Consulting Practice Note

Private Equity's Strategic Role in Institutional Investment Funds

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Author(s): Mike Smith
Office(s): Tacoma

Issue

Does private equity (PE) have a role in a diversified institutional investment fund?

Response

A private equity (PE) position is a potentially attractive substitute for some portion of the strategic equity allocation in a diversified investment program. Russell offers clients the following guidelines:

- Clients should not consider establishing a PE exposure until their governing and managing fiduciaries are comfortable accepting illiquidity for 7-12 years, sparse pricing information, relatively high fees, and the lack of a specific private equity benchmark.
- Consider PE to be part of the overall equity allocation. The valuations and long-term results of private equity investments will be related to activities within the equity markets.
- Do not attempt to determine a PE allocation using mathematical optimization techniques. PE return distribution data is simply too sparse to produce robust results.
- Target a minimum policy allocation of 5% of total assets. Less than 5% will have minimal impact on overall fund performance.
- Hire an external manager with expertise to run the portfolio. Professional management will provide an increased opportunity set, access to top funds, and skills that can't be hired as internal staff.

For benchmarking purposes, focus on the opportunity cost of private equity. For most, this will be a foregone exposure to liquid equities. A reasonable performance benchmark would be a liquid equity index return, plus a minimum return premium that justifies the additional risk and illiquidity of a PE investment--perhaps 3% - 5%.

Background

PE is a small market segment. Private equities have a market value of something less than 3% of liquid equities. On a transaction volume basis, PE is far smaller. To have a meaningful impact on investment program performance, a PE program will usually be larger than its market weight by whatever definition, and will constitute a very long-term active bet. A successfully managed private equity program should provide a return premium over public market securities given the attributes of the marketplace:

- Less researched environment than public markets
- Liquidity premium for taking private companies public
- Leverage present in many of the investment vehicles
- Management efficiencies created by owners/managers
- General partners can use inside information in making investment decisions

PE investments are illiquid. They are made through limited partnership vehicles, typically with an investment horizon of seven to 10 years, but often extending to twelve or thirteen. During the life of the partnership, the manager controls all cash flows into and out of the partnership. Because illiquidity makes it more difficult to establish an effective exposure to PE, sponsors should be willing to over-commit to the asset class. It is likely to take a minimum of $125 million in commitments to reach a target allocation of $100 million invested.

The allocation to PE is best determined by informed judgment. PE is conceptually part of the equity asset class and should not be treated as a separate asset class for strategic asset allocation purposes. Further, PE price and return data are too sparse to permit an accurate statistical characterization of its expected return distribution. For both these reasons, Russell believes that it is inappropriate to attempt to determine an appropriate allocation to PE using mathematical optimization techniques, including MAAM.

There exists no investable private equity benchmark. Issuance and pricing information are too difficult to obtain to permit creation of a published PE index. Venture Economics (VE) provides the most widely accepted peer universe data covering the market. The VE median and first quartile results are often quoted as performance targets. However, any selected bogey for performance monitoring will provide only a very imprecise match to the assets being measured.

Active management is the only option for PE investors. Because there is no investable benchmark, it is not possible to create a passive index replication product in private equities. Therefore, active management is the only viable way to obtain an exposure to this segment of the equity market.

Successful PE investment relies completely on active management. The absence of a suitable benchmark precludes passive investment strategies within this segment of the equity market. The ability to select and access top managers is the most critical and challenging aspect of running a private equity portfolio. The difference between first quartile and third quartile performance among active PE managers can exceed 2000 bps over a 10-year span, contrasted to 300 bps in US public equity. While successful PE partnerships can post long-term performance numbers not attainable by liquid equity managers, the majority of PE managers fail to beat the results of public market indexes. Top private equity managers source the best deal flow and possess the ability to turn these deals into successful companies. Once demonstrated, these talents are highly coveted, reducing new investors' access to top managers. New investors are relegated to discovering rising stars or settling for second tier players.

Partnership fees are high. The 2% annual management fee typical of PE private partnerships is more than double the fees charged by most liquid equity managers. Top venture capital firms can now charge 3% to their limited partners. In addition to high fees is the share of profit or "carried interest". This has historically been a 20% share for general partners, but top firms have increased this to 30%.

Related Reading

Goff, Adam, "An Introduction to Private Equity", *Russell Research Commentary*, August 1999

Goldman, Sachs & Co and Frank Russell Capital, "Report on Alternative Investing", 1999

Venture Economics, "1999 Investment Benchmarks Report", 1999