Private Equity Returns: Myth and Reality

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The paradox

- Private equity is among our most sophisticated industries.
  - Venture capitalists fund complex high-tech start-ups.
  - Buyout specialists engineer complex restructurings.
    - Smart, creative, and articulate people.

The paradox (2)

- Yet in many senses, backwards:
  - Emphasis on secrecy.
  - Little access to data.
  - Persistence of myths.
- In recent years, more access.

Myth 1: Private equity has had spectacular returns

- Track record of some endowments in private equity has been spectacular.
- E.g., annual returns for Yale, 1973 to 2006:
  - U.S. venture capital: 34.8%.
  - U.S. buyouts: 22.1%.
  - International: 17.1%
    - *Overall: 30.6%.*
- Many groups have sought to duplicate success.

But average returns are far lower

- Venture Economics returns, 1987-2006:
  - U.S. venture capital: 16.6%.
  - U.S. buyouts: 12.2%.
  - Europe: 10.4%.

Comparing to public markets

- Kaplan and Schoar [2005] compute "public market equivalents":
  - U.S. venture slightly outperformed public markets.
  - U.S. buyouts did somewhat worse.
- But may also need to control for riskiness, e.g., leverage.
    - Will depress performance even more.

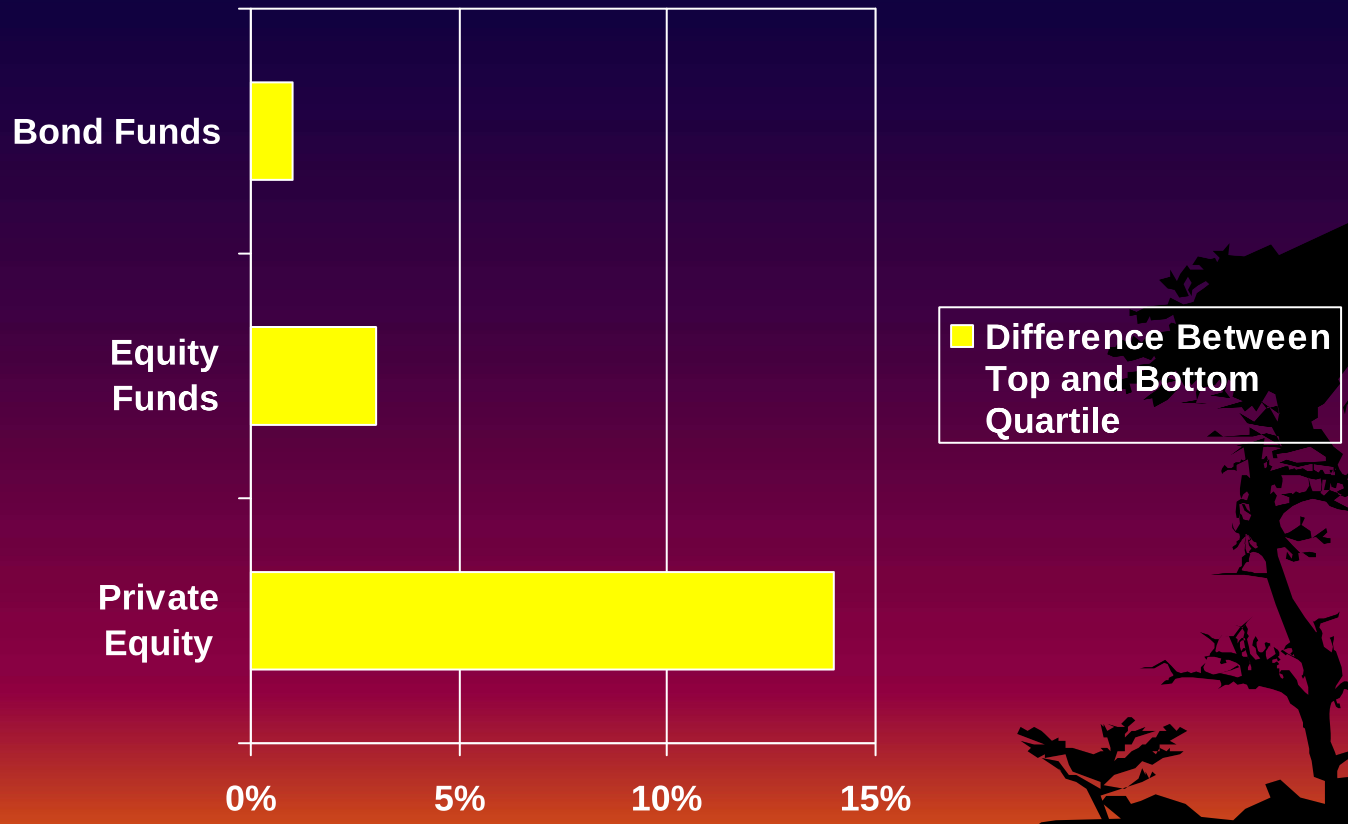
Myth 2: Private equity is an "asset class"

