STATE OF THE MARKET

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The four virtues of private equity

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In classical philosophy, we are taught that there are four virtues of mind and character: prudence, temperance, fortitude and justice. Given the uncertainty that lies ahead in 2024, it is prudent (pun intended) to revert back to these virtues — as they relate to private equity — to outline a framework that may help investors effectively navigate the market.

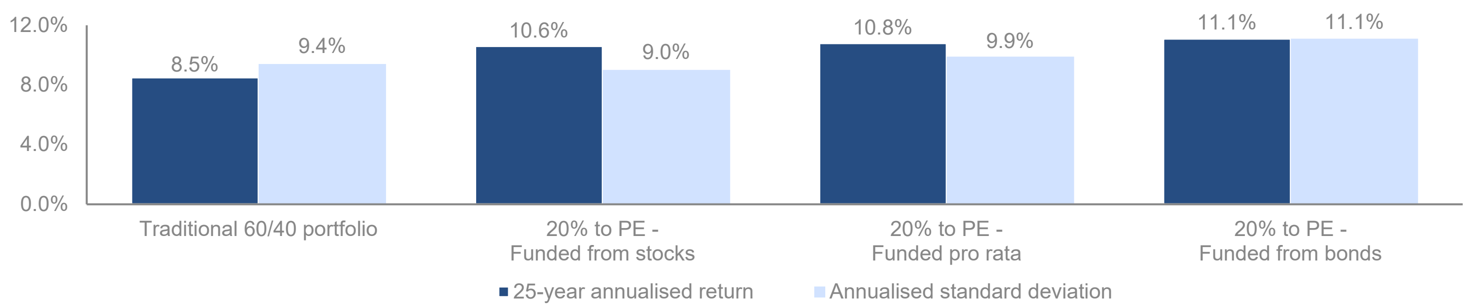
PRUDENCE: The ability to discern the appropriate course of action

Private equity may appeal to investors and fiduciaries if the goal is growth over the long-term with reduced short-term volatility (given the long-term nature of illiquidity of private equity investments). Institutions willing and able to invest in private equity typically allocate anywhere from 5% to 20% of their portfolio to the asset class. Figure 1 below compares the risk and return characteristics of a traditional 60/40 portfolio to one with a 20% allocation to private equity.

An asset allocation study will illustrate how a portfolio may perform over the long-term, with stress-testing of the assets in periods of economic and market downturns, some notable examples being the dot-com bubble of the early 2000s and the Global Financial Crisis ("GFC") seven years later, as shown in Figure 2. The US private equity index fared better than public equity indices with less volatility during both drawdowns and outperformed over the long-run.

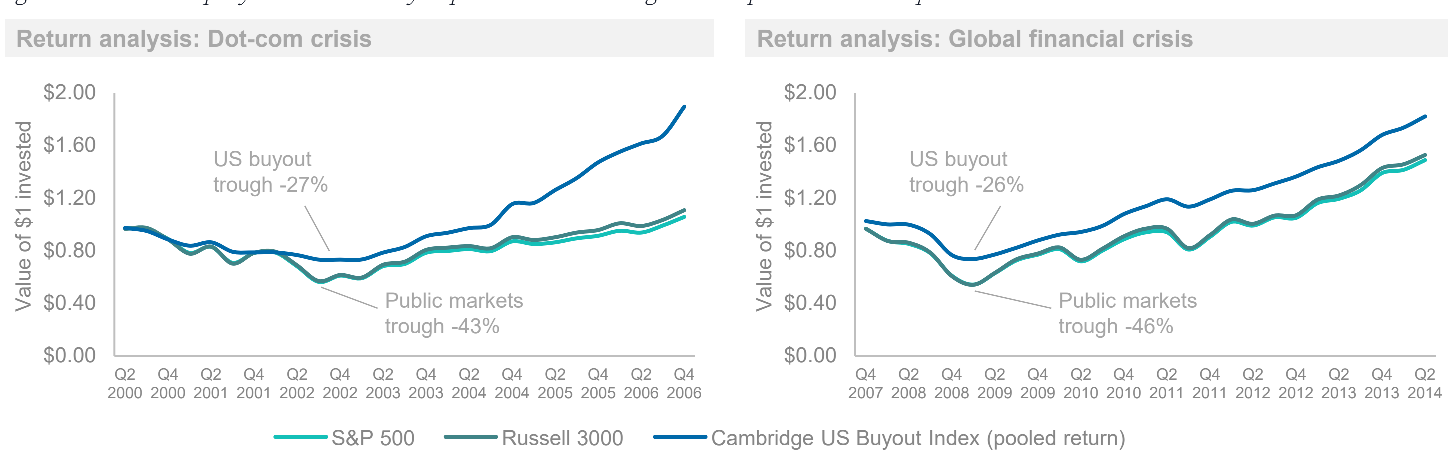
Subsequent to an allocation determination, a commitment pacing study can be performed which will determine how much capital should be committed each year in order to achieve a target allocation over a predetermined number of years.

