing or a disposition) results in the realization of a gain or loss on the investment. Also, valuations from the general partner are typically available well after the valuations for public market portfolios. For example, year-end valuations are usually not available until the second quarter of the following year. Once private equity investments are sold, usually over a period of five or more years, performance evaluation then becomes more meaningful.


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## What is a fund of funds?

To achieve adequate diversification, investors have two options. First, as described above, they can establish positions in a variety of direct partnerships, diversifying across vintage years, sectors, regions, and general partners. This approach minimizes costs and allows the investor to create a customized pool of partnerships. The main disadvantage of this method is administrative: selecting and overseeing many different partnerships is an ongoing, complicated process. A second solution is to hire a "fund of funds" manager. A fund of funds is what its name implies: a collection of many partnership funds managed by a master partner.

A fund of funds is structured as a partnership. The manager of a fund of funds is the general partner and may or may not be an investment manager as defined by ERISA. The manager selects the underlying funds and provides administrative accounting.

Fund of funds are designed to appeal to a broad spectrum of potential investors but particularly those without the resources to select and monitor funds themselves. A typical fund of funds is designed to provide exposure to many different sectors, in proportions that the manager believes are prudent. As a consequence, it is not possible for participants to control individual investments. For example, when using a fund of funds approach, an investor usually cannot favor buyout funds while limiting venture capital exposure.

Just as with direct private equity funds, a fund of funds is organized as a blind pool. That is, when a new fund of funds is announced, and a subscription target is set, early investors usually do not know what specific funds will be selected by the manager. Generally, the manager has broad latitude in making subsequent investments.

The significant advantages of a fund of funds are potential access to top performing funds, diversification, and administrative ease. The top performing private equity funds are in the market raising capital for a relatively short period of time and are often oversubscribed. The general partner, in that situation, has the right to select the limited partners. A fund of funds manager may have relationships with these groups and, as such, may have easier access to them. A fund of funds may invest in 15 or more underlying funds, each of which may consist of 10 or more investments. When fully invested, a fund of funds may therefore consist of several hundred different investments. Also, individual funds may be selected from several vintage years, and thus, there is some diversification across time as well.

This added diversification comes at a significant cost. Fund of funds managers typically charge a management fee of 1% per year, which is added to the fees charged by each of the individual funds. Also, the manager of the fund of funds often takes a share of the profits (usually 5%-10%) that remain after each of the underlying funds deducts their share of the profits.


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Since a fund of funds is a partnership, it has a finite lifetime and is self-liquidating. The manager may take several years to invest in underlying funds thus investing across multiple vintage years. Once the fund of funds is fully invested, it has effectively entered its harvesting phase and will self-liquidate over the rest of its life as the underlying partnerships make distributions. *Thus, a fund of funds does not eliminate the need to search for new funds in order to stay fully invested in private equity.* Additionally, a fund of funds may have a longer term than individual funds and could be less liquid in the secondary market.

## Conclusion

Private equity investing is compelling primarily for its potential to produce higher returns, attributable to several drivers. First, investors should receive a premium for sacrificing liquidity. There is enhanced alignment of interests between management and owners. Additionally, private equity managers often have differentiated expertise and the ability to add value by executing on a repeatable playbook that includes long-term operational and governance improvements. Finally, private equity is an inefficient asset class with more opportunities to identify mispricings and alpha than in the public markets. All these rationales are substantiated by the historical track record of private equity.

While the case for investing in private equity is compelling, investors should be aware of the asset classes' unique risks. Private equity is expensive and can be administratively difficult to implement. Private equity differs from many other investment vehicles in terms of the timing of cash flows, fee structure, liquidity, and areas for diversification. As always, Meketa Investment Group recommends that investors conduct careful due diligence to make sure that any investment matches the fund's objectives and constraints.


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