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Taking the Road Less Traveled: Avoiding Disappointing Expected Returns Among the Crowds in Private Markets

May 2023

In March, the CIO of the $152 billion University of California investment fund said, **"…we will primarily be all out (of hedge funds) …we'll replace that with private credit – which has been a better place to be."**[1] This headline, alongside an 'eye roll' emoji, joined numerous others posted in our investment team group chat – all various twists on the (in)famous quote from the then-CIO of Calpers, Ben Meng, who in 2019 said, **"We need private equity, we need more of it, and we need it now."**[2]

It is no secret the allocator community loves private markets. Flows data consistently reveals a growing appetite for private assets over public ones or 'tradeable strategies' such as hedge funds. For example, McKinsey reports that total private market AUM has grown at an annual rate of nearly 20% since 2017, while Goldman Sachs calculate just a 4% annualized growth rate for hedge funds since 2015.[3] Dry powder in private markets has continued its decade-long growth streak and rose to a new record $3.7 trillion in 2022.[4] 63% of institutional investors anticipate making private equity their largest allocation over the next two to three years.[5]

When the great David Swenson popularized the 'Yale model' during his tenure as the Yale endowment's CIO in the 80s, he recommended increased exposure to a spectrum of alternative asset classes and strategies, not just private markets. Since then, the performance of hedge funds has largely disappointed while the performance of private assets (although harder to measure and typically less transparent) has exceeded expectations. Alongside quotes from Swensen himself calling private equity 'a superior form of capitalism'[6], private markets investing has become synonymous with patient, wise, long-term capital, while hedge fund and public equity investments are conflated with short-termism and price movements rather than true 'value creation' (more on this later).

As one might expect, our paper will argue that investor preferences for private markets, while initially somewhat valid, have reached a tipping point that will have consequences for future returns. None of the arguments we present are novel, but when summed together we think they make a strong case. We question:

- Whether the unthinking acceptance that private asset returns beat public market equivalents is supported by unbiased data;
- Why private markets are considered less risky than public market equivalents;
- To what extent privates were advantaged by low rates (and could be disadvantaged by higher rates, despite marketing narratives to the contrary);
- The influence of incentive structures and career risk on allocators of capital;
- And how forward returns for private markets could differ from past returns based on compositional changes in modern private portfolios.

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[1] https://www.bloomberg.com/news/articles/2023-03-16/uc-endowment-plans-to-jettison-hedge-funds-cio-bacher-says
[2] https://www.wsj.com/articles/calpers-wants-to-double-down-on-private-equity-11552834800
[3] McKinsey Private Markets Annual Review 2023
[4] https://www.bain.com/insights/topics/global-private-equity-report/
[5] https://www.ipe.com/news/private-market-allocations-growing-says-state-street-research/10064925.article
[6] https://www.cfr.org/event/conversation-david-swensen

The Historical Return Premium for Private Equity

The most obvious explanation for why investing in private markets is so popular is the belief that they have performed much better than public markets. For example, private equity is often quoted as having outperformed the stock market by *at least* 3-4% a year.[7] This makes some intuitive sense: private equity is illiquid, so investors theoretically require a return 'premium' to offset this perceived disadvantage; highly paid investment teams at PE funds should be able to drive value at their portfolio companies, increasing earnings growth; and pricing is less efficient in private markets, so bargains should be available to those willing to look for them.

Leaving aside, for the moment, whether those return drivers exist in modern day private equity markets, there are caveats regarding historical returns that are worth exploring. The co-founder and former CEO of Cambridge Associates recently wrote in an article for the FT, **"From the research I have seen over the years, buyouts, net of fees and leverage, have not outperformed public markets."[8]** This statement is consistent with research from Verdad Capital who believe, **"leverage, size, and value (the factor) together explain all of private equity's performance"[9]** rather than investment alpha. Harvard Business School professor Erik Stafford also argues that if PE returns were compared to small cap indices, rather than broader market benchmarks, the return premium would disappear. Instead, investors would see the merit in a **"…passively replicating strategy (that) represents an economically large improvement in risk- and liquidity-adjusted returns over direct allocations to private equity funds, which charge average fees of 6% per year."[10]** Most PE portfolios historically have been heavily weighted towards the US, which makes comparisons with global equities look attractive over the past decade plus. Adjusted for geographical, size, and sector exposures, it becomes even more difficult to find evidence of a return premium. Indeed, authors from the Canada Pension Plan Investment Board (CPPIB) and Abu Dhabi Investment Authority (ADIA) wrote in a 2016 paper for the Financial Analysts Journal that, **"After adjusting for appropriate risks, we found no outperformance of buyout funds vis-à-vis their public market equivalents on a dollar-weighted basis."[11]**

