The toughest song to hear

Private-equity investing isn't for everyone, but here's what you need to know just in case

›BY ARTHUR SALZER

I WAS SPEAKING RECENTLY at an event put on by the Canadian Association of Alternative Strategies & Assets, an organization of managers, family offices and pensions, to engage in and share best practices about investing in the areas of private equity, real estate and hedge funds. The subject was the better performance of private equity over the public markets or stocks. Investing in private companies has been quite popular of late, and brokers, advisers and exempt market dealers have been singing the praises of this asset class. Now, they are bringing access to such investments to accredited retail investors who meet minimum net-worth or income requirements.

The siren song of better returns sounds appealing, especially given the weak returns from Canadian stocks, but should investors be like Odysseus and listen to the call, though with their hands bound, or place wax in their ears and ignore it? The answer: it depends.

It is common knowledge that PE can be an attractive asset class, since average returns tend to be higher than those from public-equity markets, but investors don't often realize that top-quartile managers outperform their peers by 10% or more. Subsequently, managers who fall below the average mid-point tend to either not generate sufficient returns for the risks and lack of liquidity, or, worse, lose money. This is generally different than public-market managers, who, due to worries about career risk, tend to produce returns similar to the index, albeit with slightly lower returns due to fees. In general, there aren't a lot of extra gains, or losses, generated by using active managers in the public markets.

For most retail investors — those with portfolios of less than $10 million or who deal with advisers at banks and brokerages — it is very difficult to access top-tier PE managers, especially since the typical minimum investment is usually $5 million or more per fund. But using an independent family office may allow an investor access to these best-in-class managers and have the minimum reduced to a more palatable range of $250,000 (5% of a $5-million investment portfolio). A family office is considered an institutional investor in terms of total commitment size and its ability to understand and deal with the often complex partnership agreements created by PE managers. With these more moderate investment minimums, the objective over time would be to create a PE allocation of 10% to 25% of a portfolio (depending on an investor's risk, return and liquidity requirements) by committing to multiple vintages from top-quartile managers. Like wine, PE funds use the term vintage to designate the year that the fund makes its first investment. Typically, PE funds have 10-year lifespans (with some extensions), although new funds are doubling that time frame.

Private-equity investments still experience market cycles, but the price volatility isn't as extreme as public markets, due to accounting delays and how the manager, or general partner, marks prices. Some vintages are fortunate and invested at the start of a cycle when valuations are low and there is an economic recovery occurring. Others are less fortunate, especially if a fund deploys most of its capital right before a market crash.

Timing is a challenge for investors, who are also known as limited partners in private-equity funds. This is because fund investments are not made in one lump sum. Instead, the manager calls the committed capital over an investment period that typically lasts five years. Following that, there is a subsequent harvesting period, where the exit environment becomes more relevant. The optimum exit conditions are when the manager has the ability to maximize the fund's return by either having the company go public through a stock exchange listing or by selling to an acquirer.

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As most investors would agree, attempting to forecast market conditions over a decade is a difficult, if not futile, exercise. By reinvesting with a top-quartile manager across a number of vintages, an investor has the best chance of achieving the desired returns for the risks taken. Allocating across vintages also allows an investor to build a systematic private-equity program that eventually becomes self-funding by producing a distribution stream that can be reinvested or distributed as income. Finally, if an investor cannot access best-in-class PE managers, it's best in many cases to ignore the Sirens and take a pass on this asset class entirely — otherwise be prepared for a 10-year odyssey. **FPM**

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