THE IMPORTANCE OF PRIVATE MARKETS

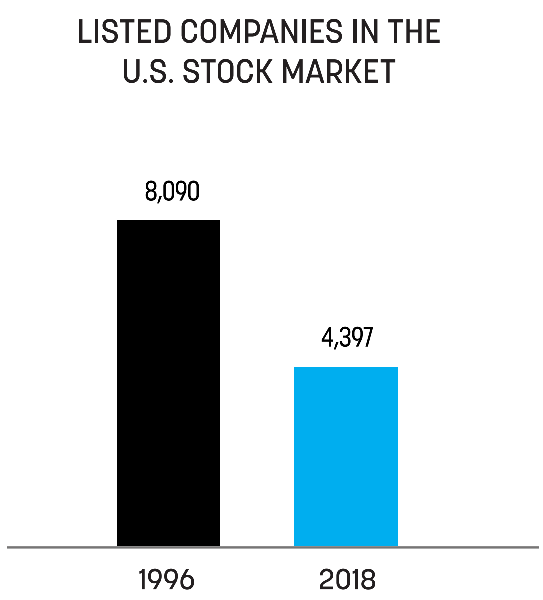
By Nick Veronis, Co-Founder & Managing Partner

The vast majority of individual investors are familiar with one market – a liquid and public one where companies are well researched, prices quickly reflect new data, almost everyone sees the same information, and news spreads in seconds.

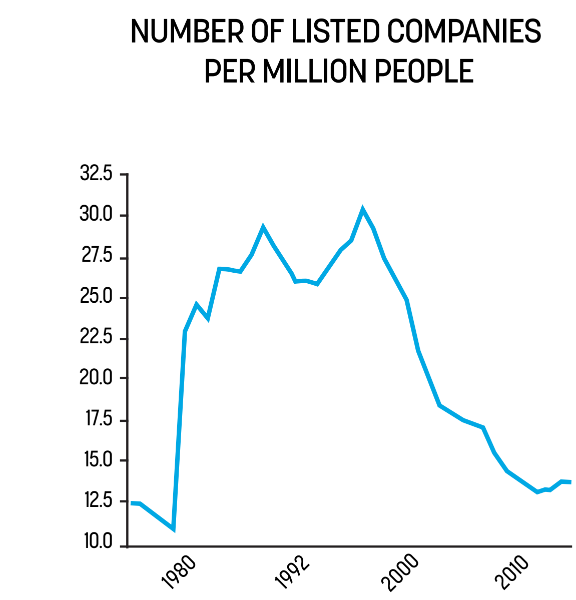
This, of course, is the market for public equities and the related market of publicly traded debt securities, which continue to dominate individual investor portfolios and business headlines.

But beneath the continuously updated stream of public company news, the investable universe being covered is shrinking at a steady pace. Over the past two decades, the number of publicly listed U.S. companies has nearly dropped in half, from a high of 8,090 in 1996 to around 4,397 in 2018, while the average age of a public company has increased from 12.4 years to almost 20 years.[1]

FIGURE 1
THE NUMBER OF LISTED COMPANIES HAS DECLINED



Source: The World Bank



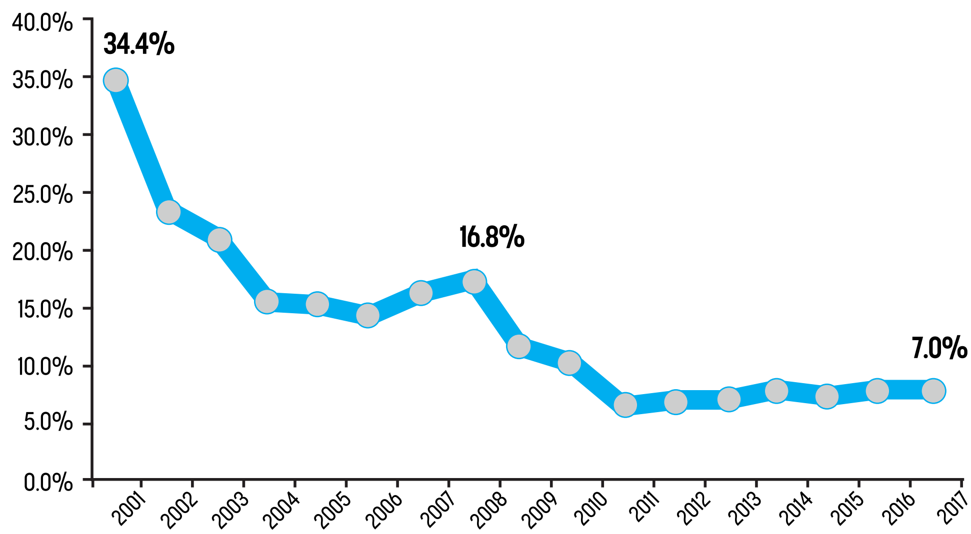
Source: Federal Reserve Bank of St. Louis and World Bank

