

Private Equity Perspectives | April 2023

Potential in persistence: Staying the course with private equity commitments

- Vanguard believes that maintaining a consistent commitment strategy to private equity is critical to fully capturing the increased return potential and diversification benefits of private equity investing.
- In an analysis of the broad private equity fund universe, Vanguard found that a hypothetical investor who reduced the amount of their commitment or stopped their commitments during periods of economic uncertainty would have underperformed an investor who followed a consistent commitment strategy. This paper explores this analysis and more.

Public or private: Timing the markets tends to be futile

Recent Vanguard research has reaffirmed the difficulty of timing the public equity markets. For example, the best and worst trading days often happen close together and occur irrespective of the overall market performance for that year. A review of market data going back to 1928 shows that being out of the stock market for just the best 30 trading days would have cut the resulting return for that period by half (Vanguard, 2022).¹ It pays to remain invested precisely when it is most difficult to do so.

The same holds true for investing in private equity. Industry research provides evidence that investors cannot reasonably predict which private equity vintages will outperform (Brown et al., 2020). In choosing whether to commit to a given vintage, an investor is timing their allocation of capital to funds. Once they have committed to a fund, however, decisions about when to invest the capital and exit investments are at the general partner's discretion. The general partner's investment period can span several years after the investor's commitment. This minimizes an investor's ability to time investment decisions, even if the investor is inclined to do so. Research also supports an investment strategy that focuses on selecting top-performing managers, which may provide greater potential for enhanced performance than a strategy based on timing private equity commitments.

As in public equity markets, a consistent private equity commitment strategy that allows investors to stay invested through all market cycles, rather than sitting on the sidelines, is critical to supporting an investor's success.

¹ Sources: Vanguard calculations, using S&P data from Macrobond, Inc., as of December 31, 2021. Based on daily price returns, the U.S. stock market returned an annualized 6.2% for the period from 1928 through 2021. If you missed the 30 best trading days, the annualized return would be 3.3%. The S&P 90 Index was used as the proxy for the U.S. stock market from January 1928 through March 1957, and the S&P 500 Index was used as the proxy thereafter. The returns did not include reinvested dividends; including them would make all figures higher. **Past performance is not a guarantee of future results.**

Private equity has performed well in volatile markets

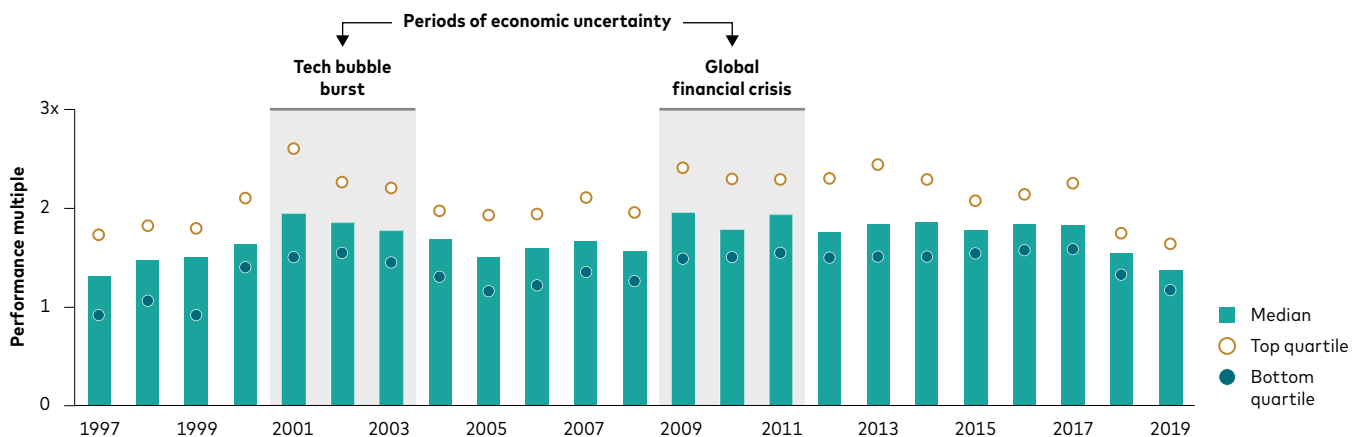
Also as in public markets, different market environments are likely to yield varying investment opportunities in private markets. Times of public market volatility and contracting equity valuations can provide robust conditions for private equity managers to invest in high-quality companies at attractive prices. This makes investing during times of turmoil an important input into the overall returns realized from a private equity allocation. Private equity

has historically generated stronger investment results during periods of economic uncertainty (Figure 1).