Figure 1 – Adding a private equity allocation to a traditional portfolio may enhance returns while reducing volatility



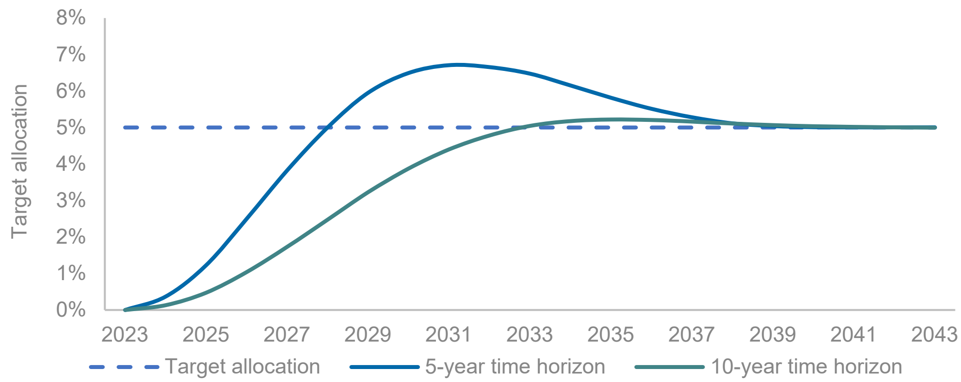
Source: eVestment, for the period June 1994 – June 2019. For illustrative purposes only. Data through 2019 provides the most sufficiently seasoned private equity returns. Based on S&P 500 monthly returns, Bloomberg Aggregate Bond Index monthly returns and Cambridge US PE Index quarterly returns

Figure 2 – Private equity has historically experienced fewer significant pull-backs and quicker recoveries in times of distress



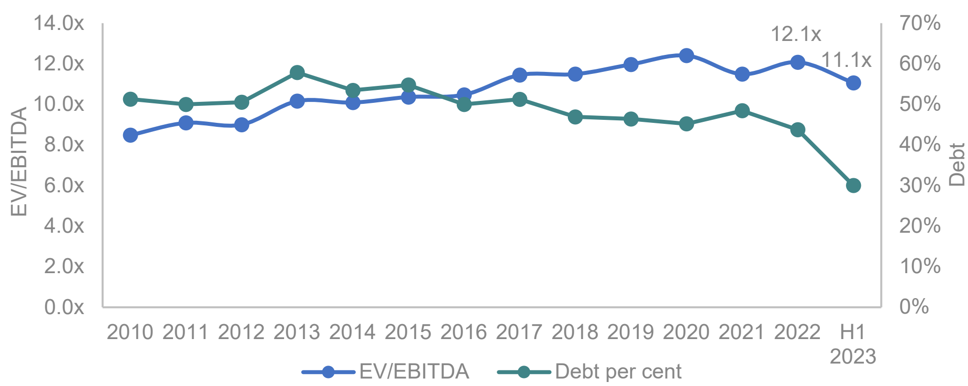
Source: Bloomberg, Cambridge Associates, Neuberger Berman

Figure 3 – Allocating to private equity over a longer time horizon can mitigate short-term over-allocation risks



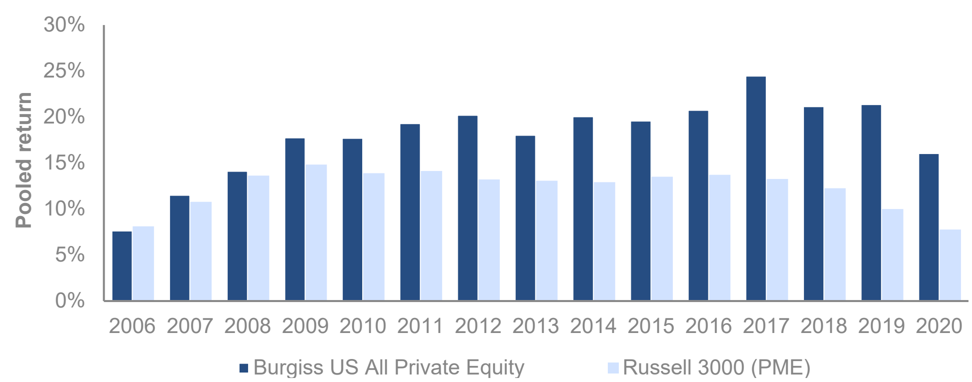
Source: Pitchbook Cash Flow and Commitment Model. For illustrative purposes only. It cannot be guaranteed that a portfolio will precisely mirror this model