The implications of this trend are profound. Companies that remain public are older and more mature, on average, than listed firms in years past. Companies are staying private longer and, by the time they IPO (if they do at all), most of their growth and value creation is behind them, reaped by a relatively small number of private investors.

To take the oft-cited example of today's tech giants, investors in Amazon's 1997 IPO, which took place three years after its founding, would have made 893 times their money if they held on until now, compared to 24x for investors in Google's 2004 IPO (six years after founding) and only 5x for investors in Facebook's 2012 IPO (eight years after founding).[2] And the trend continues—Snap's IPO in March 2017 priced the company just below Google's valuation when it went public and more than two years later, Snap is still trading below its IPO price.

FIGURE 2

R&D EXPENSE AS A PERCENTAGE OF REVENUE



Source: GreenSpring, NDX 100R&D Expense as a Percent of Revenue, Capital IQ data as of December, 21 2017

One might conclude that venture capital and private equity firms today are extracting most of the value out of their portfolio companies before considering taking them public, and that the best small companies are increasingly opting to sell to PE firms or strategic acquirers rather than go public. Moreover, the majority of the stocks that have disappeared from the public markets are small cap, which have historically generated higher levels of growth than their large cap peers.[3]

Meanwhile, the percentage of revenue that large corporations are allocating to research & development has declined dramatically since 2002, and there are those who believe that public companies have simply gotten worse at innovation.[4] Figure 2 shows the decline of R&D expenses as a percent of revenue for 100 of the largest non-financial companies listed on the NASDAQ.

The sad fact is that most economic growth today is taking place outside of the public markets, seemingly beyond the reach of most investors.

What's more, with valuations near all-time highs and the bull run in U.S. equities more than 10 years old, many asset managers are now forecasting 4%-6% nominal returns over the next 10 years from a conventional 60/40 portfolio, rather than the 8%-9% returns such an approach yielded in past decades.[5]

While those forecasts might seem pessimistic, the likelihood of traditional equities driving future performance is increasingly difficult to fathom. Considering the extended valuations of companies in the S&P 500 Index, should P/E ratios and profit margins "normalize," the possibility of negative returns from public equities must be considered when building a diversified portfolio.

To achieve an 8% return going forward, qualified investors should have some exposure to the private marketplace, which offers diversification and the longer-term fundamental growth opportunities that used to be available in the public markets. Figure 3 shows the historical

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outperformance of private equity (using average performance) relative to the public markets across multiple time periods. Given the historical outperformance of private equity, it's no surprise that 87% of the institutional investors surveyed recently by Preqin said they were planning to either maintain or increase their long-term allocations to private equity, while 93% reported that the performance of their private equity portfolios met or exceeded their expectations over the prior 12 months.[6]

So, what does this private market look like and how large is it? In terms of number of companies, it is massive relative to the public markets.

Here are some basic facts:

- There are 7 million private U.S. companies.[7]
- The top 225 private companies alone have combined revenues of $1.6 trillion and employ 4.8 million people.[8]
- There are nearly 200,000 U.S. middle market businesses, over 98% of which are private, and they represent one-third of private sector GDP and employ approximately 48 million people.[9]
- Earnings at private, middle market companies increased 8.5% in Q2 2019 from a year earlier, representing continued strong annual growth.[10]

