Exposed: The Myth of Private Equity and Venture Capital Outperformance

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by Larry Swedroe

Don't believe the claims of outperformance among private equity and venture capital investors. A recent study documents the daunting odds against picking a winner in these complex alternative asset classes. Fortunately, there's a way for advisors to gain similar exposure to potentially higher returns in low-cost passive funds.

Capital committed to private equity (PE) funds worldwide has risen substantially in the last two decades, thanks largely to U.S. pension funds searching for alternatives to public equity markets that might help them meet their return objectives. Endowments seeking to replicate the successes of the Yale Endowment have also contributed to the growth of PE funds, which obtained commitments for more than $460 billion in 2013, a twelve-fold increase over the $38 billion committed in 1995.

The term "private equity" is used to describe various types (e.g., buyout funds and venture capital funds) of privately placed (non-publicly traded) investments. Even though buyout (BO) funds and venture capital (VC) funds have a similar organizational form and compensation structure, they are distinguished by the types of investments they make and the way those investments are financed. BO funds generally acquire 100 percent of the target firm (which can be public or private) and use leverage. VC funds take minority positions in private businesses and do not use debt financing.

Steven Kaplan and Berk Sensoy contribute to the literature on the performance of PE funds through an extensive survey of current research on the performance of private equity. The following is a summary of the findings from their October 2014 paper, "Private Equity Performance: A Survey":

- Buyout funds have outperformed the S&P 500 net of fees on average by about 20 percent over the life of the fund.
- Venture capital funds raised in the 1990s outperformed the S&P 500 while those raised in the 2000s have not.
- Before the 2000s, buyout and venture capital fund performance showed strong evidence of persistence.
- Since 2000, there is little evidence of buyout fund persistence (with the exception of persistence among the worst performers, those in the bottom quartile) while venture capital fund persistence has remained strong.

That’s the evidence presented by Kaplan and Sensoy. Unfortunately, the returns data presented isn’t risk-adjusted. Private equity is much riskier than an investment in a publicly traded S&P 500 index fund, making it a wholly inappropriate benchmark. For example:

- Companies in the S&P 500 are typically among the largest and strongest companies, while venture capital typically invests in smaller and early-stage companies with far less financial strength. Studies have estimated betas for BO funds at about 1.3 and for VC funds from 1.6 to 2.5. Adjusting for the higher betas alone would have wiped out any evidence of outperformance.
- Investors in private equity forego the benefits of daily liquidity. It’s well-documented in the literature that investors will demand a premium for investing in illiquid assets, especially ones that perform poorly in bad times (like PE). There’s no adjustment in the returns data for the risk of illiquidity. In addition to the lack of liquidity, relative to investments in mutual funds, private equity investors also forego the benefits of transparency and broad diversification (and for individuals, the ability to harvest losses for tax purposes).
- The median return of private equity is much lower than the mean (the arithmetic average) return. PE’s relatively high average return reflects the small possibility of a truly outstanding return, combined with the much larger probability of a more modest or negative return. In effect, PE investments are like options (or lottery tickets). They tend to provide a small chance of a huge payout, but a much larger chance of a below-average return. And it’s difficult, especially for individual investors, to diversify this risk.
- The standard deviation of private equity returns is in excess of 100 percent. Compare that to standard deviations of about 20 percent for the S&P 500 and about 35 for small-value stocks.
- Given the greater risks and the fact that PE investments are typically in smaller companies, a more appropriate benchmark than the S&P 500 Index is the Fama-French Small Value Index. Small-value stocks have outperformed the S&P 500 by about 3.5 percentage points a year over the last 88 years, and by even greater amounts over the past 35, 25 and 15 years. Once this adjustment in the benchmark is made, it’s clear that, overall, both BO funds and PE funds have performed poorly.

Even adjusting the benchmark does not take into account the risk of liquidity. Clearly, whatever alpha there was being generated was going to the PE fund general partners, not the investors (the limited partners). And that leaves us with the puzzle of why PE continues to attract so much capital. My own view is that it reflects the triumph of hype, hope and marketing over evidence and wisdom.

At least with VC funds, there is evidence of persistence of performance among the winners. Unfortunately, it’s likely that those funds showing persistence in performance don’t need your money and are closed to new investors. They can get all they need from the largest endowments (such as Yale and Harvard). If you’re considering investing in PE, or sit on the board of a committee that is doing so, be sure you consider these sage words of advice from David Swensen, the chief investment officer of the Yale Endowment: “Understanding the difficulty of identifying superior hedge fund, venture capital, and leverage buyout investments leads to the conclusion that hurdles for casual investors stand insurmountably high. Even many well-equipped investors fail to clear the hurdles necessary to achieve consistent success in producing market-beating active management results.”

In their survey, Kaplan and Sensoy observed that a 2014 study, "Limited Partner Performance and the Maturing of the Private Equity Industry," found that in the more recent sample of PE funds raised between 1999 and 2006, there was no evidence that endowments outperform other types of limited partners or display any superior skill at selecting general partners.

According to Kaplan and Sensoy, this study (which Sensoy also co-authored) concluded that "the disappearing endowment advantage is consistent with other secular trends in the industry, particularly the decline in VC performance since the late 1990s and the decline in performance persistence in BO firms."

As I noted earlier this year, in his book *Unconventional Success*, Swensen offered the following observation on BO funds: "Investors in buyout partnerships received miserable risk-adjusted returns over the past two decades. Since the only material differences between privately owned buyouts and publicly traded companies lie in the nature of the ownership (private vs. public) and character of capital structure (highly leveraged vs. less highly leveraged), comparing buyout returns to public market returns makes sense as a starting point. But, because the riskier, more leveraged buyout positions ought to generate higher returns, sensible investors recoil at the buyout industry's deficit relative to public market alternatives. On a risk-adjusted basis, market equities win in a landslide."

He also cited a Yale Investments Office study that provides some insight into the additional return required to compensate for the risk in leveraged buyout transactions. Swensen writes: "Examination of 542 buyout deals initiated and concluded between 1987 and 1998 showed gross returns of 48 percent per annum, significantly above the 17 percent return that would have resulted from comparably timed and comparably sized investments in the S&P 500. On the surface, buyouts beat stocks by a wide margin. Adjustment for management fees and general partners' profit participation bring the estimated buyout result to 36 percent per year, still comfortably ahead of the marketable security alternative…. Because buyout transactions by their very nature involve higher-than-market levels of leverage, the basic buyout-fund-to marketable-security comparison fails the apples-to-apples standard. To produce a risk-neutral comparison, consider the impact of applying leverage to public market investments. Comparably timed, comparably sized, and comparably leveraged investments in the S&P 500 produced an astonishing 86 percent annual return. The risk-adjusted marketable security result exceeded the buyout result of 36 percent per year by an astounding 50 percentage points per year."

In a footnote, Swensen further observes that "the sample for the buyout study contains extraordinary survivorship bias. The data employed came from offering memoranda provided to the Yale Investments Office by firms hoping to attract Yale as an investor. Needless to say, only firms with successful track records came calling on the university, hoping to attract funds."

If you're willing, able and have the need to take more risk in search of higher returns, the most likely to place to find them is not in PE but rather in publicly available small-value stocks. And you can access these higher expected returns through low-cost, passively managed and tax-efficient funds. You can globally diversify their risks as well. In addition, you'll have all the benefits of daily liquidity and transparency.

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