

The Role of Private Equity in a Portfolio

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Why Include Private Equity in Your Investment Portfolio?

Private equity involves investing directly in private companies or taking public companies private (known as delisting), with the goal of enhancing the company's valuation through strategic and operational improvements. Investing in private equity can be an intriguing prospect for investors looking to diversify their portfolios and potentially enhance their investment returns. This paper explores several reasons to include Private Equity in an investment portfolio.

PE investment opportunities are abundant - there are 7x more private companies than public companies in the US, which creates a significant opportunity for private equity managers to identify target investments with limited competition.[1] Another factor is that companies seem to be trending towards remaining private for longer and shying away from going public. At the start of this century, the median age for a tech company to IPO was 5 years and as of 2021 the median age has increased to 12 years. Over the same period, the median market value was \$702MM and now the median market value increased to \$3.1B indicating there is significant value creation being generated when companies stay private for longer.[2]

Many private equity investment opportunities are simply not available in public markets. These opportunities include early-stage companies, venture capital, growth equity, and buyouts of established companies.

The potential for enhanced returns is one of the more compelling reasons to include private equity in an investment portfolio. Looking ahead over the next decade, long-term capital market assumptions imply that public equity performance will lag its private market counterpart by about 200 basis points.[3] The reason is that private equity firms typically target high-growth opportunities with companies that are in their early stages or undergoing significant transformations. Private equity firms bring capital, strategic guidance, and operational improvements, aiming to enhance the value of their company investments significantly.

Many of these investment opportunities are simply not available in public markets. These opportunities include early-stage companies, venture capital, growth equity, and buyouts of established companies. Some of the bigger factors for an ideal investment are strong management teams, recurring cash flows, and a clear exit strategy. These opportunities can

be especially appealing to investors looking for niche markets or innovative sectors with high growth potential. Additionally, investors can gain exposure to a diverse range of industries and products that can complement existing public equity investments.

Unlike passive investments in public markets, private equity involves high levels of active management. Private equity firms take an active role in managing their portfolio companies through taking on board responsibilities, guiding strategic initiatives, working closely with the management teams to improve operational performance, requiring accountability, and driving growth. This hands-on approach can lead to significant value creation, as private equity firms leverage their expertise and resources to enhance the business prospects of their investments. Investors benefit from the professional management and strategic oversight provided by private equity firms, which can translate into higher returns.

Private equity investments typically have a longer time horizon compared to public market investments, which often makes it unsuitable for most investors. While public equities can be bought and sold quickly during market hours, private equity investments are usually held for several years, often ranging from five to ten years or more. The extended investment horizon allows private equity firms to implement comprehensive strategies and improvements, maximizing the potential for value creation and not having to worry about quarterly earnings results. This long-term focus aligns with higher-net-worth investors seeking to build wealth over an extended period.

Challenges with Private Equity:

While the benefits of private equity are substantial, it is important to consider the associated risks and challenges:

- **Illiquidity:** Private equity investments are not easily liquidated. Investors must be prepared to commit their capital for the long term and may not have access to their funds until the investment is realized, typically through a sale or public offering of the portfolio company.
- **High Minimum Investment Requirements:** Private equity investments often require substantial initial capital commitments, making them less accessible to smaller investors. High-net-worth individuals and institutional investors are typically the primary participants in these markets.
- **Potential for Loss:** Like any investment, private equity carries the risk of loss. Specific strategies and/or criteria may mitigate the likelihood of losses within the portfolio of companies, but company investments may fail to meet growth targets or face unforeseen challenges, leading to underperformance or potential losses for investors.



Including private equity in an investment portfolio can provide significant benefits, such as diversification, potential for high returns, access to unique opportunities, active management, and a long-term focus. However, investors must carefully weigh these benefits against the associated risks, such as illiquidity, high minimum investment requirements, and potential for loss. For those who meet the criteria and have a long-term investment horizon, private equity can be a valuable addition to a well-rounded investment strategy.

If you are interested in participating in Private Equity Investments, reach out to a HoyleCohen Advisor to discuss how it might fit into your portfolio.

[1] Stepstone Private Markets investor presentation, as of 6/30/2024. The data set only includes companies with revenue greater than \$100MM.

[2] AMG Pantheon investor presentation, as of 6/30/2024.

[3] JPMorgan Capital Market Assumptions 2024

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