Even without adjusting performance for appropriate risks, some would argue that the industry's tendency to present since inception performance as internal rates of return (IRR) gross of fees may initially have helped propagate the belief that PE outperforms. As University of Oxford professor, Ludovic Phalippou, points out, **"Something large PE firms have in common is that their early investments did well. These early winners have set up those firms' since-inception IRR at an artificially sticky and high level. The mathematics of IRR means their IRRs will stay at this level forever, as long as the firms avoid major disasters."[12]** Gross IRRs since inception for the 'mega-funds' are reported between 25%-40% but money-on-invested-capital typically settles in the 1.5x-2x range. For IRR assumptions to be representative of real returns generated, average holding periods of underlying investments would have to be unrealistically short.[13]

Admittedly, no informed institutional investor today would use IRRs as a relevant performance metric. Still, since allocators and industry consultants have started using more accurate measures of net returns (accounting for the impact of substantial annual fees and removing the influence of early year distributions on performance figures) public and private equity returns are essentially the same since the start of the great bull run post-GFC in 2009. As Bain have reported, **"…parity with public markets is not what PE investors are paying for…All things being equal, public equities offer more liquidity at less cost."[14]**

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[7] https://www.bain.com/insights/topics/global-private-equity-report/

[8] https://www.ft.com/content/7a6bc5f8-be62-4360-8e5c-edfbed2187d5

[9] https://verdadcap.com/archive/explaining-private-equity-returns-from-the-bottom-up

[10] https://www.hbs.edu/ris/Publication%20Files/ReplicatingPE_201512_3859877f-bd53-4d3e-99aa-6daec2a3a2d3.pdf

[11] https://www.tandfonline.com/doi/epdf/10.2469/faj.v72.n4.1?needAccess=true&role=button

[12] *An Inconvenient Fact: Private Equity Returns & The Billionaire Factory* p.4.

[13] Phalippou compares Apollo's 39% gross since-inception IRR as reported to the SEC to their gross MoM of 1.82x. For 39% to be close to the rate of return they generated, they would have needed to hold their investments, on average, for less than two years ($1 earning 39% over two years would turn into $1.93).

[14] https://www.bain.com/insights/public-vs-private-markets-global-private-equity-report-2020/

Private Credit

Private credit has a shorter history than private equity or venture capital, but it is seen as perhaps the biggest winner of the new higher interest rate regime within alternative assets. There is seemingly no environment which is negative for private credit. Recession? Great opportunity for private credit. Bank failures? Private credit tailwind. Higher for longer? Private credit is floating rate. Loans that feature yields of 12% or higher are touted as providing equity-like returns with just a quarter of the volatility. Annual loss rates are said to be a tenth of those experienced in high yield bonds.[15]

It's a compelling narrative for investors, both institutional and retail (high net worth individuals). Blackstone said in their Q1 2023 earnings call they were, **"…seeing the greatest demand today for private credit solutions given higher interest rates and wider spreads. Coupled with the pullback in regional bank activity, this is a golden moment for our credit, real estate credit, and insurance solutions teams, which accounted for 60% of the firm's inflows in Q1."[16]** Even as private equity fundraising fell 15% in 2022 due to the 'denominator effect', US private credit fundraising *grew* 11%.[17] What's not to like about higher yields and more downside protection than public market equivalents?

Two sentences from an article in Institutional Investor by Daniel Rasmussen and Greg Obershain explain why this 'can't lose' combination may not be as attractive as it looks on the surface: **"Lending being perhaps the second-oldest profession, yields tend to be rather efficient at pricing risk. So empirical research into lending markets has typically found that, beyond a certain point, higher-yielding loans tend not to lead to higher returns — in fact, the further lenders step out on the risk spectrum, the less they make as losses increase more than yields."[18]** There is no free lunch in investing, not even in private markets.

For historical perspective on private credit returns, Rasmussen and Obershain note that publicly traded business development companies (BDCs) are the 'original direct lenders'. BDCs historical performance offers some insight into whether headline 'distribution yields' in the double-digits in private credit today are representative of expected real returns. From 2004-2019, BDCs offered yields between 8% and 11%, but returned just 6.2% with a max drawdown of -77%.[19] Although that period included 2008 and accounts for mark-to-market risk blissfully absent in private credit vehicles, there is some indication that headline distribution yields likely overstate the performance investors will end up capturing.

