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Private Equity: The Missing Pillar in Your Portfolio?

Bernstein Private Wealth Management

Investment Strategy Group

The authors of this white paper are members of the Bernstein Investment Strategy Group, a team of senior investment professionals who are responsible for the development, oversight, and strategic asset allocation recommendations for Bernstein's investment offerings.

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Executive Summary

- Private equity has grown from a niche, institutional asset class three decades ago to a sizable and more accessible asset class today.

- Private equity exposure can add value to a diversified portfolio through incremental relative returns stemming from an illiquidity premium, operational improvements, and a less efficient market.

- In the prevailing higher-rate environment, firms are underwriting investments designed to succeed via lower entry prices and operational improvements. They do not require low or falling rates to earn their returns.

- In the US, 85% of companies are privately owned, creating an attractive universe for investors deploying capital. Furthermore, valuation multiples for these private businesses generally remain lower than those in public markets.

- While some have characterized the asset class as a levered version of public equities, most private equity managers use prudent amounts of debt.

- Lower liquidity and lower volatility are two related hallmarks of private equity. While the former may give some investors pause—especially those investing in public markets—capital in private equity is by definition long-term.

- Many investors have sufficient liquidity to meet their needs and, after a careful assessment of their constraints, can allocate a reasonable amount to private equity or other illiquid strategies to enhance total risk-adjusted returns.

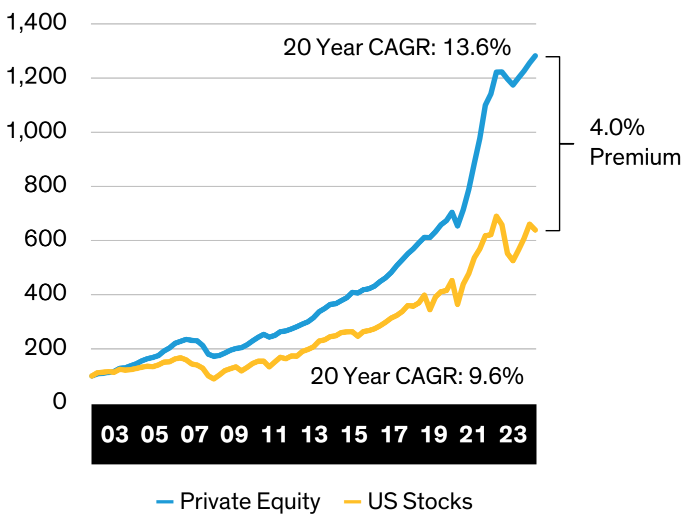
- Investor caution around transparency and fees is understandable. On balance, though, we believe that private equity can offer as much transparency as most investors would expect from public equities. Fees can also be justified by the excess returns generated over time relative to other available asset classes.

What Drives Private Equity Returns?

Private equity has grown significantly as an asset class in recent decades primarily due to its consistent ability to outperform public markets. Over the past 20 years, private equity returns have compounded at 13.6% net of fees, compared to just 9.6% for public equities (*Display 1*). In other words, even after fees, exposure to private equity has boosted the long-term returns of diversified portfolios.

DISPLAY 1: PRIVATE EQUITY EXPOSURE HAS HISTORICALLY BEEN REWARDING

Growth of $100 from 4Q 2003–3Q 2023



As of September 30, 2023. **Past performance does not guarantee future results.** US Stocks are represented by the S&P 500 Index. Private Equity is represented by the Preqin Private Equity Quarterly Index.

Source: Preqin, S&P, and AB

As private equity matures and attracts more capital, its outperformance is likely to narrow, while still compensating investors for its complexity and illiquidity. A realistic after-fee outperformance of 1%–2.5% per year compared to public stocks would allow investors to double their wealth in eight years in private equity, instead of ten years in public markets. Put another way, you can think of private equity returns as a combination of theoretical exposure to levered small-cap value combined with the chance to outperform peers based on manager selection.

