IN BRIEF

Private equity is a potential source of enhanced returns for long-term investors willing to hold investments that are largely illiquid. In this paper, we examine this illiquidity premium, with a focus on important considerations that investors should be informed of when investing in private equity including:

- Private equity characteristics such as the time horizon and liquidity possibilities
- The ability to achieve the return enhancement based on control, access and alignment
- The importance of an in-depth due diligence process

LIQUIDITY AND THE ILLIQUIDITY PREMIUM

Investors with a long-term investment strategy have a variety of asset classes across a wide spectrum of liquidity to consider as a part of a strategic asset allocation. Liquidity is defined as the degree to which an asset can be bought or sold, without affecting its price. Liquid investments are generally publicly traded securities with daily pricing and liquidity as a result of a sufficiently large market and high trading activity.

Investors generally expect a higher return as compensation for holding assets that are less liquid and therefore may be more difficult to convert into cash. Less liquid strategies, including private markets, may generate excess returns through various factors that do not exist in public, highly liquid markets. The excess rate of return that an investor may achieve above that of more liquid securities is known as the illiquidity premium. Investors with a long-term investment horizon have the potential to capture this illiquidity premium with an allocation to less liquid strategies with a goal of generating long-term appreciation of their total portfolio, with a complementary allocation to more liquid strategies for near and medium term capital needs.

ASSET LIQUIDITY SPECTRUM

Highly liquid strategies
- Cash
- Bonds
- Equities
- REITs

Moderate
- Absolute return
- Frontier markets
- High yield
- Natural resources
- Private debt

Least
- Direct lending
- Direct real estate
- Infrastructure
- Private equity

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PRIVATE EQUITY CHARACTERISTICS

Private equity consists of equity investments in operating companies that are not publicly listed and traded on a stock exchange. Investors typically gain access to private equity through fund structures or separate accounts, and less frequently through investments directly into operating companies. Regardless of the way in which an investor accesses private equity, the investments are long-term in nature and largely illiquid.

- **Long Term Horizon** An investor in a fund determines their commitment amount to the private equity investment and that capital will be invested, or “called”, as and when it is needed for investments or the payment of fees and expenses. Private equity funds invest in a number of private companies over a specified investment period, typically 3-6 years. Those investments are realized through sales or public market events and capital is returned, or “distributed,” on average in 4-6 years. However, the exit of an investment could take as long as 10 years or more based on factors such as the operating performance of the company, the overall business cycle, and the M&A and IPO environments. As a result, the total life of a partnership investment is 10-12 years on average, with fund extensions often granted thereafter.

- **Illiquid Asset** Unlike many other alternative investments, private equity investments generally do not have investor-driven reinvestment or redemption features. Additionally, many private equity investors are limited or restricted in their ability to sell a private equity investment. Though there is a secondary market available for selling private equity interests, those sales generally occur at a discount and fund advisors may restrict or limit sales of fund interests.

THE PRIVATE EQUITY ILLIQUIDITY PREMIUM

Investors in private equity expect to achieve return enhancement to their public equity portfolio, or an illiquidity premium. As private equity is typically highly correlated with public equity markets, this return enhancement should be the ultimate objective for investing in private equity.

Over a long-term horizon, private equity has the ability to generate high real rates of return due, in part, to the following attributes:

- High degree of control and influence by managers over investments
- Legitimate access to non-public information prior to making an investment
- Strong alignment of interests between investors and management
- Expanded opportunity set of investments not typically available through the public markets

Using quarterly time weighted returns from the Burgiss Manager Universe and quarterly levels (for an equivalent comparison) of the MSCI World and S&P 500 indices, average annual returns over various time periods were assessed. Private equity excess returns, or what could be considered the illiquidity premium, is over 500 basis points over the long term, for time periods 10 years and greater.

