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Private-equity investment has serious merits

Michael Nairne, Serious Money

Private-equity funds that focus on buying out or providing financing to individual companies, typically privately owned, have achieved stellar returns. Illustration by Chloe Cushman for National Post

The hard economic reality of the new millennium has pummelled many growth oriented investors. Investors in U.S. stocks, on the receiving end of a “one-two-three punch” from the tech wreck, soaring loonie and global credit crisis, are still in the red. International stocks have struggled and, while Canadian equities have delivered so-so positive returns, you can’t build wealth running on one cylinder.

In contrast, private-equity funds that focus on buying out or providing financing to individual companies, typically privately owned, have achieved stellar returns. The Canadian Venture Capital & Private Equity Association reported that independent private-equity buyout and mezzanine financing funds in Canada returned 16.4% annually for the 10 years ended Dec. 31, 2011. The longer-term numbers in the United States are equally alluring.

A recent study covering the 25 years ended 2008 found that buyout funds achieved a 15.7% annual return, far outpacing stocks. Venture-capital funds that invest in business startups and early-stage growth companies clocked in with a remarkable 19.3% return. It’s no wonder that many wealthy families are looking to hitch their investment wagon to this star.

Private-equity investment has serious merits. It allows ownership participation in a portfolio of growing, private companies without the concentration risk of a single business. It can generate attractive returns while its long-term orientation removes concerns about short-term market swings. Investors can diversify broadly or target particular industries or geographies. It is a "hands-off" investment — the burden of execution falls on the fund managers and the portfolio company executives.

However, investors should always look before they leap since private equity comes with drawbacks. First, it is illiquid. It's a lot easier to get in than out. Many endowments and pension funds found this out the hard way when they needed to raise cash in the depths of the global credit crisis.

Then there is the "J curve." In the early years of a fund, the private-equity managers are busy evaluating and structuring acquisitions while investors are writing cheques to satisfy their original investment commitment. It's a one-way street with cash going out the door. At the same time, the initial fees and expenses of the fund as well as early writeoffs of underperforming acquisitions can result in negative returns. The positive gains and cash flow occur much further down the line as the portfolio of companies matures and is sold or taken public. This pattern of early losses and later gains is shaped like a "J" and hence, its name. In fact, the typical life of a private-equity fund runs in the order of 10 years. Many private investors accustomed to the liquidity of publicly traded markets find this disconcerting. Like time spent in a bad marriage, it can be chronically painful if a fund isn't doing well.

Private-equity performance is also cyclical. A recent study found that returns over the past 29 years were much higher for funds started after a recession compared to those started later. Moreover, the trend in returns overall has been downward. Venture capital in particular has struggled over the past decade, registering only a 3.3% annual return, according to the Cambridge Associates LLC U.S. Venture Capital Index.

There is good and bad news about private-equity manager performance. Unlike the realm of publicly traded stocks where there is little evidence of persistence in manager outperformance, some private-equity managers possess unique skills, networks and experience and have been able to deliver excess returns with some consistency. However, access to these star managers is typically restricted.

Also, an investor faces real risk in manager selection. There is considerably more dispersion in the returns achieved by private-equity managers than is the case for investment managers of stocks and bonds. The wrong choice or just plain bad luck can result in abysmal returns, and high minimum investment amounts aggravate this risk. One of the appeals of a fund of private-equity funds is the mediation of this risk through diversification.

Wealthy investors should definitely consider this asset class. But they need to fully understand its "perks and quirks" before pulling out a chequebook.

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