BDC Returns vs. High-Yield Index, 12/31/04 - 12/31/19

	Annualized Returns	Maximum Drawdown
BDC Index	**6.2%**	**-77.8%**
BBB	5.9%	-17.2%
BB	7.1%	-25.1%
B	6.2%	-34.0%
CCC	7.4%	-48.6%

Source: Bloomberg Barclays Indices, S&P BDC Total Return Index, Verdad.

[15] https://www.blueowl.com/wp-content/uploads/2023/01/Blue-Owl-Direct-Lending-2023-Outlook.pdf
[16] https://www.ft.com/content/8b50cf70-b379-42a0-b373-18cd1afea8fe
[17] Private markets outperformed public markets last year, so private market allocations were driven higher on a percentage basis across institutional portfolios, often above preexisting target weights for many LPs. McKinsey Private Markets Annual Review 2023
[18] https://www.institutionalinvestor.com/article/b1k369v2lg69qt/High-Yield-Was-Oxy-Private-Credit-Is-Fentanyl
[19] Ibid.

'Make-Believe' Prices

Besides returns, the other most obvious reason for allocators' increasing exposure to private markets is low volatility and correlations to other assets. This looks great when evaluating portfolio asset allocations; allocators (including us) get very excited by high risk-adjusted return measures such as Sharpe ratios. Being stuck with a levered long portfolio of small cap equities in a falling market used to be seen as a 'bug' that justified higher expected return, the so-called illiquidity premium. This illiquidity is now a coveted 'feature' of investing in privates. Infrequent mark-to-market practices help delay recognition of portfolio losses and significant discretion is afforded to valuing and reporting portfolio prices. For example, in Q2 2022, PE returned -3.2%, while the S&P 500 fell -16.7% and the Russell 2000 lost -17.2%.[20] Outperforming in bear markets (when correlations between liquid assets typically become more positive) makes allocators feel even better than looking at nice Sharpe ratios.

So, why do PE managers, the world's foremost experts in company valuation, find it so difficult to answer the question, 'what would we get if we sold in today's market?' Cliff Asness of AQR believes it is simply because they don't want to tell investors, who in turn don't want to know anyway. This is an extremely well-paid gentleman's agreement for those who take part. As Asness puts it, **"Unlike Swensen's PE market, which was primarily about earning extra return, today's PE market is now seemingly as much about not having to report market prices."[21]**

Being told your private equity portfolio has high single digit volatility and low correlations to other assets of course justifies increasing allocations to the asset class year-on-year. There is a theory that believing a portfolio of levered small cap equities is half as volatile as the market (and uncorrelated) makes allocators better investors by avoiding selling in drawdowns or trying to time markets. The CIO of the Public Employee Retirement System of Idaho lauded this 'wilful ignorance', saying **"If (private equity) just gave public market returns, we'd be in favor of it because it has some smoothing effects on both reported and actual risks."[22]** We have some sympathy with this argument and have written before on how volatility induces behavioral errors reducing investor returns. But only if one is *actually* reducing volatility can one sustainably reap the benefits of consistent returns. Pretend marks as a desired feature merely increases complacency and investor enthusiasm, allowing prices paid and leverage employed to climb to historically high levels, as they are today. Lower returns simply become tomorrow's problem.

Expected Returns in Private Markets

If private equity portfolios struggled to outperform their public market equivalents when they resembled levered small cap value stocks, maybe they will have a better chance in future now PE looks like (more) levered small cap growth stocks.

Multiples paid in buyout deals have reached record highs: EV/EBITDA multiples for US buyout were close to 12x in 2022, almost double the 7.5x paid on average in 2000. Industry composition has changed too and is reflective of investor preferences in public markets – information technology (particularly software) and healthcare companies have replaced cyclical and industrial sectors in private portfolios. Debt levels have risen commensurately to help underwrite higher purchase prices. The SEC warns that debt/EBITDA over 6x 'raises concerns' for most public companies, but this milestone was breached by US buyouts in 2015 and reached nearly 7x in 2022.[23] On top of this, multiples are typically based off *adjusted* EBITDA, which conservatively overstates actual EBITDA by about 30%, so valuations and debt burdens are likely much worse than reported.[24] S&P Global ratings believe this EBITDA 'addback fallacy' has become institutionalized across private markets. What effect could this have on future performance?

