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Private Markets: *A Staple for Financial Managers*

By John K. Paglia, Ph.D., CFA, CPA

Investors are generally aware of the concept of a single public market, often known as a liquid market, in which disclosures are comprehensive, enterprises are thoroughly probed, prices react swiftly to new information, and news spreads like wildfire.

By far the most popular is the public equity market and the linked exchange-traded debt market. They account for the majority of individual investors' portfolios and are widely reported in the media on a daily basis.

Due to a number of factors, including company delistings (primarily due to M&A activity and a floundering IPO market), the covered investable universe declined at a steady pace from 1996 to 2018 Indeed, over this two decade span, the number of listed corporations in the United States virtually halved, from 8,090 in 1996 to around 4,397 in 2018. Meanwhile, over the same time period, a public company's average age has risen from 12.4 years to more than 20 years.

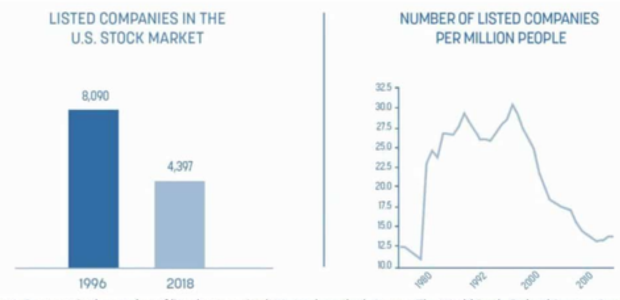

Figure 1: Decrease in the number of listed companies (U.S. stock market). Source: The World Bank, Federal Reserve Bank of St. Louis.

Fast forward to today when, as of the first quarter of 2022, there are 1,936 NYSE domestic listed companies and 2,918 on NASDAQ for a collective 4,854. While there has been a net increase in the number of listed companies in the last few years, the numbers are still significantly less than what was reported over 25 years ago. This decline has far-reaching effects. Companies generally stay private for longer, and by the time they are listed (if at all), the majority of their returns and wealth creation (in percentage terms) has often already occurred, with only a relatively few private investors benefiting. Indeed, firms that are still publicly traded are older (and more mature) than those that have previously been listed, and this attribute is often correlated with lower growth rates and percentage gains on investments.

As a few examples to highlight the value creation that exists in the early years of an entity, if investors in Amazon's IPO, which took place three years after the company's founding, had stuck with it to the end of 2021, their investment would have grown by 1,700 times. In comparison, Google investors would have received a 58-times multiple, while Facebook investors would only have earned 8-times their initial investment.

These examples suggest that the pre-IPO phase is when VC and PE firms realize the majority of their percentage returns on investment. Additionally, rather than going public, the most promising small businesses are more frequently opting to sell to private equity groups or strategic acquirers. Furthermore, the majority of the stocks that have vanished from public markets are small-caps, which have consistently outperformed their large-cap counterparts in terms of growth.

At the same time, the share of revenue spent on research and development by major corporations has decreased significantly from 2001 to 2017, leading some to assume that public firms have actually grown less innovative. The reduction in R&D spending as a proportion of sales for the top NASDAQ-listed nonfinancial companies is shown in Figure 2.

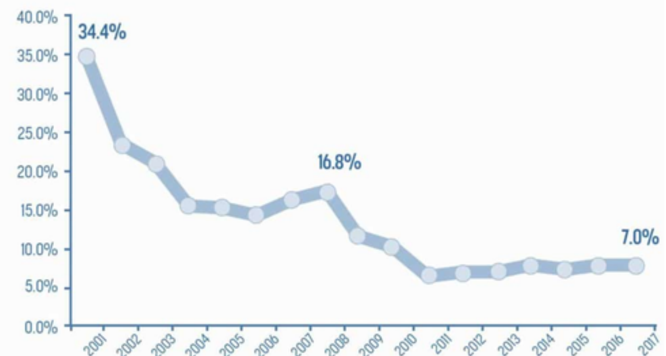

Figure 2: R&D expenditures as a percentage of revenues (as of December 21, 2017). Source: GreenSpring, NDX 100R&D Expense as a Percent of Revenue, Capital IQ Data.

Unfortunately, most of today's innovation and economic development takes place outside of public markets, seemingly beyond the scope of most investors.

