CIBC PRIVATE WEALTH MANAGEMENT

ALTERNATIVE INVESTMENTS

Understanding Your Private Equity Returns

Let's lay out a common scenario for a high net worth client. A client sits down with their financial advisor to review the performance of their portfolio.

First, they're shown the performance of their stock portfolio and how it compares to relevant benchmarks (e.g., the S&P 500 Index). This all seems straightforward enough. Then the client reviews the private equity (PE) portion of the portfolio, and the numbers are not so straightforward. It can leave one wondering if PE adds value to portfolios.

Investors are often bombarded with unfamiliar PE terms, like internal rate of return (IRR), distributions to paid-in (DPI) and total value to paid-in (TVPI). Many advisors spend too much time trying to explain these arcane terms and not enough time addressing the two questions most important to the client:

1. "Is my PE portfolio making money or losing money?"
2. "Would I have been better off in the stock market?"

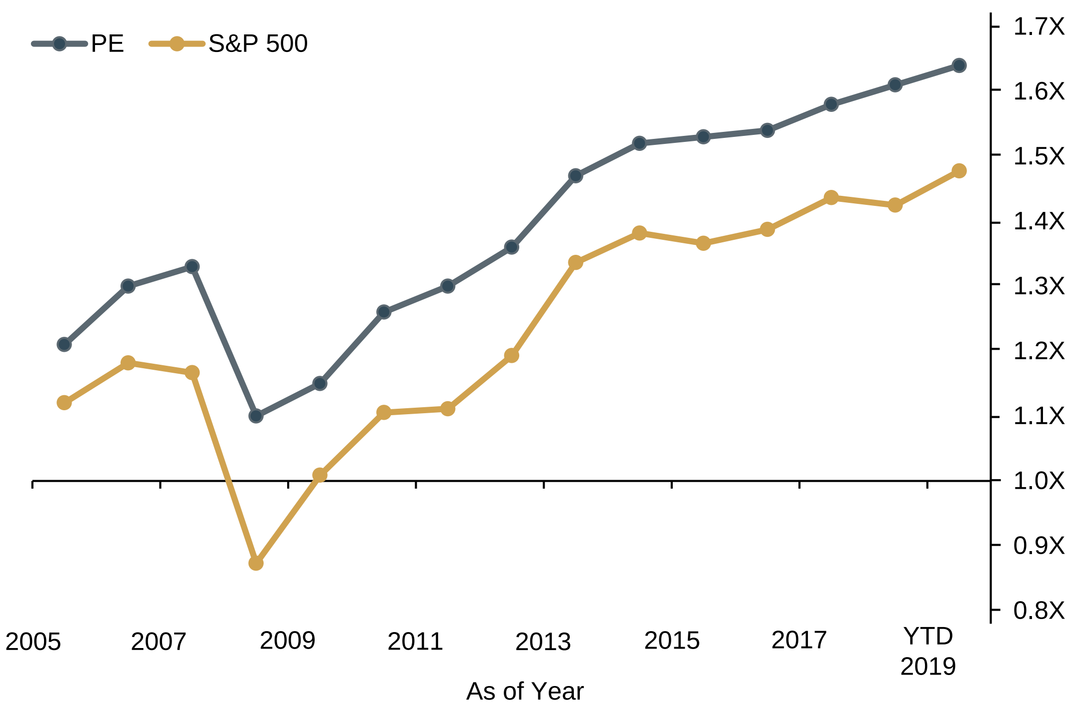
The first question is easily answered by comparing a portfolio's total value (unrealized plus realized) to the total invested amount. It's the second question that has plagued clients and advisors for far too long. The dilemma lies in the stark differences in the way money is put to work in the public stock market vs. a private equity investment. Let's take the example of investing $1 million in an S&P 500 Index Fund vs. a $1 million PE fund investment. When we see a 20-year return for the S&P 500 quoted, it assumes that the entire $1 million was invested on day one and left alone, other than the reinvestment of dividends. That's not how a PE investment works. While a PE investor may make a "commitment" of $1 million to a PE fund on day one, that money will actually be invested in tranches over three to five years. In the interim, the investor retains control of the balance, which can remain invested in other return-seeking or income-producing asset classes. If comparing the results of these two investments seems like comparing apples and oranges, it is.

However, there is a way to level the playing field and create a valid performance comparison. The solution is called the Public Market Equivalent, or PME. This performance tool illustrates how much money an investor would have made in a public index vs. their PE investments. The calculation assumes that money is invested into the stock market in the same staggered tranches as PE funds. By equalizing the timing of cash flows, an apples-to-apples analysis is now possible.

So, what does that comparison look like? Does it clarify if an investor would have been better off in the stock market? Every specific investment will provide a different answer, but looking at broad market results for the two asset classes is a good start.

Using a PME calculation, we can compare the historical performance trend for PE investments vs. the S&P 500. The PE composite below consists of over 2,300 funds from 2000 through 2019. The chart below shows the "Multiple on Total Invested Capital" for the PE composite and the S&P 500. In other words, how many times your invested money would have been returned to you. The spread between the two lines below represents the return premium of PE over the S&P 500.

Multiple on Total Invested Capital



Past performance is not a guarantee of future comparable results. Source: Private iQ, as of 06.30.2019.

Of course, this does not mean that every PE investment earns a healthy premium over the S&P 500—quite the contrary. In our experience, selection of high-quality managers is an essential element of effective PE investing. But the broad results above suggest that a well-executed PE program has an excellent chance of adding long-term value as a complement to a public equity portfolio. ■

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