- Frequent claim among investors:
  - Emphasis on balancing portfolio by:
    - Type of fund.
    - Location of fund.
    - Vintage year.
- Similar to what's seen in public market investing.

Recent work

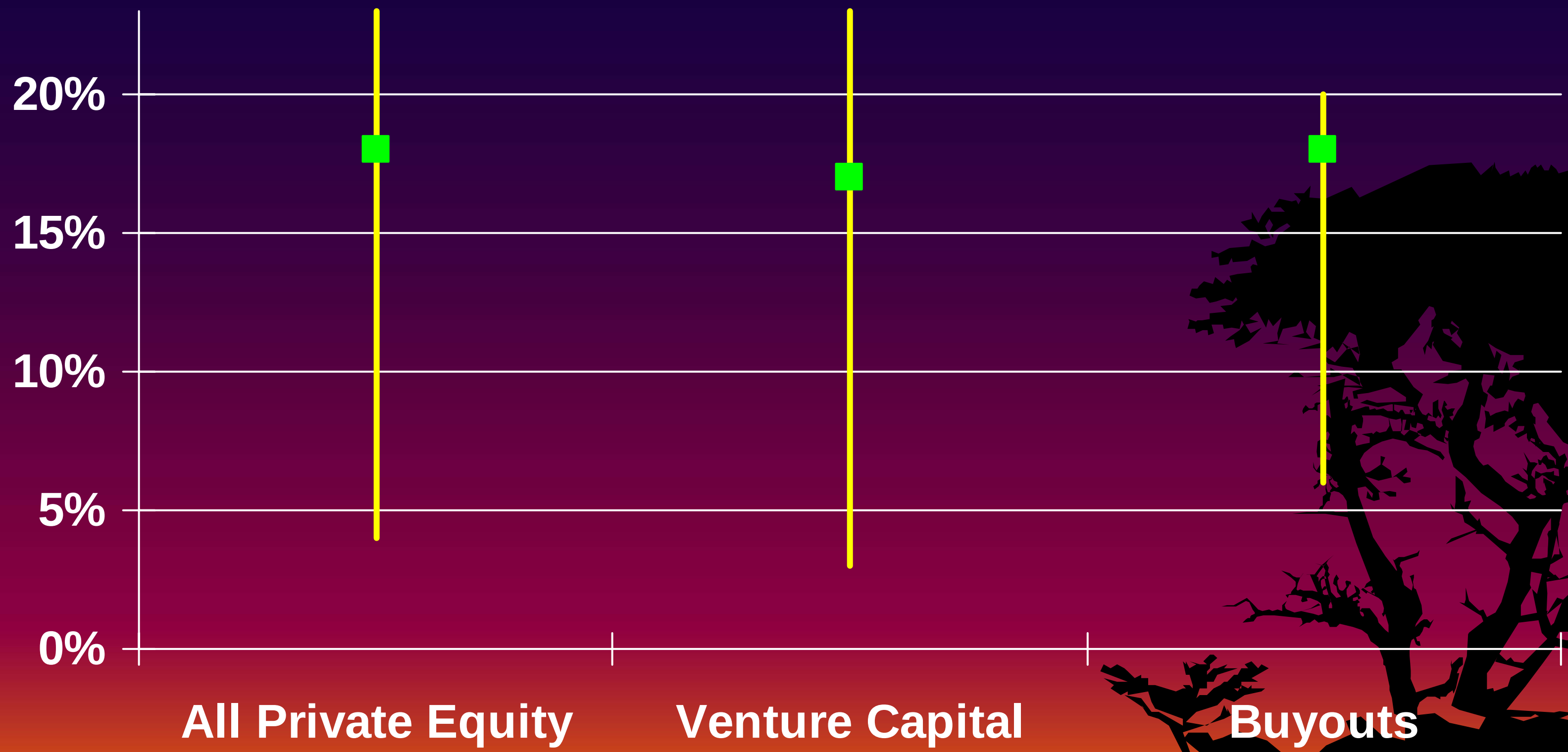
- Has sought to understand how much difference is…
  - Between fund classes.
  - Between funds ***in*** private equity.
- Seeking to distinguish importance of individual performance.