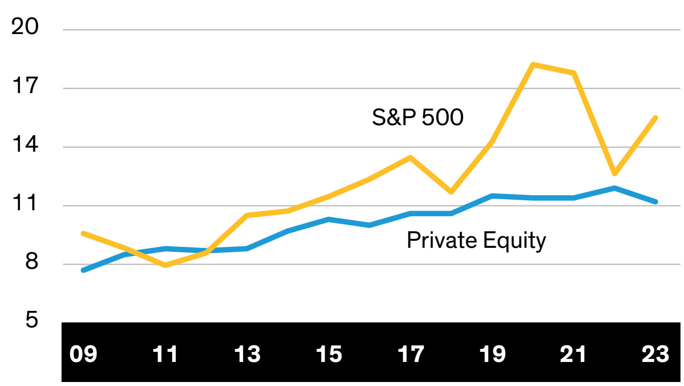
Still, private markets tend to be less efficient and the discount for illiquidity generally keeps multiples for the asset class lower than in public peers. While there have been periods of convergence, the overall trend has persisted and at the time of this writing, the spread remains relatively wide (*Display 2*).

Yet we'd advise against becoming too attached to today's attractive relative multiples. The inherent structural discount poses a long-term tailwind for the asset class—providing a higher cash flow yield, a greater margin of risk mitigation, and more room for private equity owners to enhance multiples through improved operational results.

That ability to drive operational improvements by exerting control over companies is another factor that fuels private equity's outperformance. Owners usually do this by placing or attracting more professional and experienced management teams into leadership roles at underlying portfolio companies. They also upgrade systems from legacy home-grown tools to more modern efficiency-enhancing solutions. By using their networks and deal pipelines, they're frequently able to identify accretive bolt-on acquisition targets and complete those deals to generate further efficiencies. Once in place, the companies gain more pull to negotiate and wring better economics from items like office supplies, software, legal fees, and

DISPLAY 2: PRIVATE EQUITY MULTIPLES ARE GENERALLY LOWER THAN IN PUBLIC MARKETS

LTM EV/EBITDA Multiple



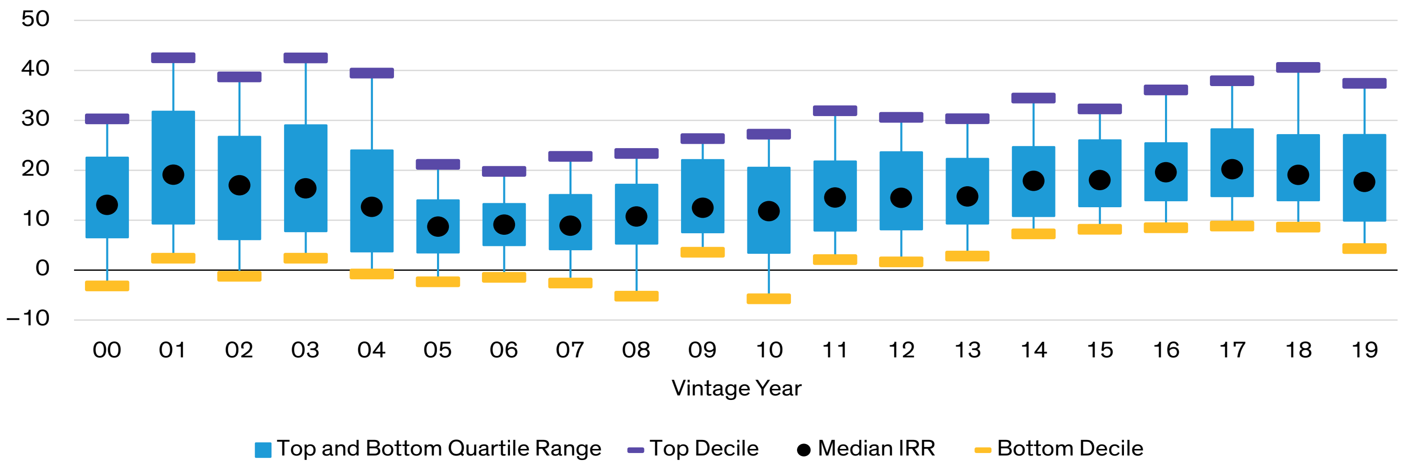
Past performance does not guarantee future results.

