ABR Dynamic Funds' Portfolio Construction Series: Part 12

Fooled by the Wrapper V:

Private Equity and Direct Lending have mostly just been Leveraged Stocks and Bonds

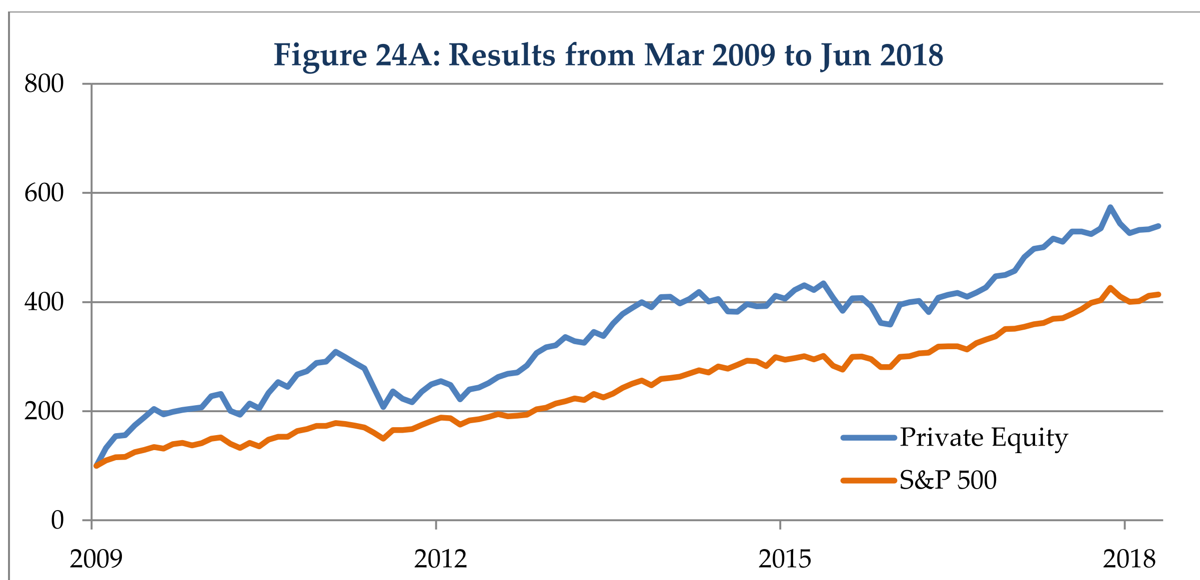
Some investors favor private equity and direct lending over, or as diversification for, public equity and more liquid bond issuances. The reasons tend to include perceived diversification, reduced volatility, and an illiquidity premium.

However, many private equity and direct lending strategies are not marked to market daily, so the perceived diversification and reduced volatility were mostly an illusion arising from infrequent pricing. **Simply put, the perception of stability was often just the result of stale pricing. In other words, as an extreme example, it doesn't make sense to assume a privately held company that was worth $100 million at a valuation event on June 30, 2007 is still worth $100 million on December 31, 2008 just because it hadn't had another valuation event. It doesn't make any more sense than using the price of the S&P 500 on June 30, 2007 to value a portfolio in the depths of the Financial Crisis.**

Furthermore, although there is evidence of an illiquidity premium in long-term historical stock data, most of the outperformance of private equity and direct lending over public equity and more liquid bonds, during bull markets, may have been attributable to simple leverage.

To support these claims and illustrate the similarities between public stocks and private equity, we will use the LPX50 Listed Private Equity Index (LPX50TU – referred to as "Private Equity" for the remainder of this installment). LPX50TU is an index of private equity companies listed on global stock exchanges; therefore, it is marked to market regularly. In this installment, we address only private equity strategies, but much the same logic applies to similarities between direct lending and more liquid bonds.

The following graph illustrates the outperformance touted by many proponents of Private Equity since the end of the Financial Crisis. The graph does indeed show outperformance, although it immediately dispels the illusions of Private Equity's lower volatility and meaningful diversification.