Implementation through investment selection is the most crucial element in achieving this return enhancement of an illiquidity premium. The dispersion of returns (top through bottom quartile) among private equity investments is significant in absolute terms and substantial relative to other segments of the investment universe. As illustrated in the exhibit shown below, the dispersion of returns among private equity funds is significant, over 1,800 basis points in a 20 year time period and greater for shorter durations. Due to this dispersion, portfolio implementation is as important (or more important) than the asset allocation decision of how much to allocate to alternative investments.

Importantly, private equity pooled time weighted returns as well as pooled IRRs are higher than median private equity returns. It is our view that the requisite return enhancement objective will not be achieved consistently by matching average or median industry-relative performance. Private equity...
DUE DILIGENCE AND MANAGER SELECTION

Achieving top quartile performance is not random but rather correlated with a partnership’s level of access to investment opportunities, strength of relationships with entrepreneurs and management teams, ability to capture the best business plans and tap strategic investors, and first-hand operating experience in building and strengthening businesses, to name but a few factors. In order to meet the objective of return enhancement, it is critical that a private equity investor “invest with the best” on a consistent basis by partnering with a team that has long standing relationships with the best partnerships, a due diligence process to identify “up and coming” top performing partnerships, and a selective and disciplined nature to ferret out those groups that are not able to maintain their premier performance.

The importance of an in-depth due diligence process cannot be understated. It can serve as an extremely effective mechanism by which to strengthen partnerships with the most talented manager, thereby fostering a deeper understanding of transparency and dialogue, and sometimes a first call when capacity becomes available. Some of the key items to understand/review in the due diligence process include:

- Background of firm and partners
- Status of general partner
- Deal flow
- Performance track record
- Investment strategy
- Terms of proposed fund

DISPERSION BETWEEN TOP AND BOTTOM QUARTILE PRIVATE EQUITY IRRS

Source: Burgiss. The dispersions results are sourced from the Burgiss Manager Universe and are based on the individual Internal Rates of Return (IRRs) as of 12/31/2015 for the global Corporate Finance and Venture Capital funds. Past performance is no guarantee of future results.

equity investment strategy must be formulated with the goal of consistently delivering industry leading (e.g., top-quartile) relative performance.

Additionally, private equity investment performance is dependent upon numerous exogenous factors including the business cycle, the receptivity of public debt and equity markets, and capital flows in the market. It is impossible to accurately “market time” private equity investments. The illiquidity and contractual obligations of commitments limit the ability to tactically enter and exit the market. A disciplined long-term approach of committing to attractive investment opportunities each year, over typically a three-year period, is the optimal strategy to diversify across vintage years in order to mitigate the volatility of the investment cycle.

CONCLUSION

Long-term investors seeking return enhancement should consider allocating a portion of their portfolio to private equity with a goal of capturing the illiquidity premium achievable with less liquid investments in the private market. Private equity investments in aggregate have historically demonstrated excess returns greater than 500 basis points over 10-20 year periods. Investors must be aware, however, that implementation through vintage year diversification and manager selection is a key factor in developing a return-enhancing private equity portfolio. Dispersion of returns among private equity investments is larger than perhaps any other asset class and median private equity managers may not demonstrate the expected illiquidity premium. Due diligence and careful investment selection are therefore crucial for success in private equity investing.
INVESTMENT INSIGHTS

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Private Equity Funds invest exclusively or almost entirely in financial instruments issued by companies that are not listed (or that take-over publicly listed companies with a view to delisting them). Investment in private equity funds is typically by way of commitment (i.e. whereby an investor agrees to commit to invest a certain amount in the fund and this amount is drawn down by the fund as and when it is needed to make private equity investments). Interest in an underlying private equity fund will consist primarily of capital commitments to, and investments in private equity strategies and activities which involve a high level of risk and uncertainty. Except for certain secondary funds, private equity funds will have no operating history upon which to evaluate their likely performance. Historical performance of private equity funds is not a guarantee or prediction of their future performance. Investments in Private Equity are often illiquid and investors seeking to redeem their holdings can experience significant delays and fluctuations in value.

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