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The remarkable rise
of private assets

A SECULAR OUTLOOK

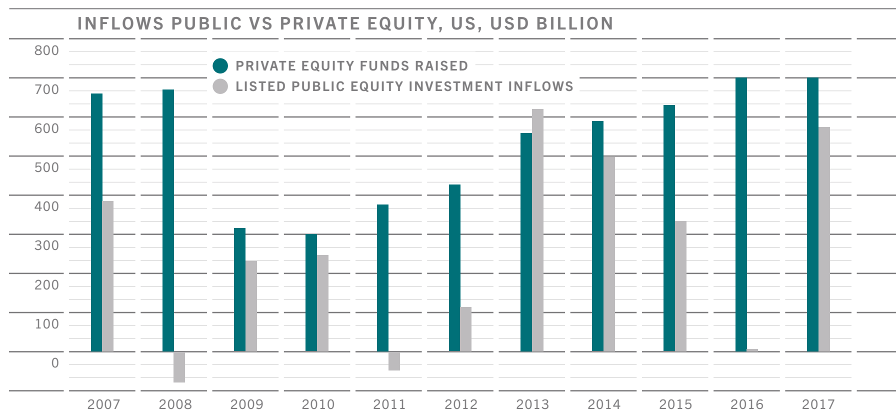
2018

The remarkable rise of private assets

It provides companies with access to cheap capital. And it offers virtually everyone in society an affordable and straightforward way to acquire a stake in human ingenuity. As a mechanism for lifting economic growth and democratising finance, the stock market has few genuine rivals.

But the listed company's unique status in the world of investment is being contested. The challenge comes from privately held firms, which account for an ever bigger slice of the economy. This is particularly true of the US. Although the total number of US companies has remained relatively steady in recent decades, fewer of them are publicly traded. As a percentage of all US firms, the proportion of listed companies has fallen by more than half since peaking in 1996.[1]

Private equity markets trump public stocks



Source: Preqin, Morningstar; data covering period 31.12.2016-31.12.2017

If this trend continues, it could make equity investing more complicated and costly for all but the wealthiest and largest investors. It could make equity investment riskier too.

1 Doidge, C., Karolyi, A., and Stulz, R. The US Listing Gap, on file with the Journal of Financial Economics, September 2016.

There is little doubt that private equity is enjoying a golden period. Globally, private equity assets under management reached a record USD2.8 trillion in 2017, growing some 7 per cent year-on-year over the past decade.[2]

And as FIG. 2 shows, funds raised in private equity have outstripped investment flows into listed equity funds in four out of the last five years.

Unicorns – private companies with a valuation of above USD1 billion – are central to this trend. According to The Wall Street Journal there were 155 of these unicorns by the first quarter of 2017, more than three times the number in 2014. Private investment in tech start-ups, meanwhile, has tripled since 2013.[3]

Theories abound as to why this is happening.

Large pension funds have had a big influence. Concerned by the high valuations of publicly traded stocks and by their own stubbornly wide deficits, pension plans are increasingly attracted to the illiquidity premium offered by private investments, especially private equity. According to the investment consultant Willis Towers Watson[4], pension fund allocations to listed shares decreased by some 10 per cent over the past two decades, while holdings of alternative assets such as private equity and real estate increased by 20 per cent.

But there are other forces supporting private equity at the expense of publicly listed stocks, particularly in the US.

One is the rise of passive investing. The growing popularity of index-tracking means there are fewer investors buying the stocks of companies excluded from major equity indices such as the S&P 500.

For firms that lie outside the big market benchmarks, the appeal of remaining listed in the US naturally diminishes. At the same time, public companies are becoming frustrated at the short-termism of shareholders. In the 1980s, an investor could be expected to hold a stock for at least two years. The holding period today is less than eight months, making it difficult for executive boards to plan and invest for the long term. A private firm's board wouldn't face such constraints.

A lopsided regulatory regime is also undermining the role of the US public company. While oversight of listed firms has tightened, the same cannot be said for the private sector, where disclosure requirements have, if anything, become less onerous in recent years.