As of September 30, 2023. **Source:** FactSet, Pitchbook, Bank of America, S&P LCD, and Bernstein analysis

Some may wish to time their private equity allocation based on entry valuation spreads—an approach we'd strongly discourage. Private equity commitments tend to be deployed into a series of deals over a one- to four-year investment period. Rather than being driven by any tactical view, our focus is on the long term. The core idea is that investors increase their exposure over the course of several years and as capital is returned, recycle a portion of those returns back into future private holdings. This "laddering" strategy allows clients to slowly build their private equity allocation to a target level that can be maintained over time. As a result, while individual deal valuations may significantly impact returns—and valuation makes private equity a relatively attractive asset class overall—it's impractical to try to tactically time your entry.

DISPLAY 3: PRIVATE EQUITY RETURNS HAVE A WIDE DISPERSION, WHICH CAN BE VALUABLE TO INVESTORS IN HIGH-RANKED FUNDS

2000–2019 Vintages (IRR in Percent)



Data as of June 30, 2022. **Past performance is not necessarily indicative of future results. There can be no assurance that any investment objectives will be achieved.** Please see important risk disclosures at the end of this document.
Source: Pitchbook and Bernstein analysis

more. Finally, private equity firms often look at the business model in place and overhaul it, implementing a more attractive one that generates greater recurring cash flows over time.

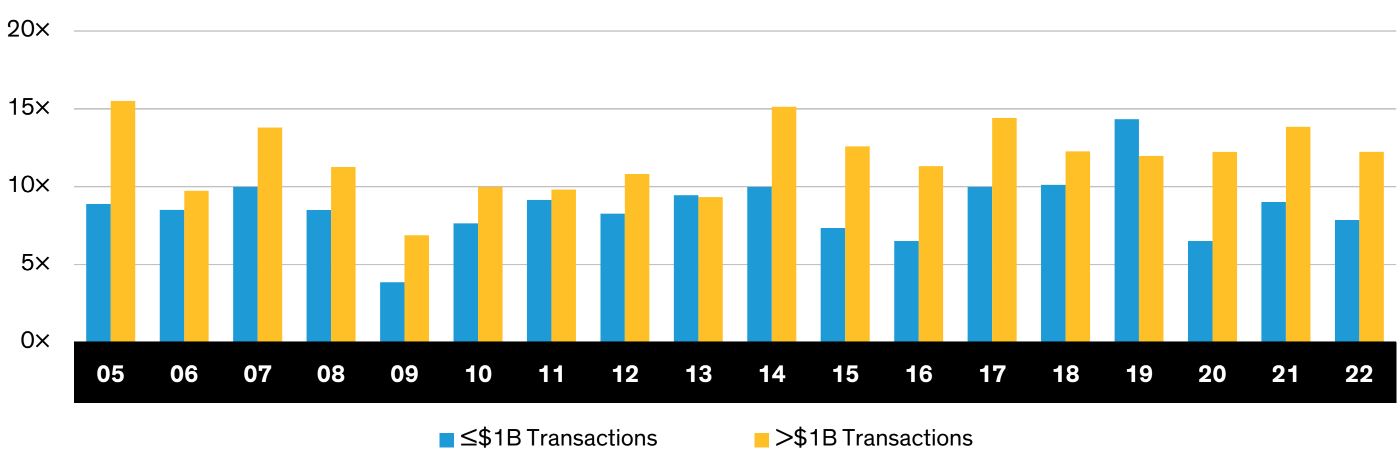
Ultimately, by enhancing operating performance and extracting value from what is usually low-hanging fruit, the business may merit a higher valuation multiple. Even allowing for the liquidity discount in private company valuations, improved operations can lead to multiple expansion and generate additional returns for investors.

Manager Selection and Capitalization

Manager selection tends to play a critical role in total returns, adding another point in private equity's favor. While the median private equity fund has historically delivered impressive results, there is a significant variation across managers, with top quartile returns materially surpassing the median (*Display 3*). In addition, because of the tighter correlation between managers' historical and future performance in private markets, investors with access to top-half and top-quartile funds have even more reason to complement their public equity exposure with private equity.