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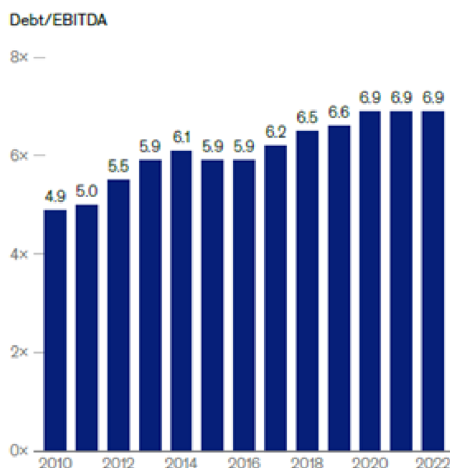
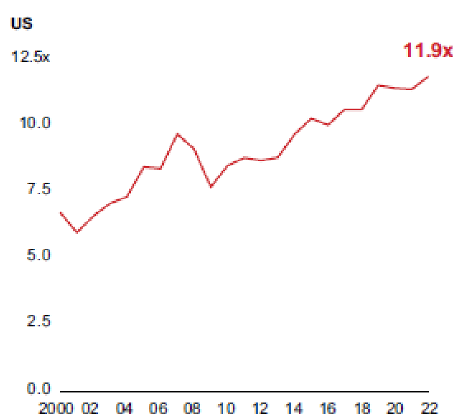
[20] https://pitchbook.com/news/articles/private-equity-fund-returns-Q2-2022
[21] https://www.institutionalinvestor.com/article/b1h9csrci656v4/Why-Does-Private-Equity-Get-to-Play-Make-Believe-With-Prices
[22] https://www.youtube.com/watch?v=JlXnzGv4D5w&t=5330s
[23] https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf
[24] https://www.institutionalinvestor.com/article/b1b3lb38cvhstb/S-amp-P-Global-Warns-of-Aggressive-Private-Equity-Tactics





Source: (LHS) McKinsey & Company, (RHS) Bain & Company.

If multiple expansion keeps driving exit prices higher, overstating profitability and understating leverage levels will remain a palatable 'quirk', like smoothed returns, of investing in private markets. Against a backdrop of zero interest rates, Bain reports that multiple expansion has been the largest driver of buyout returns over the past decade: **increasing valuations accounted for 53% of returns to buyout PE between 2011 – 2016, and almost 60% of returns between 2017 – 2022.**[25] The shift from old economy sectors to new economy businesses paid off.

How long can this multiple expansion persist from record high starting levels in a world of higher rates and less enthusiasm for expensive assets? Plentiful dry powder and a willingness to use more debt continues to put a floor under – or raise the ceiling of – prices today. 65% of US buyouts in 2022 attracted multiple bidders or involved a formal auction process, and there is a steady increase in transactions being financed with 70% equity and 30% debt instead of the traditional 50-50 split.[26] Investors willing to 'pay up' appears less a reflection of a wonderful opportunity set than the reality of too much money chasing too few deals.

But unless multiples expand inexorably, revenue growth and margin expansion will have to increase their share of value creation. Unfortunately, that will be a difficult task for most private equity backed companies. S&P Global Ratings report that 60% of PE-backed companies missed EBITDA targets by at least 25% in 2021 and only 23% exceeded EBITDA projections.[27] An older study by Verdad, which looked at deals in the mid-2010s, corroborates S&P's findings, **"In 54 percent of the transactions we examined, revenue growth slowed. In 45 percent, margins contracted. And in 55 percent, capex spending as a percentage of sales declined. Most private equity firms are cutting long-term investments, not increasing them, resulting in slower growth, not faster growth."**[28]

It is unlikely operating performance has improved since then. Higher rates are pitched only as a positive by most in the industry, especially, as we noted earlier, by private credit providers. But at what point will interest payments several turns higher than during the ZIRP years start to impact the operating performance, exit values, and default risk, of PE-backed companies? Between 1980 and 2016, 20% of PE-backed companies went bankrupt.[29] In the Bain 2023 private equity report a chart shows that 80% of the financing for middle-market buyouts was provided by non-bank direct lenders. Credit ratings for private equity sponsored companies have historically been single B at best.[30]

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[25] https://www.bain.com/insights/topics/global-private-equity-report/
[26] Ibid.
[27] https://www.spglobal.com/ratings/en/research/articles/230216-leveraged-finance-fifth-annual-study-of-ebitda-addbacks-finds-management-continues-to-regularly-miss-project-12643170
[28] https://americanaffairsjournal.org/2018/02/private-equity-overvalued-overrated/
[29] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3423290
[30] https://www.ft.com/content/674c5678-2af8-4772-8c29-108e95d4ad5b

	Credit Rating	Proportion of Companies: Non-PE High Yield	Proportion of Companies: Private Equity	Avg. 5-Year Default Rate (1920—2018)
Invest. Grade	BBB and above (Investment Grade)	0%	0%	<2%
High Yield	BB	42%	2%	8%
	B	53%	84%	19%
	CCC	5%	13%	33%
	CC	0%	1%	55%
	Average Default Probability	**15%**	**21%**	

Source: Moody's Investors Service, The Financial Times.