The upshot is that as private equity has grown, the number of companies listed on US exchanges has almost halved to about 3,600. Not only are American firms moving out of stock markets in greater numbers, but initial public offerings (IPOs) are also in decline. In the two decades to 2000, US entrepreneurs launched an average of 300 IPOs per year. From the 2000s onwards, the annual IPO

2 Source: Preqin, 2018
3 Source: McKinsey, 2018
4 Willis Towers Watson Global Pension Asset Study, 2017

count dropped to just 99. Moreover, the total US share of IPOs worldwide has fallen from 31 per cent to just 10 per cent over that period even though, measured as a proportion of the world's total output, the country's economic standing has remained constant.[5]

A transformed equity landscape

If, as we expect, the shift from public to private equity gathers strength in the next several years, the implications for investors will be profound.

Equity investing is bound to become more complex and expensive.

Compared to their listed counterparts, private firms are hard to invest in. Typically, only the very wealthy can afford the sums demanded for direct access via private equity funds. Investment charges are another problem. Even as the volume of private equity investments has soared, the industry has broadly stuck to its standard fee arrangement, taking 20 per cent of total investment gains on top of a 2 per cent management fee. And while retail investors can access private equity through fund of fund vehicles, such products levy an additional charge of at least 2 per cent.

Then there's the risk. Private firms face a far lower degree of regulatory scrutiny than their public counterparts. In this less transparent world, investors can't be sure of a company's policies in areas such as governance and the environment.

Returns from equity investments might also prove less inspiring than in the past – both in public and private markets. For the investor in listed companies, a lacklustre IPO market is troubling because it suggests that most of the value of equity investing is realised either in the private market (via a buyout or similar transaction) or in the years prior to a firm's listing.

Those fortunate enough to be able to invest easily in private companies, meanwhile, will find that their investments will be less lucrative than in recent years (even if private equity will retain a sufficient – if narrowing – advantage over listed stocks).

With capital pouring into private equity at a rapid rate, the volume of money chasing assets threatens to outstrip the supply of viable investment opportunities. That risks inflating initial valuations and dampening future returns.

There is already evidence of this. Over the past two decades, private equity has returned some 10 per cent more per year than stocks in the S&P 500 index. In the past three years, however, that premium has shrunk to well below the long-term average, and is now hovering at just over 3 per cent annualised. Our research shows that most of this reduction can be attributed to a narrowing of the

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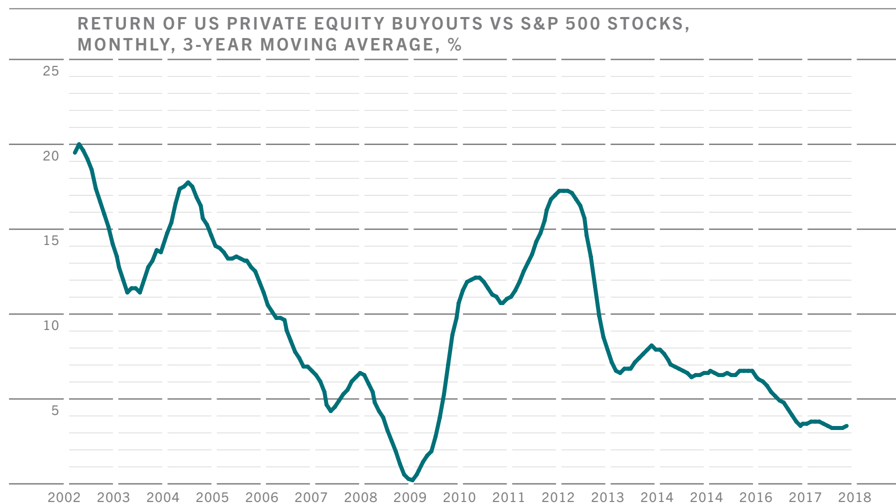
5 See, Fontenay, E., The Deregulation of Private Capital and the Decline of the Public Company, 2017, Duke University School of Law.