DISPLAY 4: SMALLER DEALS TAKE PLACE AT LOWER AVERAGE MULTIPLES THAN LARGER DEALS

Transaction Value/EBITDA



As of September 2023.
Current analysis does not guarantee future results.
Source: Preqin, Abbott Capital, and Bernstein analysis

Notably, there are different flavors of private equity, mainly based on portfolio company size. In data going back to 2005, the median valuation of small buyout transactions (deals less than $1 billion) has been lower than that of large buyout transactions (deals over $1 billion) in every year except 2013 (*Display 4*).

Also, compared to large funds, small funds have generated a flatter distribution of returns, with a notably fatter right tail.[1] Looking at their total value to paid-in (TVPI, essentially how many dollars they returned for every dollar invested), fewer of the smaller funds have had returns of 1-2x their invested capital compared to their larger peers. Plus, more of them had returns of 2.5x or more relative to larger private equity funds (*Display 5*). Given these advantages, we favor middle market private equity as a core allocation.

Top-tier private equity managers tend to reinforce the "virtuous cycle" they enjoy.[2] In public markets, a historical track record is at best weakly predictive of future returns, and at worst, not predictive at all. In private markets, however, top-tier players typically remain so from one vintage to the next. Why? Imagine you are selling your business and have the luxury of choosing from multiple buyers. While one may offer the highest bid, others may have a reputation for being the best operators. If you plan to continue running the business or if the value of your shares depends on hitting future operational milestones, you'd likely choose the buyer who can help your business thrive.

Likewise, if you're an experienced executive being asked to come in and run a private company with a performance-based compensation structure and significant equity participation, are you going to prefer working with private equity owners who have a proven history of success… or ones whose track record seems less dependable?

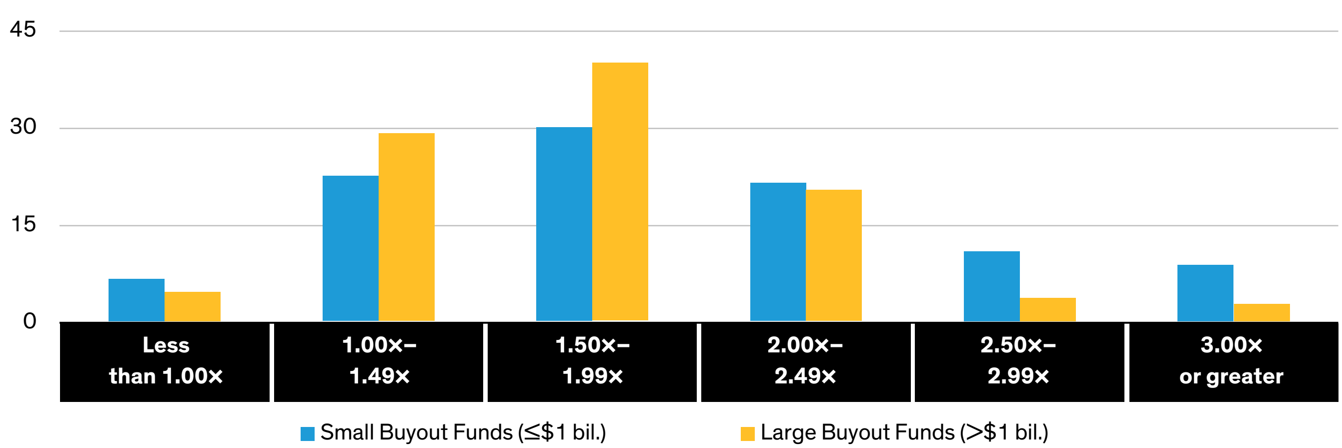
Not All Companies Want to Be Public

Great companies are not limited to the public markets. And private equity offers a variety of unique opportunities that are not accessible in public markets. For that reason, it should be considered a crucial component of a long-term investor's portfolio, in addition to public equities.

Just as the investment industry has evolved in recent decades, so too has the universe of public versus private companies and the options for financing businesses of different sizes. Since peaking in 1996, the number of publicly listed companies on US exchanges has fallen from over 8,000 to around 3,700 in 2023. Nonetheless, the total capitalization of the US market has risen in that time, as have the total profits of publicly traded companies.

