Appendix 6

London Borough of Bromley

Private Equity

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Private Equity

The following comments come from the McKinsey Global Private Markets Review 2021

1. Globally, Private Equity raised over US$600bn of new money in both 2018 and 2019 and £500bn in new money was raised in 2020 despite the Covid pandemic. 60% of this was from the US. Fund raising recovered sharply towards the end of 2020.
2. Growth rates for private markets net asset value and public market capitalization first diverged during the Global Financial Crisis, and that divergence has accelerated over the last decade. By assets, Private Equity has grown by a factor of 10x since 2000. The market capitalisation of public markets has grown by a factor of 3 over this period.
3. Globally, Private Equity AUM reached US$4.5Trillion during 2020. Driven by increased allocations from institutional investors, strong returns and rising leverage.
4. Private equity has outperformed public market benchmarks over the last five-, ten-, and 20-year periods. On a pooled basis, private equity has produced a 14.3 percent annualized return over the trailing ten-year period, beating the S&P 500 return of 13.8 percent by 50 basis points. Over the trailing 20-year period, outperformance has been even greater: private equity has produced a 9.9 percent annualized return, beating the S&P 500 return of 6.4 percent by 350 basis points.
5. Though private equity at the industry level continues to outperform, achieving industry level performance requires careful manager and fund selection. Further, most LPs invest in private equity with the expectation of outperformance, and private equity teams at institutional investors are often measured against their ability to outperform the median. There is good reason behind that rationale. The difference between top- and bottom-quartile performance is worth more than 1,000 basis points in Internal Rate of Return (IRR). Where there is opportunity for outperformance through manager selection, there is nearly equivalent downside risk. Larger Funds tend to produce similar returns, smaller fund returns are more disparate.

McKinsey's report is supported by data from PIRC who monitor the performance of 63 LGPS funds across the UK using their reported performance data.

PIRC data to March 2021 shows the following:

Asset Class	1 year return	3 year return	5 year return	10 year return
Global Equity	40.5%	11.5%	13.7%	13.0%
UK Equity	30.0%	3.9%	6.7%	6.6%
Private Equity	12.3%	13.1%	13.8%	14.4%

The table shows that over ten years Private Equity has outperformed Global Equity by 1.4% p.a. The one-year return shows that private equity does not follow the pricing in the quoted equity market in the short term. This is because of the illiquid nature of Private Equity such that, in fast moving markets, Private Equity prices lag. This was as true in the market collapse in Q1 2021 as it is has been during the recovery.

Data from Cliffwater showing US State Pension funds 10-year returns by asset class is less convincing showing the median Private Equity return over 1% below that of quoted equities per annum over 10 years.

Exhibit 6: State Pension 10-Year Returns by Major Asset Class

	Total Fund	US Stocks	Non-US Stocks	Fixed Income	Real Estate	Private Equity	Absolute Return
Highest Return	9.74%	15.02%	8.24%	9.75%	13.47%	16.91%	7.27%
25th Percentile	8.93%	13.61%	6.67%	5.17%	11.41%	13.60%	6.15%
Median Return	8.57%	13.17%	6.07%	4.57%	10.65%	12.65%	5.17%
75th Percentile	7.81%	12.65%	5.41%	3.96%	9.86%	11.37%	4.33%
Lowest Return	6.71%	8.81%	4.13%	2.91%	8.20%	5.37%	2.65%
Average Return	8.63%	12.90%	6.26%	4.79%	10.43%	12.75%	4.95%
Benchmark Return	7.94%	13.73%	4.97%	3.83%	9.70%	14.48%	3.74%
Benchmark Percentile	73%	14%	89%	78%	76%	16%	100%
25th - 75th Mid Range	1.11%	0.96%	1.26%	1.21%	1.56%	2.23%	1.81%
Count	66	38	41	60	41	41	12

Benchmarks:

The reason for this mismatch is because performance data is not as definitive as people expect and is influenced by the timing of cash flows into and out of a portfolio as well as whether the figures are gross of fees or net and how other expenses have been treated.

I suspect there is a small improvement in performance from private equity net of fees but that the costs and high fees weigh heavily.

JP Morgan produce Long-Term Capital Market assumptions (LTCM) for all asset classes. They expect a higher return from Private Equity against global Equities over the next 10 years.

	2020 forecast	2021 forecast	Historic volatility	Correlation with Global Equities
Global Equities	5.0% p.a.	4.3% p.a.	13.6%	1.0
Private Equities	7.3% p.a.	7.0%p.a.	16.5%	0.68

I would make the following comments about these forecasts:

1) The volatility estimates within the JPMorgan LTCM are wrong as they analyse price volatility yet in difficult market conditions it is liquidity that collapses not prices. i.e. Private Equity prices do not change in a market collapse, they are just untradable.
2) The average Private Equity company is 6-7 times leveraged against 3 times for quoted companies, this underlines the inappropriateness of the LTCM risk figures.

Other issues are:

1) Private Equity brings the Fund closer to ownership of a company, this increases reputational risk. Many Private Equity managers target short to medium term value creation at the expense of the longer term and focus purely on financial returns rather than building the business for all stakeholders (Debenhams et al)
2) You will need to repeat the investment to diversify across vintages. The timing of entrance is particularly important, cash should be invested when it is scarce and hopefully returned when assets are expensive.

If the Fund conducts a review of its Strategic Benchmark post the updated actuarial valuation due in 2022, I would expect Private Equity to be amongst the asset classes considered for investment as it was in the work MJ Hudson conducted in 2019.

Most importantly, the Fund does not need to invest in more volatile asset classes with a high correlation to equities. It is well funded and could look to further diversify and take less investment risk rather than more.