Evidence from the Yale endowment



Source: Lerner [2007]

More general patterns



Source: Kaplan and Schoar [2005]

The reality

- The key difference is between different funds:
  - Unlike public investing.
- Investing in the right categories is not nearly as critical as getting into the right funds!

Myth 3: “Regression to the mean”

- Frequently heard stories…
  - “Our last two funds were a disappointment, but we’re getting back on track…”
  - “I considered investing in the fund, but I decided that their success must be a fluke...”

Persistence of performance

	Bottom	Medium	Top
Bottom Tercile	61%	22%	17%
Medium Tercile	25%	45%	30%
Top Tercile	27%	24%	48%

Source: Kaplan and Schoar [2005]

- High likelihood that the next funds of a given partnership stays in the same performance bracket

  ➔ Persistence.
- 1% boost in past performance → 0.77% boost in next fund's performance.

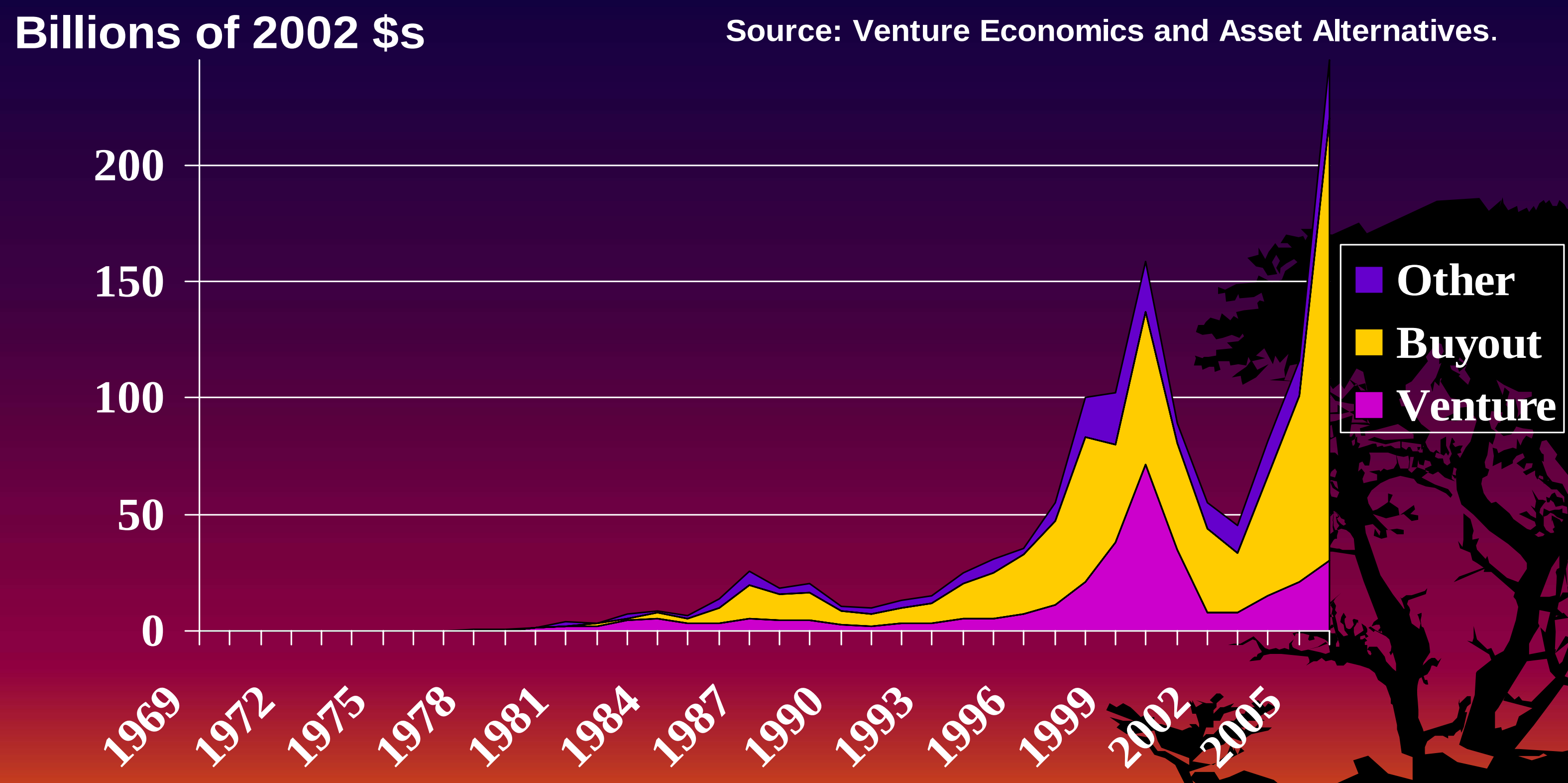
The reality

- Performance seems to be very “sticky”:
  - Good continue to do well.
  - Underperformers continue to do so.
- While exceptions, seems to be the basic rule:
  - Seen in buyouts as well as venture.

Myth 4: Growth doesn't hurt

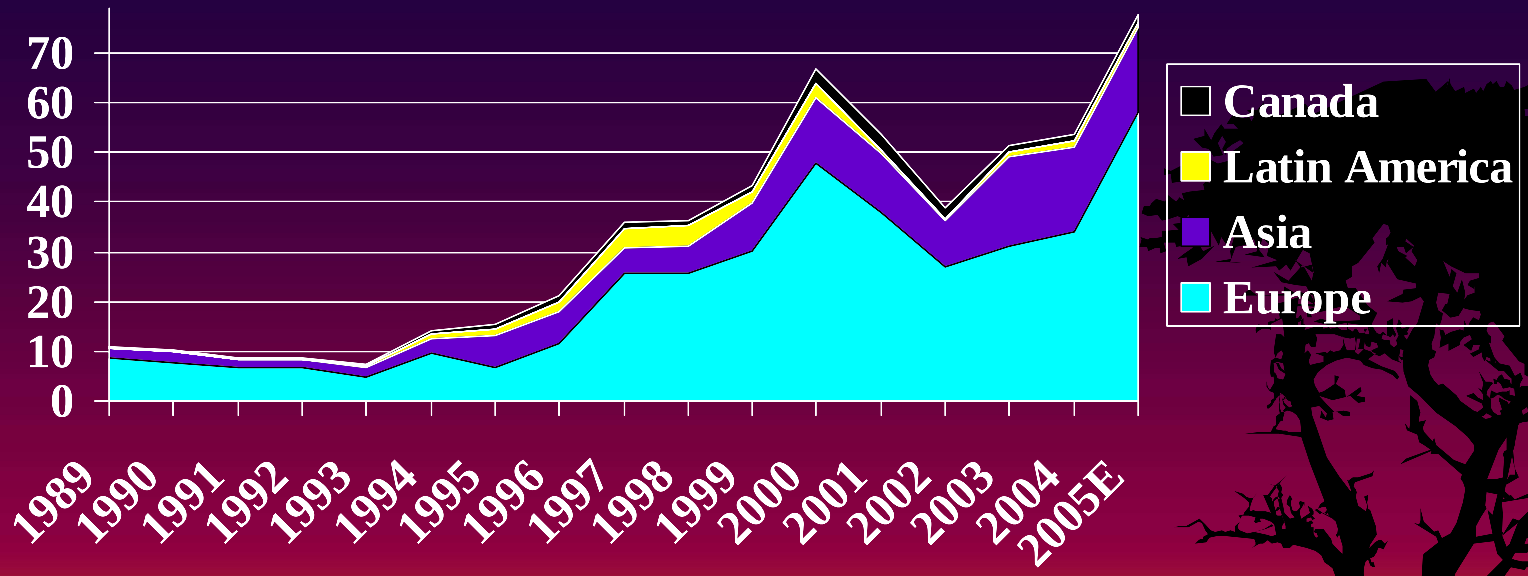
- Numerous venture groups have grown dramatically.
  - Mid 1980s and late 1990s.
- Recent dramatic growth by buyout funds.
- Have typically argued that can sustain performance despite growth.
  - But powerful incentives to grow may induce skepticism.