Furthermore, with valuations not far off from historical highs and a fairly persistent bull market cycle for U.S. equities for well over a decade, many financial advisors are now forecasting nominal returns of 4-6% for a traditional 60/40 portfolio over the coming 10 years, rather than the 8-9% returns seen in previous decades.

While these predictions may appear bleak, it is becoming increasingly accepted that traditional equities may not be the most significant driver of future success. Given the high prices of S&P 500 corporations, the risk of negative returns from public equities should be considered while developing a balanced portfolio if price/earnings ratios and profit margins normalize.

Investors must therefore allocate some of their portfolios to private market vehicles in order to achieve an expected 8%+ return going forward, as it is known to enhance diversification and longer-term fundamental growth potential.

So what are these private vehicle asset classes? They include private equity, venture capital, private debt, real estate, natural resources, hedge funds, and infrastructure. For purposes of this article, however, we will focus on the largest asset class: private equity. Private equity can also be subdivided into a number of strategies including buyout, growth, fund of funds, secondaries, etc. As an asset class, private equity has been quite successful over the years.

The figure below depicts private equity's historical outperformance vs. public markets (based on average performance) over several investment horizons as of June 30, 2021.

FIGURE 1 US PRIVATE EQUITY AND VENTURE CAPITAL INDEX RETURNS

Periods Ended December 31, 2022 • Percent (%)

Index	6 Mo	1 Yr	3 Yr	5 Yr	10 Yr	15 Yr	20 Yr	25 Yr
CA US Private Equity*	0.7	-4.3	20.8	18.6	17.2	12.5	15.3	13.3
Russell 2000® mPME	4.1	-19.7	3.0	4.0	9.7	7.8	9.4	7.8
S&P 500 mPME	2.5	-17.6	7.6	9.3	13.1	9.1	9.7	8.1
CA US Venture Capital	-9.1	-20.8	24.9	22.5	18.7	12.7	12.2	25.4
Nasdaq Constructed** mPME	-4.7	-32.4	6.8	10.3	15.6	11.3	12.0	9.9
Russell 2000® mPME	4.0	-20.1	2.8	4.0	9.5	7.6	9.7	7.9
S&P 500 mPME	2.4	-17.9	7.4	9.3	12.9	9.1	9.9	8.2
Nasdaq Composite*** AACR	-4.7	-32.5	6.1	9.7	14.4	10.7	11.9	8.7
Russell 2000® AACR	3.9	-20.4	3.1	4.1	9.0	7.2	9.4	7.1
S&P 500 AACR	2.3	-18.1	7.7	9.4	12.6	8.8	9.8	7.6

* Includes US buyout and growth equity funds only. ** Constructed Index: Data from 1/1/1986 to 10/31/2003 represented by Nasdaq Price Index. Data from 11/1/2003 to present represented by Nasdaq Composite. *** Capital change only.

Sources: Cambridge Associates LLC, Frank Russell Company, FTSE International Limited, Nasdaq, Standard & Poor's, and Thomson Reuters Datastream.

Clearly there has been a significant premium for investing in private equity as compared to the S&P 500 and Russell 2000 indices. Over the 25-year horizon, private equity has returned an average annual return premium of 4.5% over the Russell 2000 and 4.7% over the S&P 500 indices, respectively.

If 25 years ago one were to have invested a lump sum of $1,000 at the published rates of returns below, one would have an investment value today of $27,647 in private equity, $10,120 in the Russell 2000 investment vehicle, and $9,668 in the S&P, respectively. Due to compounding over longer-term horizons, the value differences are quite significant.

Considering private equity's outperformance, it is not surprising that 95% of institutional investors surveyed by Preqin in November 2021 plan to maintain or increase their long-term allotments to the asset class, and 95% say their private equity portfolios reached or topped their expectations in the previous year. Institutional investors top 3 reasons for investing in private equity include diversification (68.0%), high absolute returns (50.0%), and high-risk adjusted returns (47.0%). As a percentage of total assets, institutional investors are now targeting an average allocation of 11.0% to private equity alone.

So, what does the foundation of the investible universe look like for private equity? When compared to public markets, it has a large number of enterprises.

Here are some fundamentals:

- In the United States, there are 6.3 million private businesses.
- The top 225 private corporations generate $1.6 trillion in revenue. They have a workforce of 4.8 million people.
- There are roughly 200,000 mid-market companies (those with annual revenues between $10 million and $1 billion) in the United States, more than 98% of which are privately held. They employ about 48 million people and account for a third of private-sector GDP.
- Revenue growth for mid-market firms, the vast majority of which are private, climbed 12.3% year over year in the third quarter of 2021, indicating continued robust yearly growth.