DISPLAY 5: A LARGER PERCENTAGE OF SMALL FUNDS GENERATES RETURNS OF 2.5X OR MORE

Vintage Years 2000–2019[1] (TVPI)



As of September 2023.

Past performance does not guarantee future results.

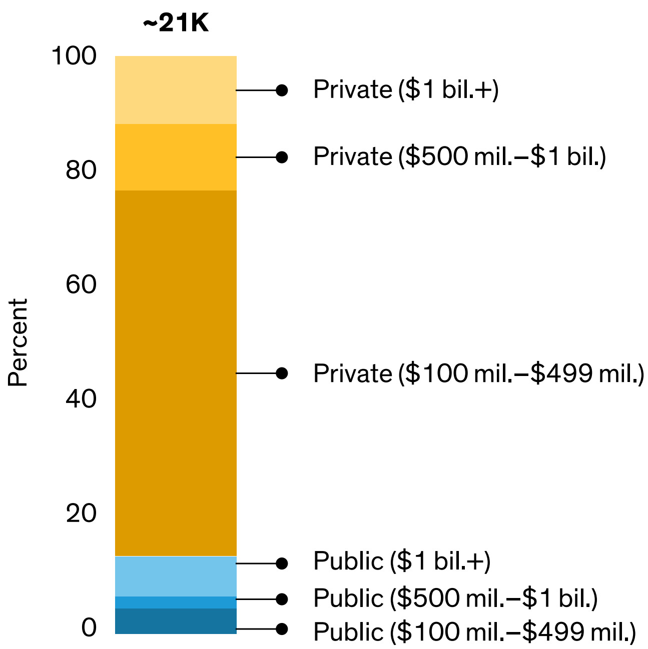
Source: Preqin, Abbott Capital, and Bernstein analysis

1 Large funds are those with over $1 billion, while small funds are those with less than $1 billion.
2 Note that the term "top tier" private equity managers may overlap with—but is not synonymous with—"large cap" private equity managers.

Today, over 85% of the roughly 21,000 companies with revenues above $100 million remain privately owned. While public market investors have access to some of the largest companies in the world—alongside many others of varying quality—a meaningful swath of the economy is not included in that universe (*Display 6*).

DISPLAY 6: SMALL PRIVATE BUSINESSES COMPOSE THE MAJORITY OF TOTAL BUSINESSES IN THE US

By Revenue



Source: Bain, Statistics of US Businesses, S&P Capital IQ, and Bernstein analysis

From a corporate standpoint, the pros and cons of being public have changed. It costs more than ever to be a public company, adding up to several million dollars per year. If you're a company with $300 million in revenue—which includes roughly half the nation's businesses—those costs amount to nearly two percentage points of annual profit margin. That's a significant cash flow that could otherwise be paid to owners and employees or reinvested in the company.

On the other hand, being public historically offered the advantage of accessing deeper and more liquid capital markets for equity or debt issuance. Now, with growing pools of capital in private markets, companies don't need to pay bankers or shoulder the annual costs for that privilege. Around $1.2 trillion in dry powder sits in the hands of buyout investors, $500 billion in venture capital, $300 billion in growth equity, and $100 billion in direct lending. Running a private business today means having a wide range of financing options at your disposal.

In some ways, this reminds us of an important concept in economics, called Say's Law, which states that "supply creates its own demand." When applied to the economy, it effectively means that producers then have the wherewithal to become consumers. In the case of private markets, the growing accessibility of funding—and a smoother, more certain financing process compared to public markets—has created its own demand for that type of capital.

The ability for insiders to generate liquidity from their shares was another longstanding impetus for going public. While that incentive still generally favors public markets, a growing number of platforms to sell private shares have blossomed over the past decade, along with other ways to sell or diversify away from outsized single-stock exposure.

As a result, more trophy assets are staying private longer, either delaying the time before they go public or passing from one private investor to another. Small- and mid-cap companies in the public market have experienced performance headwinds lately in part because dynamic smaller businesses are no longer maturing in public markets. Put simply, private investors are increasingly accruing excess returns instead of public ones.