"illiquidity premium" of private investments, or the extra return investors expect to receive as compensation for having to hold such assets for much longer periods than listed stocks.

Moreover, there is a substantial body of academic research that finds a negative correlation between fundraising activity in private equity and future returns. One study, spanning 20 years, shows that when inflows into private equity are exceptionally strong, the return from that investment is lower than average in subsequent years.[6] That should be a worry for investors given that the amount of dry powder private equity funds have at their disposal is at an all-time high of USD1 trillion, according to Preqin.

Equity investing, then, is being transformed. As little as 10 years ago, all investors had to do to build a stake in the very best corporate America had to offer was to buy a diversified portfolio of listed companies. But the continued rise of private firms and private equity will force a change in approach. To achieve the same goals today and in future, investors will need to make additional and sizeable allocations to private equity, early-stage venture capital vehicles and late-stage venture capital funds. That is bound to make investing more costly and complicated.

Private firms' shrinking returns



Source: Preqin, Thomson Reuters Datastream; data covering period 31.12.2001-31.12.2017

6 See Kaplan, S. and Stromberg, P., Leveraged Buyouts and Private Equity, 2009 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1194962

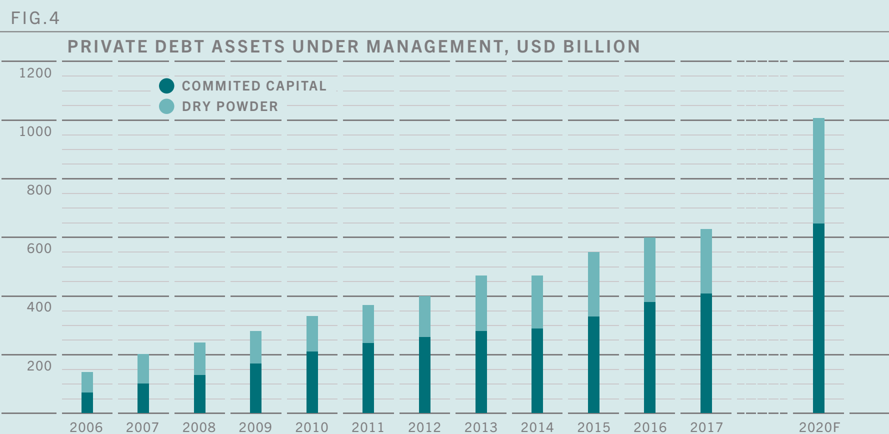
Private debt assets in the ascendancy

The rapid expansion of private assets isn't confined to equity: it's also spreading through the credit market. Since 2000, the volume of private debt assets under management has risen by a factor of 14 to more than USD600 billion. According to the Alternative Credit Council (ACC), the pace has increased over the last 10 years, with volumes of committed capital and dry powder growing at an annual compound rate of 20 per cent.

By 2020, the private debt industry's AUM will have broken through USD1 trillion, the ACC estimates. The growth reflects structural changes in both the supply of credit and demand for debt investments. On the supply

FIG.4

Private debt in the ascendancy



Source: AIMA;
data covering period 31.12.2006-31.12.2017

side, tighter regulation of the financial industry has forced banks to shrink their loan books. That has created a gap which has been plugged by alternative providers of debt capital – such as asset managers and crowd-funders. At the same time, investor demand for private debt has grown as central banks' quantitative easing programmes have pushed valuations for most publicly traded fixed income assets to historically expensive levels. More than half of all institutional investors now have allocations to private debt, according to Preqin data, and an additional 13 per cent plan to add such assets to their portfolios. Although private debt offers higher yields than tradeable bonds, that premium is designed to compensate investors for risks including lower levels of protection in the event of default. What is more, there is a greater dispersion in the returns of private debt assets compared with publicly traded bonds. So, as with private equity, allocating capital to private debt requires investors to take on considerably more risk.

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