An independent analysis by Cliffwater of state pension fund private equity performance also supports the strong performance of private equity across market cycles. Private equity vintage commitments corresponding to years of public equity bear markets produced an excess annualized return of 6.6%, versus 2.9% in vintage years corresponding to public equity bull markets, though strong excess returns occurred in both types of market environments (Cliffwater LLC, 2018).

FIGURE 1
During periods of economic uncertainty, private equity has tended to shine

Private equity fund performance by vintage year



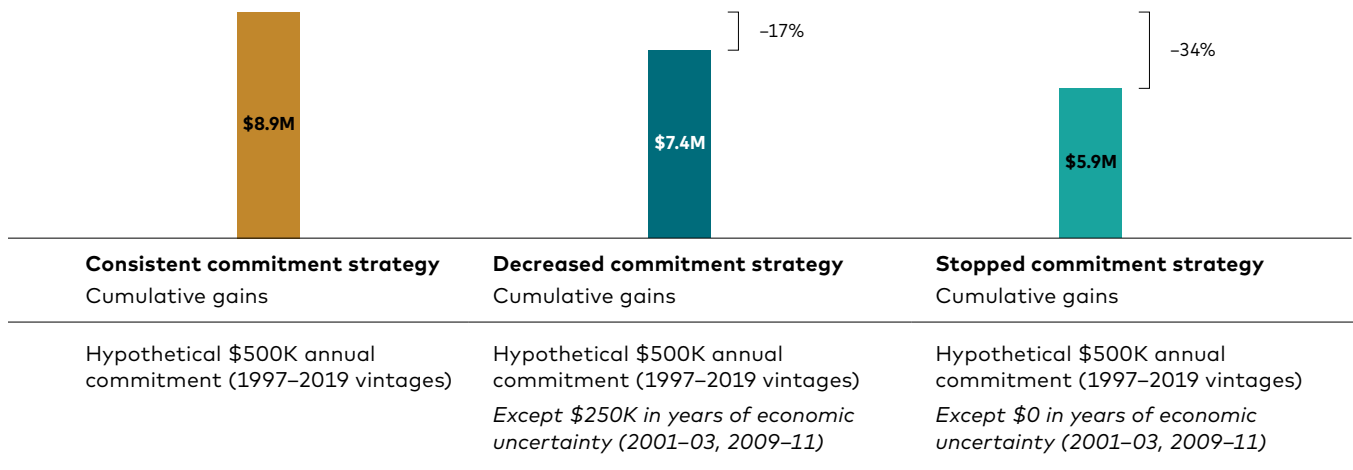
Notes: The figure is for illustrative purposes only and does not represent any particular investment. **Past performance is not a guarantee of future results.** Performance multiple for each vintage year is defined as total fund value divided by amount paid in. Each period of economic uncertainty shown includes the vintage year in which a recession (as defined by the National Bureau of Economic Research) ended as well as the two subsequent vintage years. For the periods two of economic uncertainty shown, the associated recessions lasted from March 2001 through November 2001 and from December 2007 through June 2009.
Source: Burgiss performance data for global buyout funds, as of September 2022.

The benefits of a consistent commitment strategy to private equity

To help maximize the odds of financial success, Vanguard strongly encourages clients to create a long-term financial plan and be disciplined in implementing the resulting asset allocation regardless of shorter-term fluctuations in the market environment. For clients who currently have private equity allocations in their plan, or are considering an allocation, consistent private equity commitments may prove to be a critical determinant of future financial success.

The analysis in **Figure 2** emphasizes the importance of a consistent commitment strategy to private equity. A hypothetical investor who decreased their annual vintage commitment by 50% during periods of economic uncertainty would have generated a 17% lower cumulative investment gain than one who committed to private equity in a consistent manner. Against the same hypothetical investor who followed a consistent commitment strategy, an investor who did not commit at all during periods of economic uncertainty would have seen a 34% lower cumulative investment gain.

FIGURE 2
Staying the course with private equity commitments may pay off



Notes: The figure is an example of hypothetical investment performance and is for illustrative purposes only. Gains depicted do not represent actual performance. **Past performance is not a guarantee of future returns.** Please speak to your advisor about the suitability of private equity and your unique private equity commitment pacing strategy.

Sources: HarbourVest and Vanguard calculations, based on Burgiss performance data as of September 30, 2022.