With leverage levels much higher today than between 1980 and 2016, will defaults be in line with historical averages, or closer to zero, as private credit providers propose? If we are being especially uncharitable, in sum it appears the most wildly popular investment strategy in institutional money management today is to buy the equity and debt of small-cap growth companies – which have near-distressed credit quality, significantly overstated EBITDA, and record levels of debt – at the most expensive valuations in the history of private markets.

Conclusion

Why is the sophisticated ecosystem that surrounds institutional asset allocation not seeing through this? Professor Phalippou believes it is because, **"Net-of-fee performance of PE funds being superior to that of public equity is the *sine qua non* condition for continued employment of at least 100,000 people."[31]** Hunter Lewis, the former Cambridge Associates CEO, remarked, **"A single institutional investor may have an investment committee chaired by a private equity partner who is also a major donor. It might also have an internal staff head from the same background and analysts devoted to studying private funds, many of whom aspire to join the same funds they are supposed to evaluate."**[32] Even Cliff Asness somewhat diplomatically admits it is a principal/agent problem, "…where the PE managers get paid a ton so intermediaries can then report unrealistically rosy assumptions and unrealistically calm returns", but one where responsibility should really be borne by the principals, **"Truth be told, it's whoever the agents report to who need to improve here (i.e., understanding that asset prices actually move and not needing to be fed imaginary unchanging numbers) — not the agents themselves, who are just responding to incentives."[33]**

Despite the tone of this paper, we appreciate that private investing serves a vital economic purpose. 80% of companies over $100m in size are private.[34] As companies stay private for longer, one cannot just invest in traditional assets or hedge funds to capture the 'beta' of the new economy. It is not the fault of private equity and private credit funds that they are the apple of allocators' eyes. We recognize that 'professional envy' inspired this note.

But our concern is not necessarily the lack of accurate reporting or even whether private markets have really outperformed in the past. Rather, we anticipate that investors in these asset classes today will not achieve the returns they expect in future. There is great risk of a 'Minsky' moment as dry powder and AUM levels march ever higher. Maybe multiple expansion can only drive private equity returns so far and/or yields can only go so high for private credit before defaults reduce returns? Michael Mauboussin has written about an essential interaction between the diversity of crowds and stable asset prices in public markets, but we believe the lesson applies here in private markets too, **"During the run-up to a crash, population diversity fails. Agents begin to use similar strategies as their common good performance**

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31 *An Inconvenient Fact: Private Equity Returns & The Billionaire Factory* p.13
32 https://www.ft.com/content/7a6bc5f8-be62-4360-8e5c-edfbed2187d5
33 https://www.institutionalinvestor.com/article/b1h9csrci656v4/Why-Does-Private-Equity-Get-to-Play-Make-Believe-With-Prices
34 https://milkeninstitute.org/panel/14409/inside-growing-world-private-markets

begins to self-reinforce. Markets become fragile, and a small reduction in the demand in shares could have a destabilizing impact on the market… Traders have a hard time finding anyone to sell to in a falling market since everyone else is following very similar strategies."[35]

Cracks are beginning to emerge. The typical leveraged buyout has seen its interest costs as a percentage of operating cash flow double, while coverage ratios fell by half.[36] At the end of April, Grant's Interest Rate observer reported warning signs in the 'cov-lite' loans that finance private equity deals: first-lien loan holders recovered just 73 cents on the dollar on average during restructurings over the last two years, while over the preceding 32 years, recovery rates registered at 95 cents. Jonathan Sokoloff, a managing partner at $70 billion AUM private equity firm Leonard Green, recently said **"We had kind of a 12-year party in the financial world and private equity. It was a lot of fun and very lucrative and made us all look smarter than we are. The party is over."[37]**

We believe the current popularity of private market investing is consistent with the Keynesian belief that it is better for reputation to *fail conventionally*. No allocator will be fired, questioned, or ridiculed for increasing investments in private assets in 2023, despite the poor outlook for expected returns. We hope that investors free of career risk and skewed incentives can instead *succeed unconventionally* by avoiding the most obvious pitfalls in private markets today.

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[35] https://macro-ops.com/wp-content/uploads/2019/02/Who-Is-On-the-Other-Side.pdf p.10
[36] https://milkeninstitute.org/video/investors-common-sense
[37] https://www.ft.com/content/4fab0e76-5497-48b3-8938-cb792f4ee4db