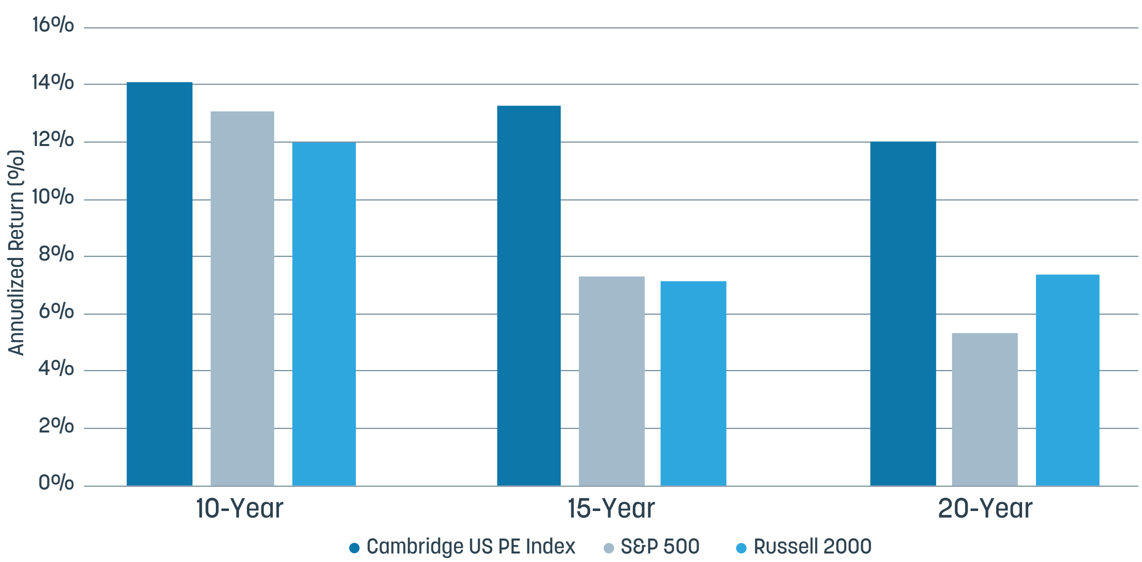
And yet the vast majority of qualified investors have little to no exposure to this market. Instead, they have rushed into passive index products, creating one of the most crowded trades in history with $7.8 trillion dollars benchmarked to S&P 500 Indexed products. By comparison, the entire private equity industry, which invests in tens of thousands of companies, had only $3.1 trillion under management, including dry powder, at the end of December 2017.[11]

What's holding back qualified individual investors from allocating to private equity? The two main obstacles are the lack of liquidity and the lack of access to high-quality companies and fund managers. Let's address these because there's an important paradigm shift underway.

Liquidity

If you accept that the traditional 60/40 portfolio built around daily liquidity is a suboptimal strategy for individuals with long-term financial objectives, then you need to question whether continued avoidance of illiquid investments is prudent. Think of it this way: particularly in this low growth environment, it makes little sense to have your entire U.S. equity portfolio invested in just the sliver of Figure 4 that represents publicly traded companies.

FIGURE 3
PRIVATE EQUITY RETURNS VS. PUBLIC MARKETS



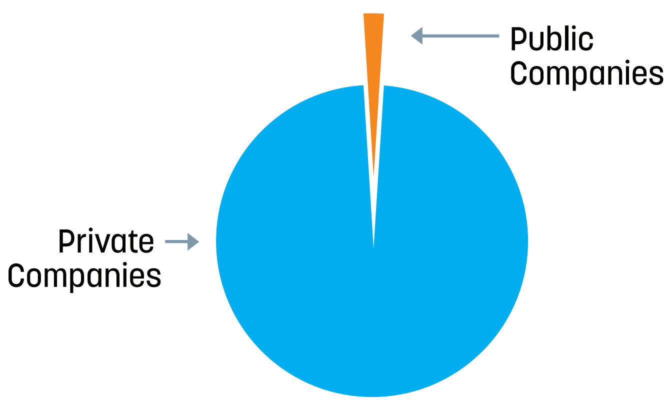
Source: Cambridge Associates, US Private Equity Index and Selected Benchmark Statistics, Q4 2018.

Private indexes are pooled horizon IRR calculations, net of fees, expenses, and carried interest. Past performance is not indicative of future results. Historical returns are included solely for the purpose of providing information regarding private equity industry returns and returns of other asset classes over certain time periods. Private equity funds and public markets have significant differences and no representation is made that there is an appropriate measure for comparison. While investments in private equity funds provide potential for attractive returns, they also present significant risks not typically present in public equity markets, including, but not limited to, illiquidity, long term horizons, loss of capital and significant execution and operating risks.

