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The Great Divide: Public or Private Equity?

Over the last four years, equity markets have seen a stealth value bull market. However, despite this outperformance, value managers have not yet seen large asset allocations being directed to this turnaround story. One of the possible drivers of the lack of interest, is the fascination with private equity (PE). Warren Buffett at his 2019 AGM commented, “We have seen a number of proposals from PE funds where the returns are really not calculated in a manner that I would regard as honest. If I were running a pension fund, I would be very careful about what was being offered to me.” An audacious quote, even from Warren, and an idea investors might be mindful of as they make asset allocation decisions.

Advocates for PE state that this category of investments offers higher returns net of fees, over the long run, while also providing less volatility through the cycle, compared to public equities. The perfect situation for investors – more upside and less volatility. Additionally, they claim this outperformance is achieved through buying companies at bargain prices, fostering operational improvements, increasing valuation of the portfolio companies, restructuring the balance sheet to create value, and exiting the investment at the ideal moment for maximum valuation. Let’s roll up our sleeves and work through these claims.

Does Private Equity Outperform Public Equity?

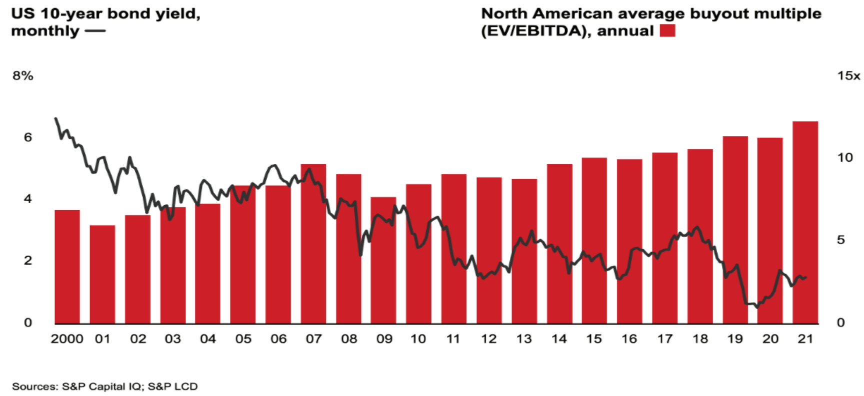
A recent working paper from academics at the Harvard Business School questions this notion of outperformance of PE relative to public equity. Nori Lietz and Philipp Chvanov’s 2024 paper, “Does the Case for Private Equity Still Hold?” presents data from a North American customized benchmark of PE funds IRR’s over different timelines. The report features a 10-year return period ending in Q3 of 2021, and when compared to the S&P 500, PE IRR’s have slightly underperformed over this time.

PE assets under management have been growing in an exponential manner. The market has become more efficient and returns of the past are much harder to achieve. The Harvard paper summarizes this debate. “In short, data from multiple sources, examining PE performance post 2005, call into question the premise that the average PE fund will outperform a public market equivalent (PME) benchmark [i.e., public stock market] on a nominal and net of fees basis, much less on a risk adjusted basis due to the leverage of PE portfolio companies. It is plausible to argue that PE has underperformed on a risk adjusted basis relative to PMEs given the amount of leverage in their portfolios.” According to this report and data gathered, PE funds have not consistently outperformed and may not be worth the significantly higher fees. But as we know, past returns don’t always equate to future returns.

PE Value Creation?

In an analysis of the drivers of private equity value creation from 2013-2023, global consulting company, Bain, found almost 50% of value created from private equity firms is achieved through multiple expansion of their portfolio companies. None of the value is created from margin expansion. Between 2013 and 2023, markets experienced an extended period of depressed interest rates, which made it easier to take out leverage and increase valuations of portfolio companies as discount rates continued to drift down.

The following chart shows the multiples paid for PE buyout deals and the 10-year U.S. bond yield. It is easy to make a profit when asset prices are consistently climbing and the ability to sell at a higher price has been essentially assured. It seems clear that we may have hit a bottom on the fuel driving assets higher (interest rates approaching zero). This means PE firms are not adding operational efficiencies to improve portfolio companies' margins as the value over the past 10 years was derived from multiple expansion and revenue growth.



Source: Bain & Company. Global Private Equity Report 2022.

Adding Value or Risk?

As at the end of 2023, PE funds in the U.S. have 257% more leverage to earnings compared to the S&P 500 Index. Is this leveraging of the balance sheets in PE funds adding value to the portfolio, or is this just increasing the risk? Logically, as debt increases, risk also increases, and higher returns are required to justify this additional risk. However, we have not seen investors being compensated for the PE industry leverage risk. If interest rates rise, is this asset class sustainable into the future?

Conclusions

PE's risk and return history doesn't mean there isn't a place for it in asset allocation. Like many other asset classes, PE will have its own set of idiosyncratic returns that are not perfectly correlated with other asset classes, which can add value to a portfolio. However, it doesn't mean that public equities no longer have a place in asset allocation either. Value investing in the public equities space requires managers to seek to invest in well-managed, financially sound businesses, but only if the stock is trading at a significant discount. This margin of safety is a core mechanism in managing risk and preserving client capital. This approach to risk management and 100 years of empirical evidence supports our belief that value public equities provide the best risk adjusted returns relative to other asset classes.

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