U.S. private equity fundraising, 1969-2006



Private equity fundraising outside the U.S., 1989-2005

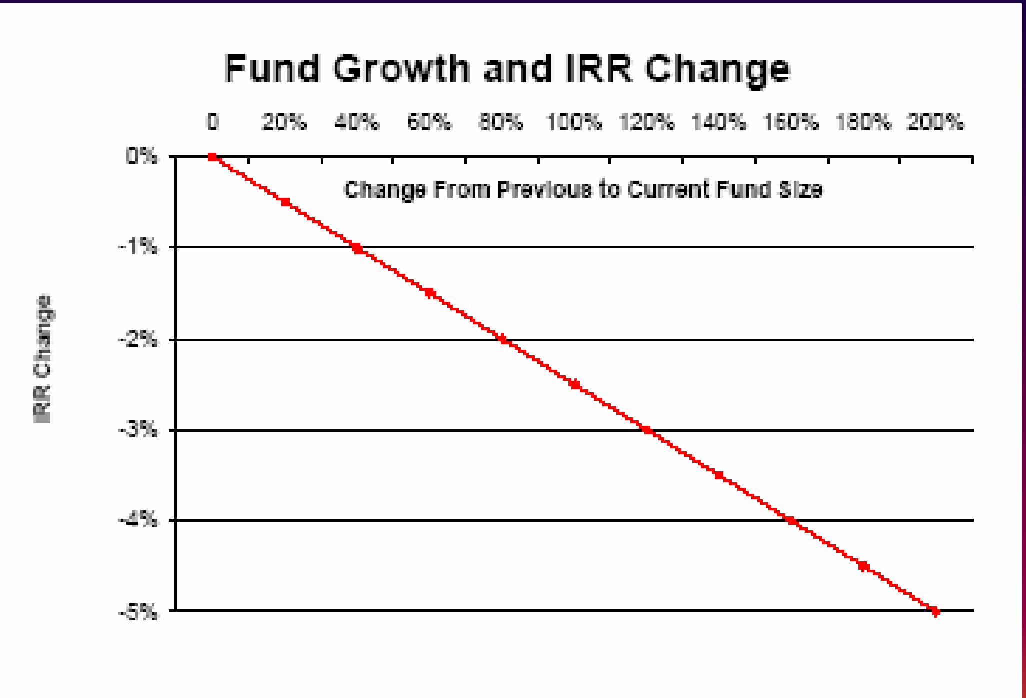
Billions of 2004 $s



Asian data are investments rather than funds raised.

Source: Various national venture capital associations.

Change in fund size



- Negative relationship between change in IRR and change in fund size for a given firm.
- Fund size is measured as capital committed at closing.
- Regression results control for vintage year effect, fund category, and firm fixed effects.

Source: Lerner and Schoar [2005]

