The Growing Role of Private Equity in Institutional Portfolios

PE INSIGHTS SPECIALIST ARTICLE

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Institutional investors utilize substantial allocations in private markets in order to build long-term oriented and diversified portfolios.

The private equity market has seen considerable growth in recent years. According to Preqin's 2019 Global Private Equity & Venture Capital Report, the capitalization of the market as a whole reaches $3.4 trillion globally. One of the primary reasons for this development is the integral role private equity has achieved within the portfolios of the most prominent institutional investors. For individual investors evaluating the investment opportunity, it pays to consider the reasons why institutional investors rely heavily on private equity funds.

WHAT LEADS INSTITUTIONAL INVESTORS TO INVEST IN PRIVATE EQUITY?

Various highly successful institutional investors, such as insurance companies, pension funds, sovereign wealth funds, endowments or multi-family offices, have about 25 percent of their portfolio allocated to private equity, and in some cases even more. As financial experts, institutional investors follow a formal process based on analysis, due diligence, performance tracking and monitoring, in order to achieve their specific investment goals. They have a well-thought strategy and proprietary intelligence behind what they are doing. This thorough process, and the results, has contributed to why private equity fund investments have become so prominent in institutional investors' portfolios.

OUTPERFORMANCE AS DRIVER FOR INVESTING IN PRIVATE EQUITY

Any investment decision starts with the question of how much there is to be gained, and between 2007 and 2018, top tier private equity funds managed by the likes of KKR, Warburg Pincus, and The Carlyle Group consistently outperformed the S&P 500 index. In a study conducted by the British Private Equity & Venture Capital Association (BVCA), the institutional investors interviewed identified private equity as an asset class that consistently delivers premium long-term returns. For many, private equity was the highest returning asset class within their portfolios. On average, institutional investors expected an internal rate of return (IRR) of between 15 and 20 percent, about 3 to 5 percent above that of public markets.

One of the reasons for such premium returns is the extended control and influence that comes with private equity investments: private equity fund managers are not just financiers – they also take an active role in the management and strategy processes of the companies in their portfolios. In this context, it is important to note private equity's long-term investment horizon, which may be a key factor in driving better returns but also means that investors lock their money in for an extended time period - typically ten years. While institutional investors would usually be equipped to handle such illiquidity, private investors often have idiosyncratic cash flow requirements. Moonfare helps alleviate this issue by opening a secondary marketplace to allow investors to buy and sell pre-selected funds, thus creating liquidity in an illiquid asset class.

PRIVATE EQUITY CAN HELP PROVIDE DIVERSIFICATION

Institutional investors know that diversification is key for a successful investment portfolio and an important factor in mitigating risk. In this way, private equity enables investors to access investment opportunities distinct from public markets and open a new avenue toward diversification.

As the number of publicly owned companies decreases, casting a wide investment net becomes more important. In that sense, private equity acts as a gateway, both to many companies that are privately owned and to interesting growth sectors such as in technology and innovation-led businesses.

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INDIVIDUAL INVESTORS TURNING TO PRIVATE EQUITY MARKET

The answer to the question “Who invests in private equity” has long been “Not your average investor”. With many private equity firms asking for minimum investments in the millions, private equity has naturally become the domain of big-ticket institutional investors.

However, overall market trends indicate change: experts have identified individual investors’ growing interest in investments away from the public markets and predict that private equity will play an increasing role in their portfolios. Alternative investments more removed from mainstream investments such as bonds and stocks, hold promise that they may be more sustainable options in volatile macroeconomic stock market conditions. Responding to this need by creating viable routes to private equity for individual investors is therefore becoming more important than ever.