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Nuances to consider when investing in private equity

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Recent stock market woes and rising inflation are leading many investors to rethink allocations to traditional asset classes such as equities and bonds.


Image: Peter von Lehe of NB Alternatives Advisers

The private equity asset class has grown significantly in recent years, due to its potential for both returns and portfolio diversification.

However, there are many nuances to consider when approaching the asset class, and investors need to be careful in their choice of funds.

Carefully crafted returns

Core to the private equity model is control. Private equity funds, which take substantial stakes in privately owned companies, typically have a higher degree of influence over the way these businesses are managed than investors holding smaller shares in public companies or minority growth investors. This gives private equity managers, who work hand-in-hand with company management teams, the potential to effect change. Together, they may implement strategic changes or operational efficiencies and often pursue M&A opportunities, which can drive value creation.

Control not only allows private equity managers the ability to deliver growth, but also allows private equity-backed companies to react to change quickly - whether in the face of economic uncertainty, disruption or a new competitive threat. Short lines of communication, alignment of interests and access to capital can make these businesses more nimble than many public market equivalents. These companies can generally execute change quickly and efficiently to seek to create long term shareholder value, rather than focusing on quarterly earnings targets.

Ultimately, we believe this control and ability to create value through transformation has driven the outperformance of private versus public markets, with the private equity asset class generating returns in excess of the S&P 500 over multiple cycles, net of fees.

But, investors need to be careful. In a market where most assets are rising in value, it is harder to distinguish performance across asset classes and managers. However, in more challenging or volatile environments, like the one being ushered in by the lingering side effects of the pandemic, the ability to generate value may depend to an even greater degree on revenue and earnings growth - which can be driven by the value a private equity manager can bring to the companies they own.

In 2022, we think the idea that you can buy an asset and expect multiples to expand is not likely to be a winning strategy, and manager and investment selection will become even more important.

Selecting a solution

One way of investing in private equity, which may seem less daunting for some investors, is to buy into a listed fund of funds. This structure provides access to a diversified portfolio of investment managers and individual companies. However, while this limits exposure to single company risk, it can also cap potential upside.

In addition, funds of funds rely on underlying managers to make the individual investment decisions, generally giving the fund less control on the timing of new investments. They also have two layers of fees, with investors paying both the fund of funds manager and underlying fund fees.

Meanwhile, direct strategies typically provide investors with a more concentrated exposure to individual companies, sectors or strategies, as well as the risk of a single manager. However, direct investors also have the benefit of fee efficiencies relative to a fund of funds structure, and retain control over the underlying investment decisions.

By investing directly alongside private equity managers, the co-investment approach, used by NBPE, aims to combine the best of both models, offering manager, strategy and sector diversification to investors, while avoiding two layers of fees. Making investments directly, on a deal-by-deal basis, also allows co-investors to speed up or slow down the pace of investment depending on market conditions and the fund's capital structure needs.

Whatever strategy they choose it is important that investors are educated on the potential performance benefits of holding listed private equity trusts, which allow investors to access direct or indirect private equity investments without being locked in for lengthy periods of time. Much like the wider private equity asset class, returns from private equity trusts have often outperformed public markets. In 2021, the AIC's Private Equity sector NAV Total Return was 30%, whereas the FTSE All-Share TR index returned 18%.

As investors increasingly seek out diversification and returns that can cut through inflation, the private equity asset class could gain in prominence. Perhaps 2022 is the year we will see private investors turn to private equity trusts in larger numbers, especially with the entry point the current sector discounts provide.

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