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Viewpoints

Lag effect in Private Equity, or "Where are my returns?"

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CONTRIBUTORS
Steve Hartt, CAIA
Stephen McCourt, CFA
Luke Riela, CFA
Lance Clarice

Over long time periods, private equity has outperformed public equity. However, there have been periods, including the first half of 2023, where private equity appears to underperform public equity. This apparent private equity underperformance can happen when public equity markets are rising, while conversely, private equity can appear to outperform when public equity markets are falling. Over long periods of time, these differences balance out and private equity has shown to outperform public equity.

While in some ways, equity is equity, whether private or public, there are some important distinctions between public and private. The observed volatility for private equity appears to be less than public equity. Driving this is that unless there is a significant event, private equity portfolio company valuation models tend to result in much more stable values than those determined in daily priced public markets. Further, private company valuations can be lagged 3 months or more and are generally updated on a quarterly basis.

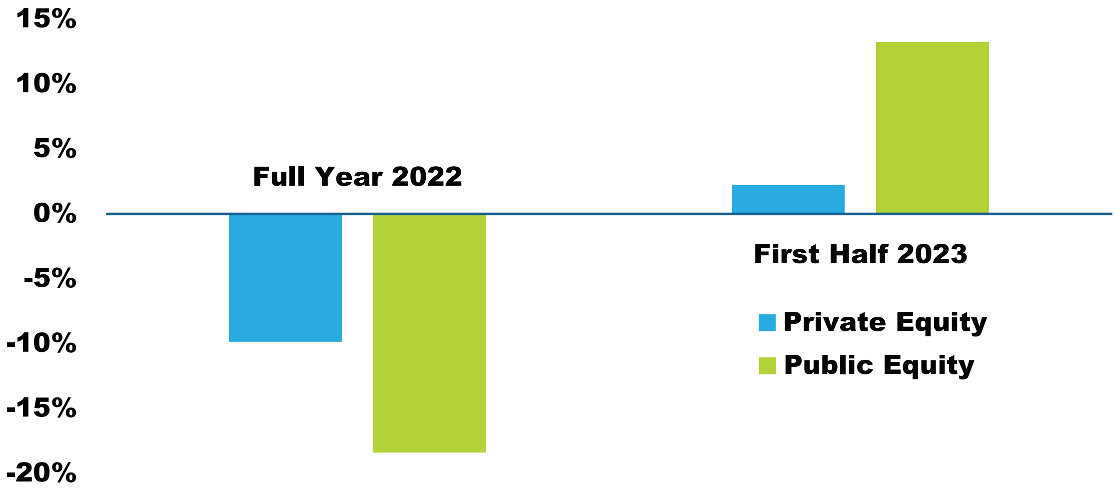

FIGURE 1

Recent Public Equity & Private Equity Performance

Source: Public Equity performance is MSCI ACWI for the calendar year 2022 and for the calendar first half of 2023 through June 30, 2023. The Private Equity performance is Cambridge Associates Global Private Equity & Venture Capital quarterly performance for the full year 2022, while First Half 2023 represents quarterly performance for Q4 2022 and Q1 2023 which are the most recently available as of July 2023.

An example of apparent private equity underperformance can be seen in the returns of public and private equity during the first half of 2023. As shown above, private equity had stronger performance than public equity for the full year 2022. However, private equity performance has appeared to lag public equity performance in the first half of 2023. This observed private equity underperformance is due, in part, to the valuation policy practices described above, as well as the lag in private equity reporting. For instance, Q2 2023 private equity performance data are likely not going to be available until late August, or perhaps September 2023. As such, private equity investors will not see how their investments performed in Q2 2023 until they receive their quarterly statements, while public equity investors can see their investment performance in real time.

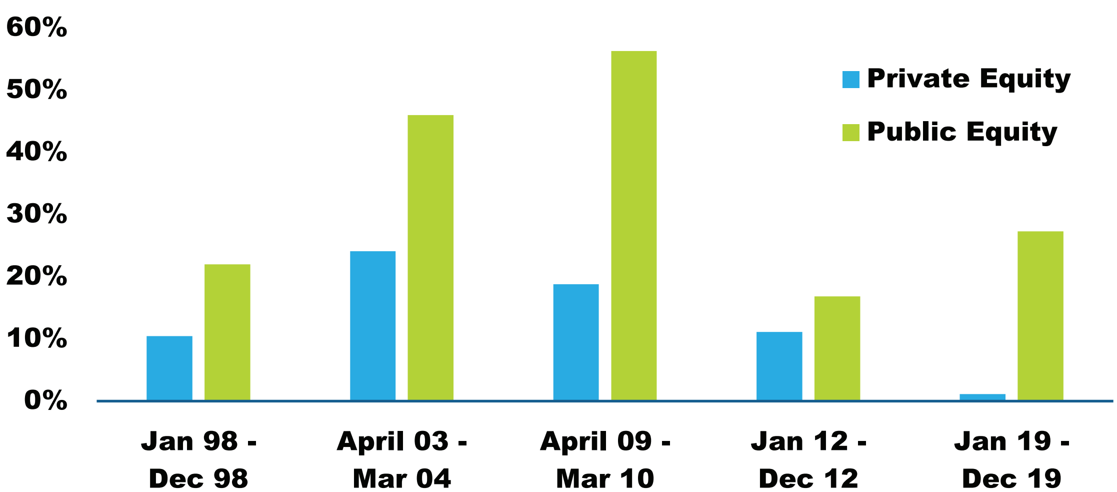

FIGURE 2

One Year Returns Public vs. Private Equity

Source: 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.