Data Source: Bloomberg

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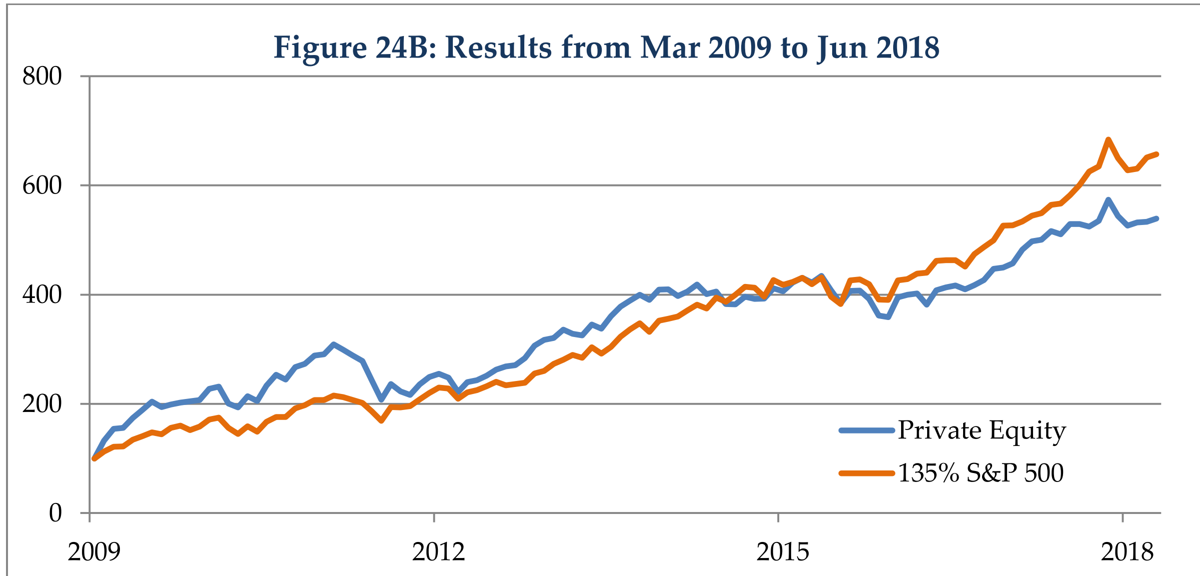
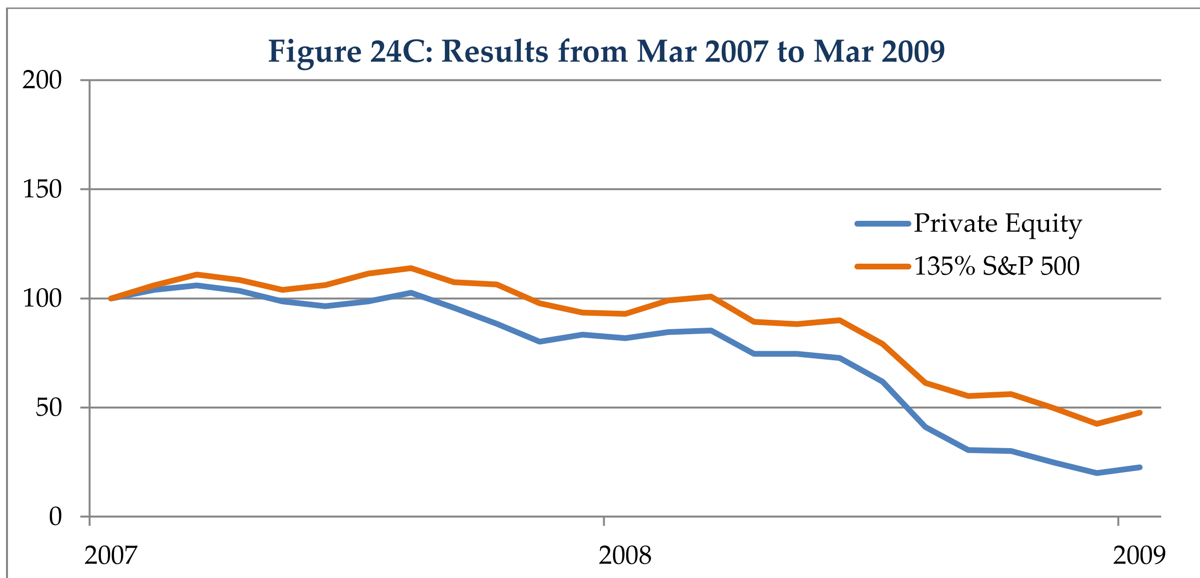
The source of the outperformance is identifiable. Using just 1.35x the S&P 500 makes it clear that Private Equity has mostly just been leveraged equity. The graphs are remarkably similar, and the outperformance of Private Equity has vanished.



