

Long-Term Private Equity Performance: 2000 to 2022¹

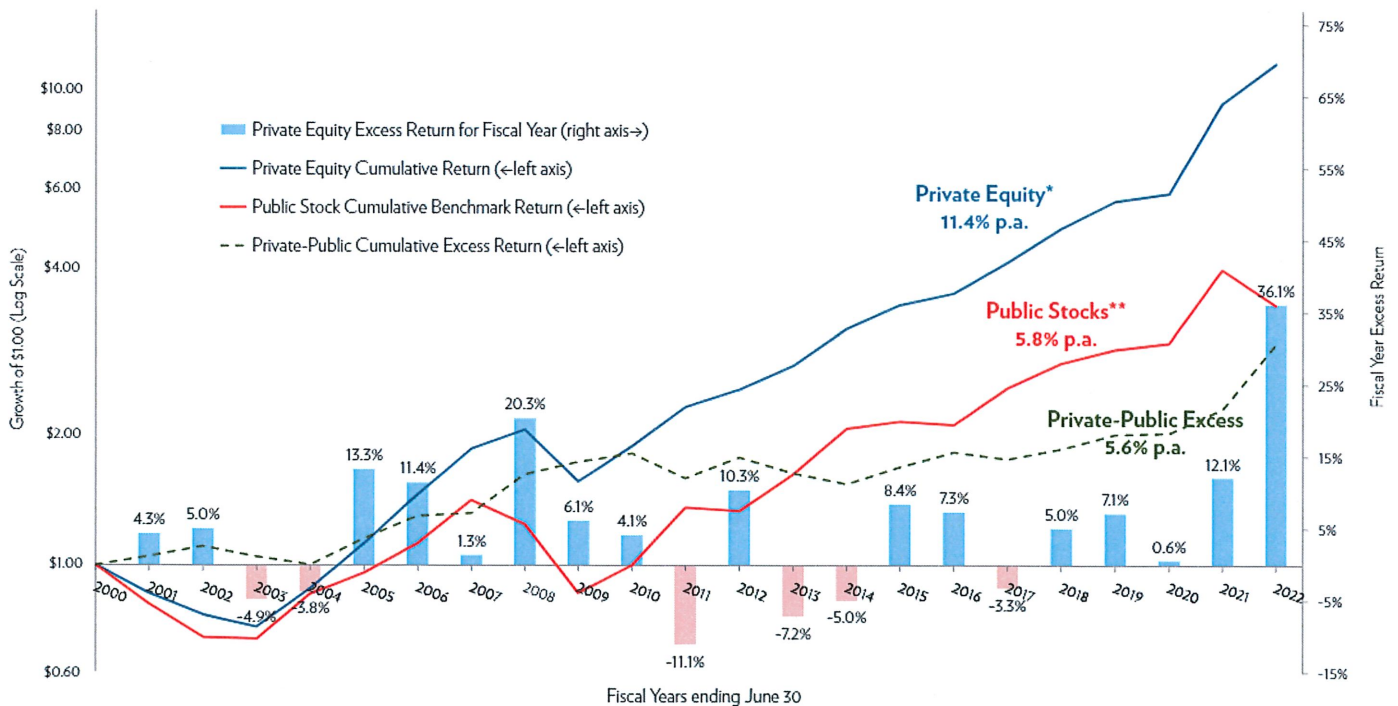
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Press coverage of private equity focuses almost exclusively on second order concerns over disclosure, fees, layoffs, debt, and an occasional scandal. Rarely is attention given to the first order benefit of high risk-adjusted returns.

Our annual performance study now includes 2022², a year that produced a 21% return for private equity, a record 36% better than the public stock markets. The 36% excess return is likely overstated to some degree by the timing of private equity valuations at June 30, 2022, and will be adjusted when 2023 returns are reported. Nonetheless, over a 22-year time period ending June 30, 2022, private equity allocations by state pensions produced a 11.4% net-of-fee annualized return, exceeding by 5.6% the 5.8% annualized return that otherwise would have been earned by investing in public stocks.

The higher private equity returns did not come with higher volatility. The annualized standard deviation of returns for private equity equaled 15.8% for the 22-year period, compared to 17.5% for public stocks.

Exhibit 1: Composite Private Equity Performance across State Pensions:
 Covering 22 Years starting June 30, 2000, and ending June 30, 2022
 Growth of \$1.00 (left axis) and Annual Excess Return (right axis)



* An equal-weighted average of all state funds who reported private equity returns in annual ACFRs for June 30 fiscal years 2001-2022. The equal-weighted average return of 19 state funds who reported private equity returns across all 21 fiscal years equaled 11.9% per annum.

** A public stock benchmark weighted 70% to the Russell 3000 Index (6.62% annualized return over 22 years) and 30% to the MSCI ACWI ex US Index (3.53% annualized return over 22 years), with assigned weights reflecting regression-based weightings (a.k.a. "style analysis").

¹ This is the sixth edition of our private equity performance report, which was first printed in 2017.

² Fiscal year 2022 from June 30, 2021, to June 30, 2022.

