



Factors that Do (and Don't) Explain Private Equity

In the performance debate about private equity, perhaps both sides are right

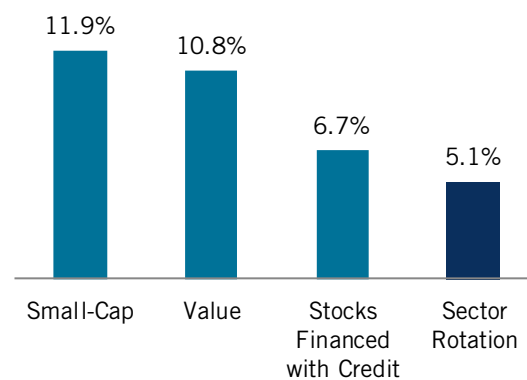
Private equity's slice of the market pie continues to grow. There are only about half as many publicly listed companies in the US today as 20 years ago;¹ meanwhile, the amount of capital raised for private equity has blown past historical records.² Private equity claims larger shares of institutional portfolio assets, too. And yet, while US buyouts outperformed the S&P 500 by more than 800 basis points per year—net of fees—pre-crisis (1997-2006), post-crisis (2010-2018) that spread has fallen to almost zero. For asset allocators this raises some critical questions: will private equity outperform public markets in the years to come, and is it worth the higher fees?

The answers are not obvious. Compared to public equities, very little is known about the drivers of private equity returns. On one hand, there are compelling reasons to believe that the financial, managerial and operational engineering associated with private equity can add sustainable value over time. On the other hand, some argue that using leverage to buy small cap value stocks should beat the market in the long run, no matter what you call it.

To address these issues, we analyzed the aggregate performance of US buyout funds compared to public markets using State Street's Private Equity Index. Contrary to popular belief, we find that neither excess market exposure (due to leverage) nor the small cap premium explain buyout performance at all. This is especially surprising as small cap indices are commonly used as stand-in investments for uncalled commitments to private equity. To track private equity, mimicking the aggregate sector exposures of the asset class is far more important. By tracking we mean that investments post up and down years in tandem; evidence that they are exposed to related factors. Correlation is key.

When all is said and done, we find that a portfolio that tracks private equity well—mostly through the sector rotation factor—captures about half of its premium over time. So while it is possible to track a portion of private equity's aggregate performance, there is also a lot that cannot be replicated in liquid markets.

Annual tracking error versus actual private equity (2002 – 2018)



Source: State Street Global Markets. Notes: Tracking error is the standard deviation of calendar year total returns from 2002 to 2018 for various indices versus the State Street Private Equity US Buyout Index.

For more on this topic, see our 2015 paper "**The Components of Private Equity Performance: Implications for Portfolio Choice**" by Mark Kritzman, Will Kinlaw and Jason Mao in the *Journal of Alternative Investments*, and our 2019 paper "**Explaining Buyout Industry Returns: New Evidence**" by David Turkington in the *Journal of Investment Management*.

Notes:

¹ Source: "Where Have All the Public Companies Gone?" Bloomberg Editorial Board, April 9, 2018.

² Source: "Global private equity report 2019," Bain & Company, 2019.

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