Figure 4 – Though purchase price multiples have begun to pull back, debt financing of middle-market private equity transactions has corrected more dramatically



Source: Pitchbook, Q2 2023 US PE Breakdown Summary

Figure 5 – During the years after the financial crisis, private equity continued to outperform[1]



Source: Burgiss US All Private Equity Public Market Equivalent, Pooled Returns (30 June 2023)

This leads us to virtue number two, temperance.

TEMPERANCE: The practice of discretion, restraint and moderation

Investors with below-target positions in private equity may be tempted to pull forward commitments in order to catch-up. Figure 3 illustrates the modelled allocation growth over a five-year and ten-year time horizon for a portfolio starting at 0% and targeting a 5% allocation. Over the shortened five-year period, an investor may temporarily over-allocate to the asset class and increase illiquidity risk within the portfolio. However, over a more standard ten-year period, the growth of the private equity portfolio is much smoother, albeit it will take longer to achieve the 5% allocation.

For investors with a programme in place that are experiencing a period of increased allocation due to the denominator effect — when the overall value of a portfolio decreases disproportionately to a specific asset class, resulting in a short-term over-allocation — there may be an instinctual urge to pause or slow the pace of commitments. However, pacing should not be a function of market movements. Consistent pacing ensures there is proper vintage year diversification and reduces any temptation to time markets. Unless there is a fundamental change, such as unexpected capital inflows/outflows or a change in strategic asset allocation, pacing should remain as consistent as possible with periodic monitoring.

It is also important for private equity managers to embody the virtue of temperance. Managers may have done so by exercising restraint when others have not, as the amount of private equity capital raised has grown and investment period deadlines loomed. Managers who have maintained discipline regarding purchase price multiples and the amount of previously inexpensive debt used in financing a deal, may expect to find their portfolio companies better-positioned to weather the potential storm in 2024 than those who did not.

Enter virtue number three, fortitude.

FORTITUDE: Strength, endurance and the ability to confront fear

Investor fortitude is being tested in today's markets. But, as with all asset classes, Marquette encourages investors to maintain discipline and remain invested through periods of stress, in accordance with strategic asset allocation targets. It is impossible to time private markets, as month-to-month volatility in public markets can alter allocations vis-à-vis the aforementioned denominator effect. Private equity is a long-term investment, and making long-term decisions based on short-term and temporary market movements can have unintended consequences. Adjustments to annual capital commitments can ultimately result in an under-allocation to private equity and potentially underperforming portfolios for several years as public market allocations snap back. As shown in Figure 5, in the years following the GFC (2009 – 2012), private equity returns exceeded those of comparable cash flows invested in the Russell 3000 index by 300–700 basis points, a delta that only further widened in the years to come.

Moreover, should fear dictate certain investors' behaviours, a broader pull-back in commitment pacing could increase competition for investor dollars. Increased competition can lead to enhanced bargaining power for those able to stay the course and deploy capital.

We arrive at our fourth and final virtue, justice.

JUSTICE: Fairness

In the realm of private equity, justice is expressed as an alignment of interests between managers and investors, visible in the terms within the Limited Partnership Agreement ("LPA"). In addition to negotiating a first close management fee or carry discount, there are other terms that can result in additional monetary benefit to investors, such as organisational expenses borne by the fund or transaction fee offsets. Trends in terms can be difficult to quantify as they vary amongst sub-strategies, fund size, and in certain cases, how many funds a general partner has raised.

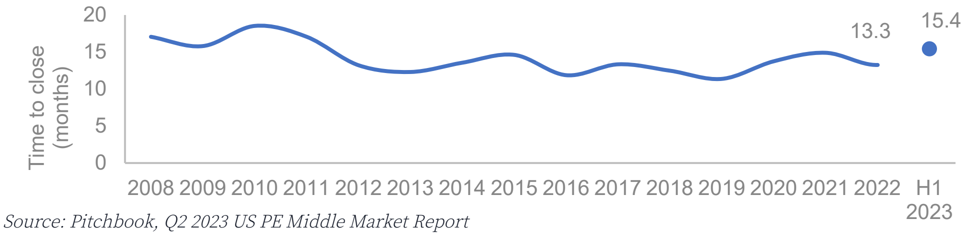
Investors do have a "Themis"[2] on their side. The Institutional Limited Partners Association ("ILPA"), a global organisation with over 600-member organisations across 50+ countries, is at the forefront of advocacy for investors. In 2020, ILPA began publishing results of a survey it conducts concerning trends in LPA terms. The 2021 survey found that while management fee rates have remained stable (1.5 – 2.0%), partnership and organisational expenses have continued to rise and have begun to include expenses that have historically been covered by management fees. These fees have increased by 123% since 2011.[3] Nonetheless, transparency regarding what is being included in these fee categories is improving.

