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A Comment on Recent Research on Private Equity Investing

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Many large financial intermediaries and high net worth investors invest in Private Equity funds. The consulting firm Cambridge Associates reports that the 25-year return on private equity of 13.5% can be compared to the Russell 2000 9.75% return over the same period. Similarly, in the survey article by Kaplan and Sensoy, they find that private equity outperformed capital markets by 3-4%.1 But private equity funds include drawbacks such as high fees, high complexity, poor liquidity, and poor transparency. Not all investors have been advantaged.

Recent research has begun to throw new light on some of the basic investing assumptions associated with private equity investing. The framework for the new research is on replicating private equity performance with public small cap securities. Chingono and Rasmussen show that leverage is a key factor in enhancing the average returns of a small-value investment strategy.2 Their results provide a better understanding of the leveraged buyout industry as well as encouraging public market value investors to consider leveraged strategies. In another recent study, Stafford reports that a passive portfolio of small, low EBITDA multiple stocks with modest amounts of leverage and hold-to-maturity accounting of net asset value produces an unconditional return distribution that is highly consistent with that of the pre-fee aggregate private equity index.3 Note that the passive replicating strategy used by Stafford 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. In a different perspective, Weisman provides a cautionary study of the impact of appraisal (hold-to-maturity accounting) reported data in leveraged strategies and the cost of fire sales when liquidity disappears.4 As Weisman notes, the impact of appraisal estimated returns during the private period can be a major factor in the misperception of enhanced returns over public equity investing.

1. Kaplan and Sensoy, 2015. “Private Equity Performance: A Survey.” Fisher College of Business Working Paper No. 2015-03-10 http://ssrn.com/abstract=2627312.

2. Chingono and Rasmussen (2015), “Leveraged Small Value Equities.” http://ssrn.com/abstract=2639647.

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3. Stafford (2016) “Replicating Private Equity with Value Investing, Homemade Leverage, and Hold-to-Maturity Accounting.” Harvard Business School Working Paper, No. 16-081, January.

4. Weisman “Forced Liquidations, Fire Sales and the Cost of Illiquidity.”Journal of Portfolio Management, 2016.

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