	Private	Public
SPACE	SPACEX	NORTHROP GRUMMAN
GAMING	EPIC GAMES	EA
SOFTWARE	OpenAI	Microsoft
SOCIAL MEDIIA	TikTok	Meta
PAYMENTS	stripe	Square

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What's more, corporate executives remain wary of all the headaches that go along with listing—being forced to focus on the short term at the expense of the long term, constantly placating investors and shoring up your shareholder base, not to mention the looming threat from activist investors should your stock price wane. In fact, many executives who have worked for both public and private companies strongly prefer the private side.

Not Just Leveraged Returns

Some claim that private equity derives its premium over public stocks by using excessive leverage. To be clear, there is leverage—and that affects the risks involved and comparisons between the two. Yet while some private equity managers aim to add value through financial engineering, most merely seek to employ a prudent amount of debt that their public counterparts are loath to assume.

For instance, buyout firms typically utilize debt financing at the company level to enhance equity returns. That said, they tend to do so in a judicious way. Debt loads typically sit in the range of 40%–45% of enterprise value and cash flows generally cover interest payments two or three times over. In contrast, public companies tend to minimize their leverage to avoid a lower P/E multiple compared to their peers, fearing that equity markets may penalize a high-yield balance sheet. Eliminating those concerns means private equity managers can instead focus on optimizing debt levels so that the company's cash flows can reliably service and pay down that debt in exchange for higher returns on behalf of their investors.

Leverage is also becoming less important to private equity's overall value proposition as rates have risen and are expected to remain elevated for the foreseeable future. This shift may be a key reason why purchase multiples have decreased fairly significantly since 2022. As financing arbitrage fades, managers must prioritize underwriting deals with lower acquisition multiples to leave more room for achievable operational improvements.

The Market Isn't Always Your Friend

One reasonable criticism levied at private equity funds is that their illiquid nature obscures the volatility of what are effectively levered small- and mid-cap stocks. Our response is perhaps unconventional. Yes, that is true. But no, we are not particularly worried about it.

How can that be? Simply put, exposure to private equity or other illiquid strategies should be sized with that illiquidity in mind. There should be no need to tap those funds during the investment period. Investors should size and fund these positions in such a way that they'll never become a forced seller.

Trading in and out of investments is not the end game for investors who are committed to a long-term strategy. Investors in public equities may wish they could turn off the news and avoid seeing constant stock quotes. Investors in private equity have that luxury, more or less.

Perhaps one of the most important parables in all of investing was put forth by Ben Graham in his canonical book, *The Intelligent Investor*. In it, he frames the opportunity that public market investors have to take advantage of the volatile opinions of "Mr. Market." For most investors, one of the most important lines comes at the very end:

> **"At other times [an investor] will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."**
>
> Ben Graham, *The Intelligent Investor*

Pulling back the lens is what we believe most long-term investors, whether public or private, should do. However, it can be challenging with constant price quotes on TV and online. Private markets offer a more conducive environment for embracing a multi-year mindset.

In fact, many investors do themselves no favors when they pursue daily, weekly, or monthly price quotations for their assets. While market fluctuations often create opportunities, as Ben Graham pointed out, market timing often ends quite poorly.

Consider Vanguard's analysis of self-directed IRA investors over the five-year period ending December 31, 2012—a period with some notable market swings. The "average investor" who traded even once during that time trailed a set-it-and-forget-it target date fund benchmark by 1.5%. Those who avoided trading lagged the benchmark by only 0.2%. Comparing time-weighted returns versus fund returns shows much the same pattern, as investors habitually chase recent winners while selling recent losers.

Coming at it another way, think about your house. Personal residences are one of the greatest forced savings mechanisms in history. They have helped countless people grow their personal fortunes over time, as they are not typically traded in and out of based on the plummets or surges of the housing market.

Finally, we would worry if we believed that portfolio marks were misleading or that the eventual exit values would culminate in lower realized returns than what was implied along the way. However, according to Bain, the majority of private equity holdings are exited at a higher valuation than their previous quarterly mark. Only around a third experience a valuation decline between their final appraised value and the realized value at sale. A greater proportion exit with a gain of 0%–10% versus that final valuation and around a quarter exit with a gain of more than 10% versus their final mark.