We have seen other periods where private equity performance has appeared to underperform public equity, so this phenomenon is not new. As shown in the chart above, there have been other times where the 12-month performance of private equity has lagged the 12-month performance of public equity. Often this happens when public markets have very strong upturns, and thus private equity can appear to lag.

Historical returns

Over the past 20 years, private equity has been the best performing major asset class. Historically, private equity investors have earned 2% to 5% per year more than investors in comparable common stocks, even net of fees.

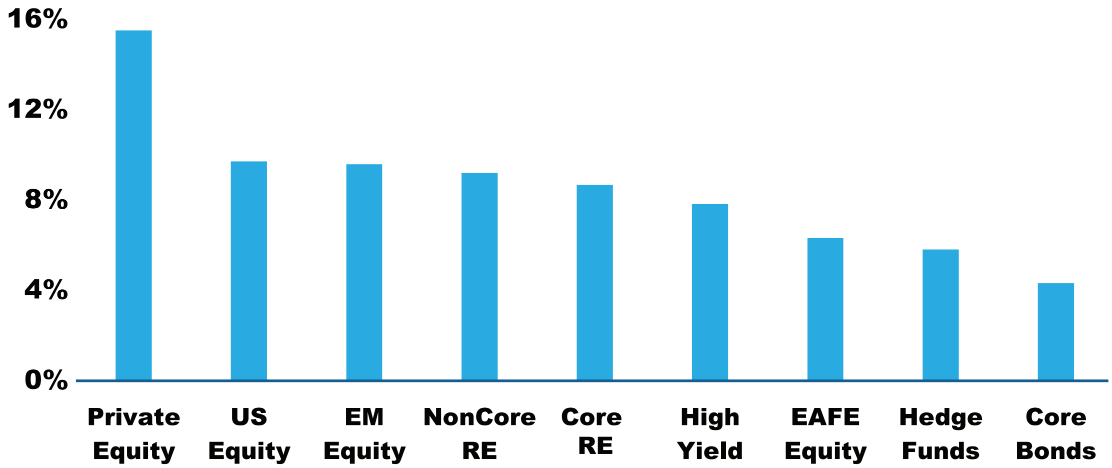

FIGURE 3

Trailing 20 Year Performance

Source: 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.

Expected returns

Private equity has the highest long term expected return among all asset classes, based on a broad industry survey of firms that produce capital markets expectations. 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 by most to persist in the future.

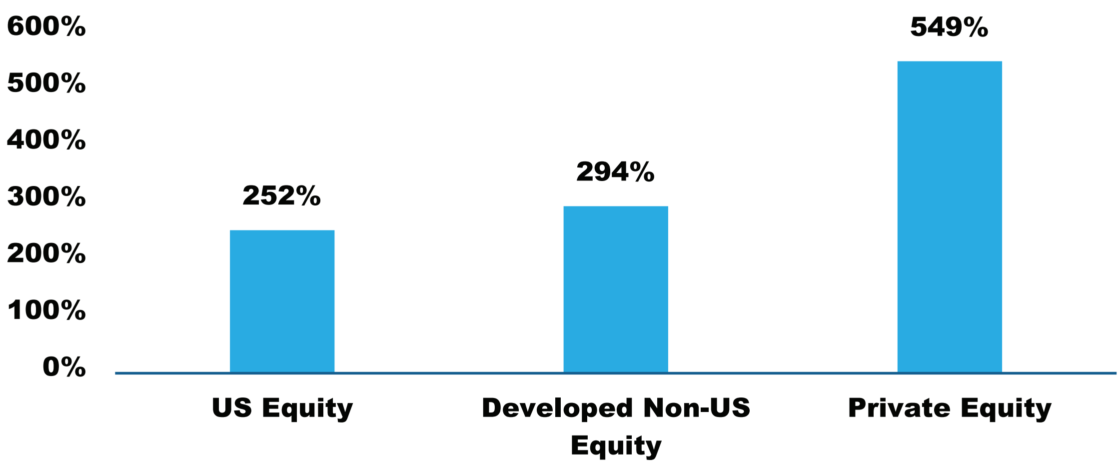

FIGURE 4

Expected 20-Year Cumulative Returns for Equity Asset Classes

Source: 2022 Horizon Actuarial Services survey.

The chart above shows the projected cumulative investment performance for US Equity, Developed Non-US Equity, and Private Equity asset classes over a 20-year period. These cumulative returns are based on average surveyed expected annual returns of 6.5%, 7.1%, and 9.8%, respectively.

Conclusion

In recent months, public equity markets have performed strongly while private equity valuations have lagged behind. Over time, the lag effect of private equity valuations should catch up, allowing private equity's long term performance advantages to become visible.

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