Another point worth considering is that the illiquid nature of private equity has the inherent benefit of eliminating panic selling (when investors unload their stocks at a low point, rather than evaluating fundamentals). Almost every market crash involves panic selling, and the simple truth is that most human beings aren't hard wired to keep their emotions in check when they see their net worth plummet. By investing in private equity funds, the investor is placing the decision of when to sell in the hands of a professional manager and is essentially forced to adhere to a "buy and hold" discipline. One of the most overlooked factors in how private equity fund managers create value is simply their ability to time their exit to the period when they can command a premium and attract an acceptable multiple.

FIGURE 4

LARGEST 185,000 COMPANIES IN THE U.S.



Source: NAICS Association, Firmographic Breakdown of Business Establishments by Company Size

So why are private equity fund managers better at timing the sales of their portfolio companies? Because the good managers spend a tremendous amount of time with the executives operating their companies, their respective profit incentives are highly aligned, and thus they work closely together to maximize value and exit at an opportune time. This is perhaps the biggest difference between private equity and public equity—the importance of thinking and acting long-term. Private equity professionals spend far more time discussing strategy and long-term value creation with their management teams than board members of public companies, which are often afflicted by short-termism. Studies conducted by McKinsey have shown that the majority of public company boards don't spend enough time focusing on long-term value creation and instead feel pressure to generate short-term results in a period of two years or less. In one survey of 1,597 directors, only 16% said their boards were completely aware of how their firms created value and just 10% claimed their boards had a strong understanding of the dynamics of their firms' industries.[12] Experienced private equity managers, on the other hand, make it their business to not only know the answers to these questions, but also to help drive the value creation by leveraging their networks and often by bringing in senior industry experts to provide additional insights.

Of course, asking an investor whether they should consider a less liquid asset class assumes that they have adequate information and access to experienced, talented private equity managers in the first place. And, historically, that hasn't been the case. The spread between the top and bottom managers in private equity is massive so manager selection and access are critical.

As a 2017 analysis by Adams Street Partners concluded, investors can't expect to outperform public markets, on a risk adjusted basis, by simply buying the PE market. The bottom half performers have delivered disappointing results, below the public markets, while an investor who was able to consistently select and access top quartile managers every year from 1994 to 2014 would have compounded the initial investment by a factor of 140x.[13]

PRIVATE EQUITY INTERQUARTILE SPREADS

25th Percentile	Median	75th Percentile
0.7%	11.1%	21.5%

Source: Cambridge Associates, as of December 31, 2018

Harry Markowitz, Nobel Prize winner and the father of Modern Portfolio Theory, summed up the uneven playing field in an interview with Barron's: "Whether you're passive or active, as a basic principle, depends on how much information you have... Warren Buffet and David Swensen, the CIO of Yale University's endowment, get offers that I don't get and I bet you don't get. They get information I don't have, and they have staff which they have personally trained that can evaluate that information."

A few years ago, Mr. Markowitz would have been 100% correct. But, thankfully, this dynamic is changing to the benefit of the individual investor.

Access

Private markets are not nearly as transparent as public markets and are not set up to facilitate investment by individuals. While opportunities for individuals to invest directly into private companies may present themselves occasionally, often through a personal connection, the level of due diligence required in this comparatively unregulated market is beyond the capabilities of most high-net-worth investors who lack the expertise and ability to actively manage direct private investments. Thus, for the vast majority of individuals, entrusting capital to professional private equity managers with the experience and resources necessary to properly select, manage and exit private investments is the best way of gaining private market exposure. Investing in the right private equity funds also ensures that a private capital allocation will be appropriately diversified.

Today, there are a number of companies that are leveraging technology to provide qualified investors with access to quality private funds at low minimums and streamline the associated reporting and administration for individual investors and their advisors. Some of these platforms also provide fully transparent, institutional-quality due diligence, a service that has historically only been available through expensive consulting firms catering to institutional investors and large single-family offices.