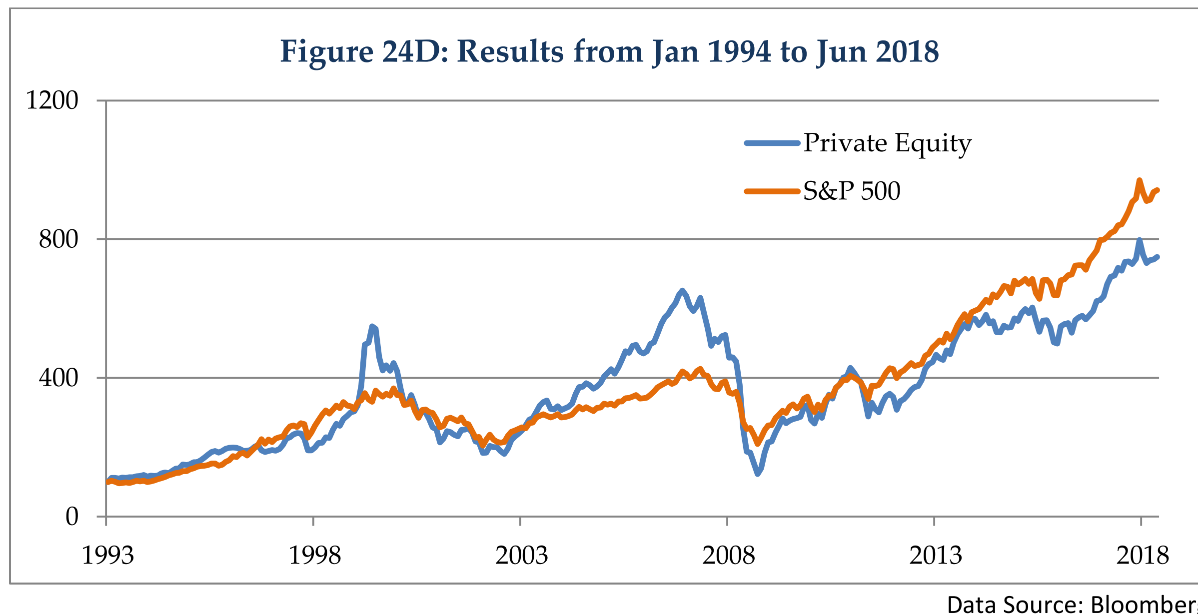
Data Source: Bloomberg

What about market downturns? The following graph shows Private Equity and the same 1.35x S&P 500 for the two years prior to the bull run in the above graph. As with the above graph, the difference in performances nearly vanishes with the use of the same simple leverage.



Data Source: Bloomberg

Private Equity (again, the LPX50TU Index) has a full index history of data going back to 1994, and the above pattern has held. Private Equity has had leveraged swings to the upside and the downside (so much for the reduced volatility!) without achieving any outperformance of the S&P 500 over that time. In this final graph, we show 1.00x S&P 500, no leverage.



Data Source: Bloomberg

The only thing that should be surprising about these results is the apparent lack of an illiquidity premium. Other than that, once the Private Equity illusion of stability is stripped away by regular mark-to-market pricing, it comes as no surprise to see that S&P 500 returns and Private Equity returns have been quite correlated over time. After all, a private equity strategy is an investment in companies that do many of the same things that publicly traded companies do. Private equity strategies have just tended to use some leverage and focus on smaller companies, both of which may have led to increased swings.

We wish to note that this example should not be taken to mean that all forms of private equity strategies are bad. The ones that carry the features just discussed may be, but that is not intended as a criticism of the ones that do not.

In fact, it may not even be a criticism for those who do not need liquidity and are looking for a source of leverage. But it is a caution not to assume private equity strategies provide meaningful diversification to core equity holdings. To reiterate one more time, if the private equity strategy in question is not marked to market on a regular basis, then it may appear more stable than the above example, but that appearance was probably largely an illusion caused by stale pricing.

Next Week's Preview: In the selection of portfolio components, a low correlation is important, but a low beta may not be.

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