Private Equity Performance

Exhibit 1 plots cumulative returns³ for the Private Equity Composite, the Public Stock Benchmark, and the return difference (excess return) between private and public equities. Annualized returns for the entire 22-year period are reported. The 11.4% annualized return for private equity for the entire 22-year period is impressive compared to the 5.6% annualized return for the Public Stock Benchmark and the resulting 5.6% annualized return difference exceeds the 3% annual premium or excess return generally associated with return objectives for private equity. Also shown in Exhibit 1 are bars representing individual fiscal year return differences (“excess returns”) between the Private Equity Composite and Public Stock Benchmark.

Study Data and Design

We draw our findings from data provided in Annual Comprehensive Financial Reports (“ACFRs”) published by 94 state pension systems. We selected this data source because, unlike commonly used commercial universes, it is a closed group with no selection biases, and represents actual results achieved by large institutional investors. The list of 94 is narrowed to 65 state systems that use the same June 30 fiscal year-end date to achieve consistent performance measurement periods. The list is reduced again to 53 state systems that reported private equity returns for all or part of the study period. Nineteen (19) of the 53 state systems operated private equity portfolios for all 22 fiscal years.

The study period was selected partly for ease of data collection but also because it covers three full market cycles, encompassing three bear markets and three bull markets. We create a “Private Equity Composite” return series calculated by taking the average of all state systems reporting private equity portfolio returns for that fiscal year. The number of state systems included in the yearly average grew steadily over the study period from 19 to 61.

Most state systems have a private equity objective to outperform public equity by some percentage point amount, the most frequent amount being 300 basis points (3%), net of all fees. The 3% incremental return is intended to compensate investors for the loss of liquidity and complexity associated with private equity, but investors do differ on the appropriate return spread for private equity over public equity. The equity index used to represent public equity varies as well with some state systems targeting a U.S. benchmark like the S&P 500 or Russell 3000 Index and others using a global equity index like the MSCI ACWI Index.⁴

We create a “Public Stocks Benchmark” by calculating a weighted average of the Russell 3000 Index (70%) and the MSCI ACWI ex US Index (30%), rebalanced annually. The 70% and 30% weights are, in our judgment, reflective of the typical mix of U.S. and non-U.S. private equity investments in large, diversified portfolios. The weightings are confirmed through a statistical analysis of periodic state pension private equity returns as the dependent variable and the Russell 3000 and MSCI ACWI ex US index returns as independent variables. Regression coefficients on the Russell 3000 and MSCI ACWI ex US variables were found to be exactly 70% and 30%, respectively, indicating that our Public Stocks Benchmark best reflects the geographic risks found in private equity allocations.

The return calculations in this study follow the reporting practices of state pension systems as described in most ACFRs. Reported fiscal year private equity returns are typically *internal rates of return*, which are then linked in a *time-weighted* fashion to create multiperiod returns. The *internal rate of return* calculation is often used in measuring private equity performance in part because it represents a better measure of return when cash flows are very large in relation to portfolio values and because managers control the timing of cash flows. These two conditions are less relevant for state private equity portfolios that aggregate

³ Cumulative returns are presented in Exhibit 1 using a “Growth of \$1.00” scale, measuring how an initial \$1.00 investment would have grown if it earned the average private equity return of reporting state systems or the Public Stocks Benchmark return.

⁴ MSCI ACWI Index represents all global public equity markets. The MSCI ACWI ex US Index excludes the U.S. equity market. “ACWI” is an acronym for All Country World Index.

many underlying private equity funds. First, aggregated private equity cash flows (both inflows and outflows) tend to be modest relative to the size of the overall portfolio. Second, at the aggregate level the timing of cash flows is also controlled by the pension system itself through its “capital budgeting”. For example, a fund manager’s eagerness to distribute cash proceeds may be offset by increased new fund commitments by the pension system to preserve “vintage diversification”.

Convergence

Not too long ago, a familiar narrative was that private equity returns were failing to deliver the excess return over public stocks compared to years past.⁵ Our study finds no such evidence. Private equity returns are tested for convergence through a simple regression analysis that uses fiscal private equity excess returns reported in Exhibit 1 as the dependent variable and time as the independent variable. Last year (excluding 2022) the resultant coefficient on time (year) was virtually zero. With strong comparative private equity performance in 2022 the resultant coefficient on time is now +39 basis points per year, without statistical significance. Convergence may be a legitimate investor concern, but so far there has been no evidence of its presence.

Strong performance from private equity is expected. Private asset classes, including private equity, private debt and private real estate, should outperform their public equivalents as investors demand higher returns for loss of liquidity. This “illiquidity premium” has generally been estimated at two percentage points in extra return across private asset classes.⁶

Conclusion

Our updated study focuses on the private equity performance achieved by large state pension systems over a 22 fiscal year period from 2000 to 2022. This data is different from return universe data available on individual private equity funds which ignores selection, weighting, co-investment, and other decision factors that state pensions make in managing a private equity portfolio.

The study finds that private equity produced a meaningful 5.6% annualized excess return over public equity. We test for any diminution of excess return over time and find no evidence of private equity and public stock return convergence.

Private equity has consistently been one of the strongest performing asset classes within state pension portfolios.

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⁵ A recent example is contained in the otherwise excellent *Bain Global Private Equity Report 2020*, recently reported on by *Pensions & Investments* under the headline “U.S. Private, Public Equity Returns Starting to Converge.”

⁶ See, for example, *Private Debt: Yield, Safety and the Emergence of Alternative Lending*, Stephen L. Nesbitt, John Wiley & Sons © 2023, Chapter 11, for illiquidity premiums in private direct loans.