From here, the bargaining pendulum may be swinging in investors' favour. We have witnessed a relatively steady increase in time to close since the 2019 trough of 11.4 months to a recent peak of 15.4 months in H1 2023, as well as a pull-back in capital raised beginning in 2019. This time last year, we observed that investor sentiment, which we can describe as "continued exuberance" through the first half of 2022, tempered in the latter half of the year, a trend that has continued into 2023. Anecdotally, we have seen both first and final close dates continue to be pushed further out during 2023. To the extent that these are signs that allocators are growing skittish, there may be increased opportunities for investors to negotiate more favourable terms.

CONCLUSION

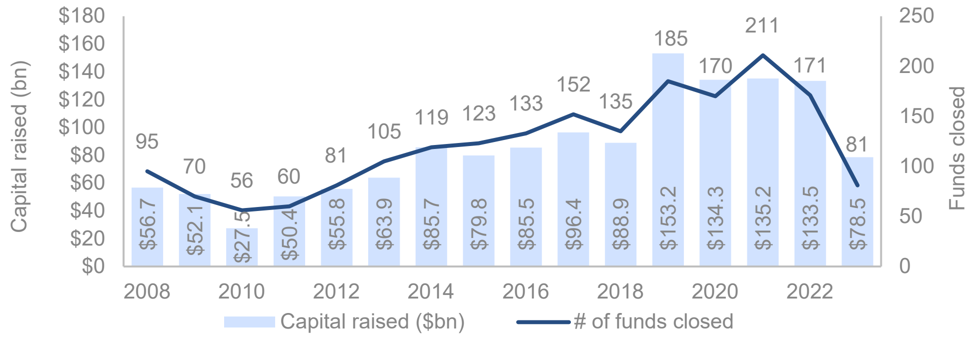
Difficult market environments like 2023 (stress) test investors, but Marquette believes that if the virtues of prudence, temperance, fortitude and justice are upheld, private equity portfolios should prove resilient over the long-term. Prudently discerning whether to invest in the asset class, practicing restraint when building out a thoughtful programme and pace, conjuring the strength to endure market downturns and negotiating equitable terms as appropriate, should serve investors well as the cornerstone virtues of any successful private equity programme.

Figure 6 – Fundraising timelines steadily ticked up from 2018 through 2021 and have continued that trajectory in the first half of 2023



Source: Pitchbook, Q2 2023 US PE Middle Market Report

Figure 7 – A tempered capital formation environment may create bargaining power with managers



Source: Pitchbook, Q2 2023 US PE Middle Market Report

Stay virtuous, fellow investors.

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1. Pooled internal rate of return (PIRR) is a method of calculating the overall IRR of a pool of funds by combining their individual cash flows. PME, or public market equivalent, refers to the Long-Nickels PME which matches cash flows in and out of a private equity portfolio into a public market index, matching dates of in/out flows
2. Themis (Greek: "Order") in Greek mythology and religion, refers to the personification of justice, goddess of wisdom and good counsel, and the interpreter of the gods' will
3. ILPA, 2021 Industry Intelligence Report – "What is Market in Fund Terms"

***Amy Miller is a Senior Research Analyst for Marquette Associates** and has 24 years of investment experience. She joined the firm in 2020 and is responsible for conducting due diligence on private equity general partners, as well as developing macroeconomic and capital markets research. She is a member of the firm's investment committee, alternative investment manager search committee and engagement committee.*

Prior to joining Marquette, Amy was the Private Markets Investment Manager at Drexel University's Endowment, where she was responsible for portfolio strategy, manager sourcing, due diligence and monitoring of the private markets investments. She also has served in portfolio management and investor relations roles, providing operations management consulting to private equity-backed businesses, and in the public sector serving as an Investment Officer for a large municipal pension plan.

Amy holds a B.A. in Mathematics from Millersville University and an M.B.A. in Finance from the Fox School of Business and Management at Temple University. She is a member of the Women's Association of Venture and Equity, and previously served on Kayo Advisory's Private Equity Advisory Board.