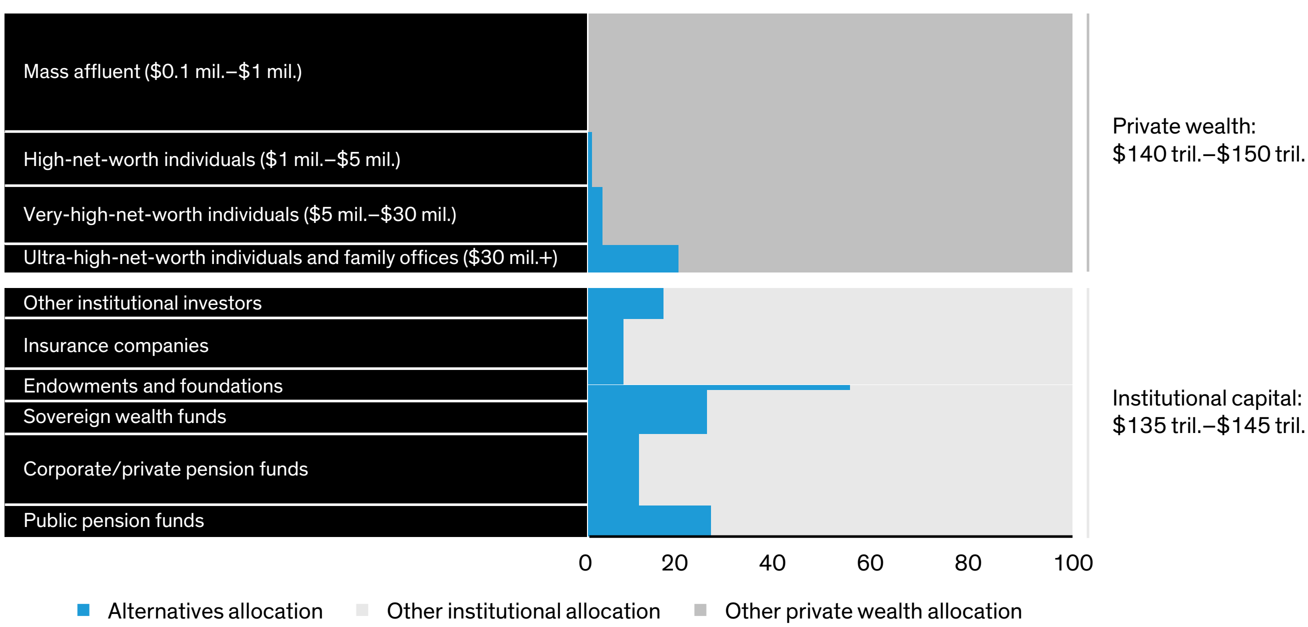
The Evolution of Investing

For decades, private equity has established itself as a pillar asset class for institutional investors such as pensions, endowments, large foundations, and family offices. Individual investors, though, have been slower to embrace private equity and other alternative investments (*Display 7*).

We attribute that to a few key reasons, some of which are supply-driven while others are demand-driven.

First and foremost, the regulations surrounding private investments are intentionally strict in order to protect the general public. While wealth and investment knowledge are not interchangeable, regulations have often treated them that way for ease of implementation. As a result, certain investments are limited to ultra-high-net-worth or institutional investors. Others have become more widely available, as they allow for proof of financial acumen to count as much as net worth or income. Still, these historical constraints have prevented many investors from being exposed to—or having the opportunity to learn more about—private investment options.

DISPLAY 7: INDIVIDUAL INVESTORS HAVE BEEN SLOWER TO ALLOCATE TO PRIVATE ASSETS



As of December 31, 2022

Source: Bain, GlobalData, Preqin, and Bernstein analysis

Due to that regulatory backdrop, providers of these types of strategies haven't historically targeted individual investors. While change is afoot, most of the leading private investment funds have traditionally geared their outreach toward institutional investors. Recent shifts have forced many firms investing in private markets to adjust. They must now be better at laying out risks, explaining contingency plans, and ensuring a solid investor base.