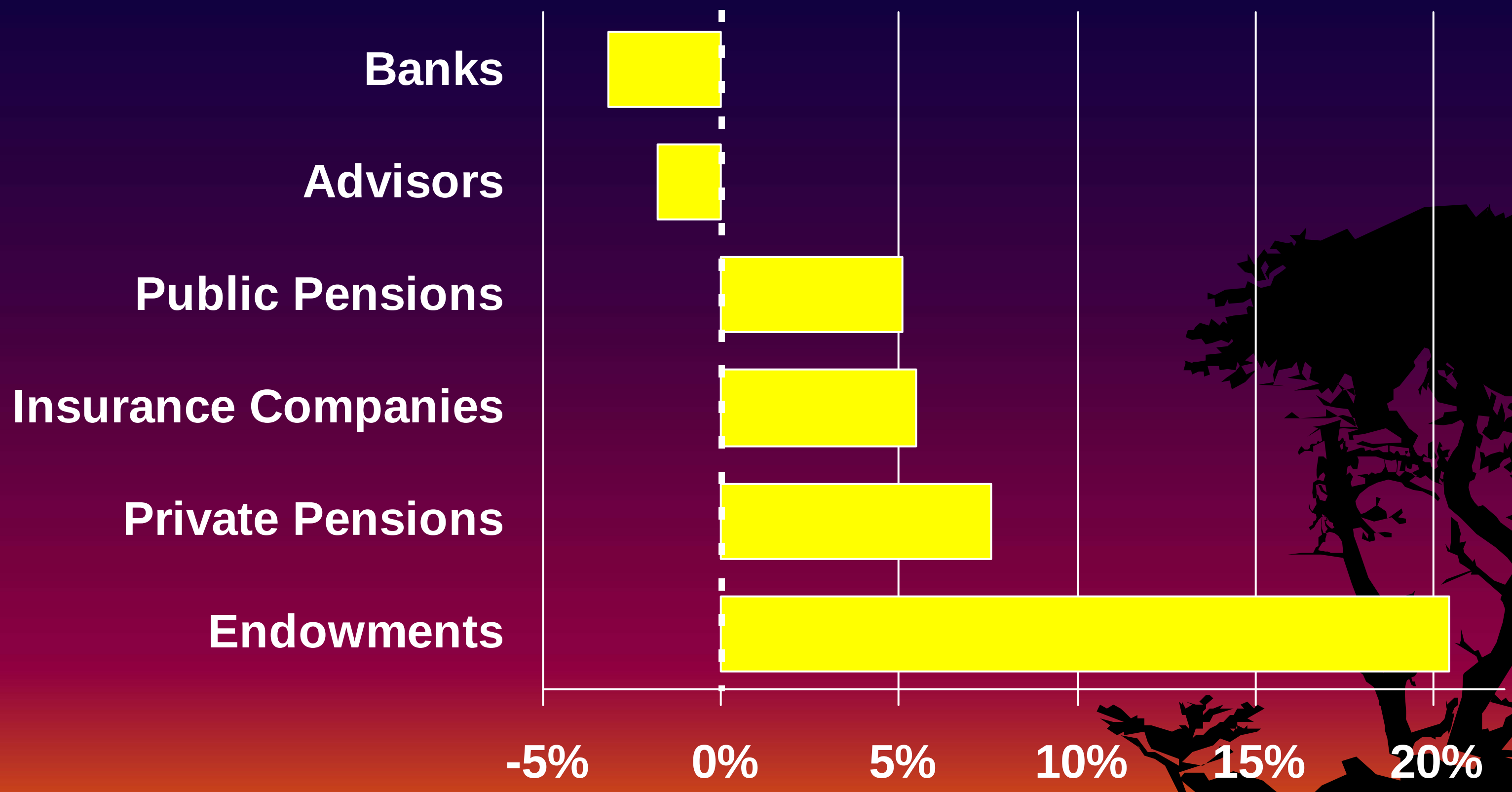
The reality

- Funds with higher sequence number, i.e., established funds, perform better.
- But rapid growth in capital under management is associated with performance deterioration.
- May be driven by dilution of impact of partners.

Myth 5:   Anyone can play

- Lately, great deal of interest from new investors:
  - Public pension funds.
  - Non-U.S. governmental entities.
- Attracted by high returns that established investors have enjoyed.
- But does everyone do the same?

Performance by investor type



Source: Lerner, Schoar and Wang [2007]

Concerns with univariate tests

- Do these reflect other differences:
  - E.g., endowments early investors and more heavily weight VC.
- Examine through regressions:
  - Regress IRR on fund and LP characteristics.
  - Only include <1999 funds to insure meaningful performance numbers.