Some might question why top tier private fund managers are suddenly open to accepting individual investor capital. The reason is that these new technology-enabled platforms have made it possible to aggregate dozens or even hundreds of individual investor commitments into a feeder fund vehicle so that fund managers effectively only need to deal with a single entity, just as they would a typical institutional limited partner that can write a $10+ million check. Private fund managers have been motivated to adopt these technologies in order to diversify their investor base and gain exposure to the multi-trillion-dollar pool of high-net-worth capital that was previously inaccessible to them.

The New Paradigm

From the advisor perspective, the shift from suitability to a fiduciary standard only bolsters the case for alternatives. While this shift has accelerated the flow of investor capital into low cost, passive products over recent years, the massive rush towards beta-oriented strategies paradoxically makes the use of alternatives even more important. After all, acting as a fiduciary is not merely about selecting the cheapest products available, but actually setting up clients to meet their financial goals. Investors who are entirely long the public equity and fixed income markets face an acute need for uncorrelated performance drivers that can provide a return premium to the public markets while diversifying their portfolios.

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A growing number of independent wealth advisors are taking advantage of the new platforms to embrace private equity and private credit. In some cases, RIAs are helping their qualified clients invest in funds that are offered on these systems, while in other cases, RIAs are collaborating with these platforms to create bespoke multi-manager private funds, taking an active role in selecting the managers and providing their clients with complete transparency and comprehensive due diligence.

Up until recently, creating such customized fund offerings was extremely time and resource intensive, requiring hundreds of man hours to conduct diligence, set up a feeder, and manage the ongoing reporting and administration. Today, it is a relatively easy process, and more and more RIA firms are constructing custom vehicles to provide their clients with a truly differentiated and value-added service.

> "Investors and their advisors must adjust their mindset from seeing alternatives as a bolt-on exposure, to seeing them as core holdings in a portfolio."

Many of these RIA firms are also beginning to leverage educational resources and portfolio construction tools in order to better communicate the value proposition of private capital strategies to clients, as well as to demonstrate a thoughtful asset allocation process that integrates alternatives into the overall analysis of exposures and risk. Advisors who can explain why private capital strategies must be treated as core building blocks of a modern portfolio and who can provide access to high-quality funds will enjoy expanded opportunity in the new investment paradigm.

With public markets on a declining growth trajectory and the likelihood of achieving historical target returns over the coming years using a traditional 60/40 portfolio close to nil, the need to incorporate a diverse range of quality private asset exposures into a portfolio is more pressing today than it has ever been. It is time to leave behind the investing orthodoxy of the past 30 years and consider a wider array of return streams that can provide both sufficient diversification to protect wealth and sufficient return potential to actually grow it. Greater or more inventive use of traditional risk assets like public equities and high yield credit is not enough—investors need to integrate private strategies that operate in less efficient markets exhibiting more growth and more opportunities to generate alpha. And to do this effectively, investors and their advisors must adjust their mindset from seeing alternatives as a bolt-on exposure, to seeing them as core holdings in a portfolio. Today, the full toolkit is available, and any RIA firm can implement an institutional-quality private capital program for its clients with relative ease, regardless of whether they only have a handful of suitable clients or hundreds.

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1 Source: Credit Suisse, "The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities," March 2017.

2 As of August 23, 2019.

3 Source: Cambridge Associates, as of March 31, 2019, the Dow Jones US Small Cap Index has outperformed the S&P 500 over the prior 20-year period, returning 9.87% annually vs. 6.04%.

4 "Is R&D Getting Harder, or Are Companies Just Getting Worse at It?" Harvard Business Review, March 21, 2017.

5 Sources: UBS, JP Morgan, and BlackRock Capital Markets Assumptions, as of 2019.

6 Source: Preqin Investor Update: Alternative Assets H2 2019, June 2019.

7 Source: Kaiser Family Foundation, "Number of Private Sector Firms, by Size," 2018.

8 Source: Forbes, "Americas Largest Private Companies," October 22, 2018.

9 Source: The National Center for the Middle Market: Q2 2019 Middle Market Indicator.

10 Source: The National Center for the Middle Market: Q2 2019 Middle Market Indicator.

11 Source: 2019 Preqin Global Private Equity and Venture Capital Report.

12 Source: McKinsey, "The Board Perspective: A collection of McKinsey insights focusing on boards of directors," August 2016.

13 Source: Adams Street Partners, "Private Equity: Manager Selection, Portfolio Construction, and Outperformance," Alternative Investment Analyst Review, Q4 2017.

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