Despite the significance of the middle market and myriad investment opportunities in same, the great majority of investors have minimal or no experience with the market. Instead, they have flocked to passive index vehicles, resulting in one of the most congested exchanges in the world, with $7.8 trillion spread over S&P 500 indexed products. By comparison, for 2021, the whole private equity profession, which invests in tens of thousands of firms, deployed just $3.5 trillion globally. Global private equity assets under management, including dry powder, are nearly $9.8 trillion as of July 2021.

What is preventing competent retail investors from making private equity investments? Liquidity and access are two very significant obstacles. It is key to examine them since we are witnessing a substantial paradigm shift.

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First component: *Liquidity*

For individuals with long-term financial goals, a 60/40 portfolio of public companies and bonds that is almost singularly focused on daily liquidity is acknowledged to be a suboptimal approach to maximizing long-term wealth. So it is crucial to assess if it makes sense to continue to avoid illiquid investments.

To put it another way, putting a complete portfolio of U.S. stocks in the narrow sliver of the chart below that reflects publicly traded companies, especially when the universe of potentially eligible and investible companies is much larger, is not a wise idea, especially given the current low growth outlook for that group.

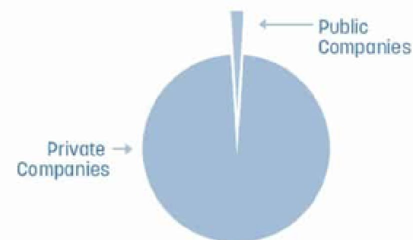

Figure 4: Largest companies in the U.S. Source: NAICS Association, Firmographic Breakdown of Business Establishments by Company Size.

Another factor to consider is that the illiquid quality of private equity provides the advantage of preventing panic sell-offs – or when investors dump their holdings at a depressed point, rather than weighing the fundamentals and taking a longer-term view of wealth creation.

However, it is important to note that nearly all stock market crises involve panic selling, and the fact is that most people are not meant to be able to manage their emotions when their assets collapse. When an investor invests in a private equity fund, the decision to sell is left to the discretion of professional management, and the investor is essentially forced to follow the conservative and disciplined longer-term investment approach. One of the most underappreciated components of private equity fund managers' value generation is their ability to strategically plan exits to maximize returns.

Why do PE fund managers do a better job of arranging the sale of their portfolio firms than public equity fund managers? Because successful managers spend so much time with their firms' management, and their incentives are better aligned, they collaborate closely to optimize value and depart in a timely moment. The significance of thinking and acting for the long term is a very significant distinction between private equity and public equity. Unlike public company board members and management, who are sometimes plagued by short-termism, private equity professionals may spend significantly more time with their management teams discussing strategy and protracted value growth.

According to McKinsey's research, most public corporate boards do not devote enough time to value building and are instead pressed to provide short-term outcomes (ranging from a quarterly reporting period to a few years' out). According to a poll, only 16% of directors said their boards were completely aware of how their companies create value, and only 10% said their boards completely understood the dynamics of their companies' industries. Experienced private equity managers, on the other hand, seek not only to address these matters but also to contribute to value generation by utilizing their connections and frequently calling on top industry experts for additional insights.

Asking an investor whether to explore an asset class with a lower level of liquidity presupposes that he or she has sufficient information and access to knowledgeable financial advisors and wealth managers. This has not always been true in the past. Because there is such a large difference between the best and worst private equity managers, the screening process and exposure are crucial. According to a 2017 report, investors cannot expect to outperform the public markets just simply by purchasing any private equity assets. If investors had, every year between the mid-1990s to the mid-2010s, been able to select and access top-quartile private equity fund managers, their original investment would have returned over 150x versus the 11x median return for all global LBO fund investments.

One can also see the significant return differentials depending on the return classification below. Funds in the top quartile posted returns of 21.5% while those in the bottom quartile returned less than 1%. It is therefore important to have knowledgeable wealth managers who can direct investors' portfolios to top fund managers.

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

Figure 5: Private Equity Interquartile Spreads (as of December 31, 2018). Source: Cambridge Associates.