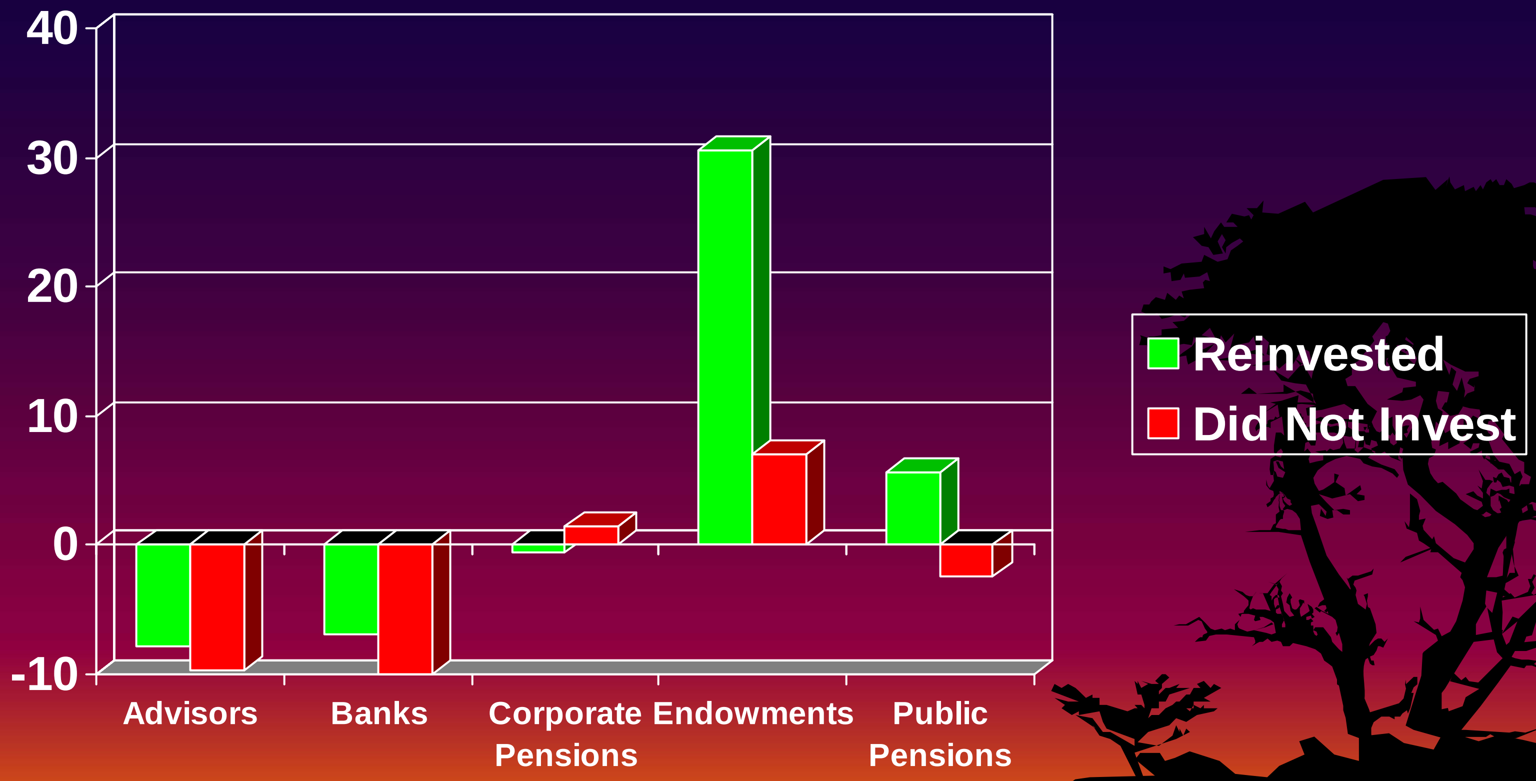
Regression analyses

- Differences persist:
  - Endowments outperform; corporate pensions and banks underperform.
  - Younger LPs do worse:
    - At least among advisors, banks, corporate pensions, and insurers.
  - Market inflows negative in general.
    - Especially for advisors, corporate pensions, and insurers.
      - Hot markets appear to lead to more herding by these investors.

Reinvestment decisions

- Reinvestment decision should be made with better information and without access constraints.
- Look at follow-on funds in our sample:
  - Only look at same classes of funds.

Reinvestment and *future* returns



Source: Lerner, Schoar and Wang [2007]

Is access an explanation?

- Do endowments do well because they were “there first”?
- Other way to look at:
  - Funds that were undersubscribed.
  - Funds which took a long time to raise.
- Same patterns appear!

The reality

- Huge disparities in performance.
- Superior performance has been largely confined to endowments.
- Raise substantial questions about ability of new entrants to succeed.