Conclusion

An optimal private equity investment allocation often consists of a programmatic approach whereby investors regularly invest across multiple private equity vintages. This type of strategy diversifies an investor’s private equity exposure over various market environments and allows for the reinvestment of capital distributions from prior vintages. For advised Institutional and

Personal Investor clients, Vanguard can customize a commitment pacing program tailored to specific goals and objectives. We encourage Vanguard self-directed Personal Investor clients who are interested in private equity but unsure how to best implement a suitable private equity allocation target to reach out to their Vanguard relationship manager about Vanguard’s Personal Advisor Wealth Management to discuss whether that service may be appropriate for them.

References

Brown, Gregory, Robert S. Harris, Wendy Hu, Tim Jenkinson, Steven N. Kaplan, and David T. Robinson, 2020. *Can Investors Time Their Exposure to Private Equity?* Working Paper No. 26755. National Bureau of Economic Research. Available at nber.org/system/files/working_papers/w26755/w26755.pdf.

Cliffwater LLC, 2018. *An Examination of Private Equity Performance Among State Pensions, 2002–2017*.

Vanguard, 2022. *Vanguard CIO Addresses a Dismal Market*. Available at corporate.vanguard.com/content/corporatesite/us/en/corp/articles/vanguard-cio-addresses-dismal-market.html.

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All investing is subject to risk, including the possible loss of the money you invest. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. Diversification does not ensure a profit or protect against a loss.

Private investments involve a high degree of risk and, therefore, should be undertaken only by prospective investors capable of evaluating and bearing the risks such an investment represents. Investors in private equity generally must meet certain minimum financial qualifications that may make it unsuitable for specific market participants.

With private equity ("PE") investments, there are five primary risk considerations: market, asset liquidity, funding liquidity, valuation, and selection. Certain risks are believed to be compensated risks in the form of higher long-term expected returns, with the possible exceptions being valuation risk and selection risk. For selection risk, excess returns would be the potential compensation, however; limited partners ("LPs") must perform robust diligence

to identify and gain access to managers with the skill to outperform. PE investments are speculative in nature and may lose value.

Market risk: Private equity, as a form of equity capital, shares similar economic exposures as public equities. As such, investments in each can be expected to earn the equity risk premium, or compensation for assuming the nondiversifiable portion of equity risk. However, unlike public equity, private equity's sensitivity to public markets is likely greatest during the late stages of the fund's life because the level of equity markets around the time of portfolio company exits can negatively affect PE realizations. Though PE managers have the flexibility to potentially time portfolio company exits to complete transactions in more favorable market environments, there's still the risk of capital loss from adverse financial conditions.

Asset liquidity risk: Various attributes can influence a security's liquidity; specifically, the ability to buy and sell a security in a timely manner and at a fair price. Transaction costs, complexity, and the number of willing buyers and sellers are only a few examples of the factors that can affect liquidity. In the case of private equity, while secondary markets for PE fund interests exist and have matured, liquidity remains extremely limited and highly correlated with business conditions. LPs hoping to dispose of their fund interests early—especially during periods of market stress—are likely to do so at a discount.

Funding liquidity risk: The uncertainty of PE fund cash flows and the contractual obligation LPs have to meet their respective capital commitments—regardless of the market environment—make funding risk (also known as commitment risk) a key risk LPs must manage appropriately. LPs must be diligent about maintaining ample liquidity in other areas of the portfolio, or external sources, to meet capital calls upon request from the General Partners ("GPs").

Valuation risk: Relative to public equity, where company share prices are published throughout the day and are determined by market transactions, private equity net asset values (NAVs) are reported quarterly, or less frequently, and reflect GP and/or third-party valuation provider estimates of portfolio fair value. Though the private equity industry has improved its practices for estimating the current value of portfolio holdings, reported NAVs likely differ from what would be the current "market price," if holdings were transacted.

Selection risk: Whether making direct investments in private companies, PE funds, or outsourcing PE fund selection and portfolio construction to a third party, investors assume selection risk. This is because private equity doesn't have an investable index, or rather a passive implementation option for investors to

select as a means to gain broad private equity exposure. While there are measures an investor can take to limit risk, such as broad diversification and robust manager diligence, this idiosyncratic risk can't be removed entirely or separated from other systematic drivers of return. Thus, in the absence of a passive alternative and significant performance dispersion, consistent access to top managers is essential for PE program success.

Private equity is generally only accessible to ultra-high-net-worth investors, either through direct investment or partnership with a private equity firm, which invests in a private equity fund. Only accredited investors who meet specific qualifications outlined in federal securities laws qualify to invest in private equity funds. Certain private equity funds require investors to meet the definition of "qualified purchaser" in addition to being an accredited investor.

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