In an interview with Barron's, Nobel laureate and founder of the modern portfolio theory (MPT), or mean-variance analysis, Harry Markowitz summed up the unequal playing field. "In essence, whether you're passive or active is determined by how much knowledge you have: Warren Buffet is getting offers that I'm not getting, and I'm guessing neither are you. They have access to information that I do not, and they have a team that they have personally trained to examine it. Markowitz would have been completely right a few years ago. However, thankfully, that balance is shifting in favor of the private investor".

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Second Component: *Access*

Individuals generally cannot invest in private markets because they are not as accessible as public markets. While opportunities to engage in privately-owned companies may arise from time to time, usually through personal relationships, the degree of due diligence needed in this relatively under-regulated market is beyond the capacity of most high-net-worth investors who do not possess the experience and skillset to actively manage direct private investments. As a result, for most people, putting their money to experienced private equity fund managers who have the skills and resources to properly identify, operate, and exit private investments is the optimal method to acquire access to the private market. Therefore, diversifying a private equity allocation by selecting the correct private equity fund managers is key.

Several organizations are now using technology to offer authorized investors access to excellent private equity funds with minimal fees while streamlining both reporting and oversight for individual investors and their advisors. Several of these systems also offer completely transparent, institutional-grade due diligence, which was previously only available through high-priced advisory firms targeting sophisticated investors and large family offices.

You may be puzzled as to why leading private equity fund managers are all of a sudden accepting funds from individual investors. The reason for this is that emerging technology platforms have enabled fund managers access to a wide spectrum of individual investor commitments into a feeder fund vehicle, allowing fund managers to engage with just one entity much like a typical institutional limited partner who might write a check for more than $10 million. Private fund managers have been encouraged to use these technologies in order to broaden their investor base and obtain access to a multi-trillion-dollar pool of high-net-worth capital that was previously unavailable to them.

Private markets, the new paradigm

The transition from a convenience requirement to a fiduciary requirement only reinforces the rationale for alternative investments from the advisor’s position. Despite the fact that this transition has boosted the inflow of investors’ capital into low-cost, passive products in recent years, the tremendous rush to emerging strategies conversely promotes the deployment of alternatives. After all, operating as a fiduciary is about putting clients in a position to achieve their financial objectives, not just selecting the most basic legacy solutions available. Investors that are fully invested in the public equities / fixed income markets have a pressing need for relatively uncorrelated, performance drivers that can deliver a yield premium over the public markets, as well as build diversification in their portfolios.

These new platforms are allowing an increasing number of independent asset managers to participate in private equity and private financing. In some instances, registered investment advisors assist their accredited customers in investing in funds provided by these platforms, while in others, RIAs collaborate with fund sponsors to develop customized private funds, assuming an active role in manager screening and offering full transparency and due diligence to their clients.

Until recently, building such a bespoke fund used to take a lot of time and effort, requiring hundreds of hours of labor to do due diligence, set up a feeder fund, and manage monitoring and operations. This is a rather straightforward procedure nowadays, and a rising number of RIAs are developing new vehicles to serve unique and value-added services to their clients.

It is common for RIAs to begin using instructional resources and portfolio builder tools to enhance communication of the value proposition of private equity strategies to their clients. In addition, it demonstrates that a thorough asset allocation process takes into account alternatives as part of the total exposure and risk analysis. Increased opportunities in the new investing paradigm will benefit advisors who can explain why private equity strategies should be viewed as key components of a contemporary portfolio and who can give access to high-quality funds.

With traditional public markets’ offerings at lower numbers and the diminished likelihood of achieving relatively high historical return benchmarks with a classic 60/40 portfolio in the years ahead, the need to diversify a portfolio with high-quality alternative assets is more crucial than ever. It is time to toss aside the 30-year-old investing dogma and embrace a broader range of income channels that can provide both enough diversification to maintain wealth and enough growth potential to develop it.

Even when employed more creatively, conventional risk assets like public equities and high-yield credit remain insufficient. Consequently, investors must consider private investment strategies towards companies that operate in less efficient markets, and with and expectation of higher yield attributes. To achieve this, investors and advisors must shift their mindsets from considering alternative asset classes as optional portfolio enhancements, to treating them as core foundational portfolio positions. The current environment is favorable for such change. With the tools available today, any investment firm, whether it has few or hundreds of eligible clients, may swiftly develop an institutional-quality private equity program for its clients.

AXXES CAPITAL

Axxes Capital Inc.
3011 Ponce de Leon Blvd
Suite 1420
Coral Gables, FL 33134
800-684-1006
info@axxescapital.com

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