From the demand side, the lack of liquidity in private equity holdings has been a long-standing obstacle. This is a structural issue that comes by design. As previously discussed, the compensation for this lack of liquidity is what generates higher expected returns over time for the asset class.

Even acknowledging that core characteristic, many individual investors have sufficient liquidity elsewhere to allow them to earmark a portion of their portfolio to illiquid strategies such as private equity. With that said, if an investor can allocate to a *diversified portfolio* of private equity holdings, we have more confidence in that element as a slice of an individual's overall wealth. We may be more concerned about strategies that significantly alter the diversification profile of an investor's portfolio.

Another hurdle has been less transparency into the underlying portfolio holdings, which tends to vary depending on the strategy. Frankly, there's often a trade-off between the diversification we just discussed and the level of transparency.

We wouldn't advise making private equity investments through one vintage of a single fund investing directly in companies. But if someone were to do so, they would only have exposure to 15–20 private companies. In some ways, they'd have less detail on those holdings than if they were public—you can't pull up the company financials on Yahoo Finance or the SEC's EDGAR database. At the same time, they might have more detail on the operating environment and business dynamics than they would if they were otherwise investing in a concentrated portfolio of public companies.

We suggest investors approach the asset class by allocating across a range of private equity funds over the course of multiple vintages. This provides what we deem a preferable—and almost required—level of diversification. But doing so means your underlying private holdings can add up to exposure to more than 300 companies. This additional degree of separation from the underlying businesses may result in limited details on individual companies' operations. But even investors in actively managed public equities are unlikely to obtain extensive details about any individual company's operations. While publicly available information is accessible, most public equity investors don't pursue it.

Public equity investors who allocate to index funds paradoxically enjoy both full transparency and no transparency. While you may know how much of your allocation is in each company, there is no portfolio manager to curate the most relevant information regarding what's going on. If you want more details, you will have to seek them out yourself. For that reason, most investors allocating to public equities shouldn't see a meaningful difference in the level of information in private equity, in our view.

The final hesitation when it comes to private equity often boils down to fees. Fees are generally higher than for public stocks. Yet historically, the average return after fees has also been commensurately higher than in public markets. Some things are worth paying more for. A meal at a fine dining establishment will likely be more enjoyable than one at McDonald's. As we've shown, the median returns in private equity and those of above-median funds have historically merited the fees.

Making the Case

In general, we believe that individual investors who have the ability and liquidity to allocate to private equity as a complement to their other holdings ought to do so. That holds especially true if they have access to above-median managers, where the incremental returns over public holdings can contribute meaningfully to long-term reward potential.

Relative valuations and expected returns compared to public equities will vary over time. The market's certainly more efficient today than it was twenty years ago. Above all, we believe that for many investors, private equity is additive to portfolios' risk-adjusted returns.

That brings us to the matter of risk. This is still an equity asset class and should be regarded as such. Yet the lack of liquidity remains the primary risk. While for some investors, that may be a reason to pass, in our experience, many investors have sufficient liquidity elsewhere to allow for some illiquid holdings like private equity. Each investor will differ in this regard. We highly recommend speaking with your wealth advisor to assess how much illiquidity your portfolio can handle and to judge conservatively. But remember—conservative doesn't always mean zero.

At its heart, private equity is just good old-fashioned business—buying whole companies and improving them. Rather than focusing on trading in and out of a stock, the aim is to grow revenues and profits of the companies you're invested in. What matters most is being able to buy businesses at a reasonable price and operate them efficiently and effectively. At the end of the day, isn't that the goal of any long-term investor?

Alternative investments involve a high degree of risk and are designed for investors who understand and are willing to accept these risks. **There can be no assurance that any alternative investment strategy will achieve its investment objectives.** Prospective investors should consider the following factors when determining if an investment in a fund is suitable.

Limited Liquidity. There is typically no active secondary market for fund interests, and none may develop. Significant restrictions on transfers or withdrawals typically apply.

Fees. Fees charged by alternative investment funds are generally higher than those of other types of investments, which can offset trading profits, if any. Performance compensation may create an incentive to make riskier or more speculative investments.

Lack of Diversification. The use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk.

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