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Does private equity mean better returns than public stocks?

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For most people, it's natural to assume that if something is exclusive to the wealthiest echelons of society, it must be better. Asset management firms looking to access trillions of "retail" investor dollars explicitly reference this exclusivity when marketing private equity offerings. But investors should be wary when fund marketers talk about "democratizing investing" or opening access to areas previously only available to the elite.

Reasons to be wary

Investing is already democratized. The SEC eliminated fixed trading commissions in 1975, and innovation has made investing in publicly traded stocks cheaper and easier ever since. Online trading platforms allow people of modest means to easily buy shares in almost any publicly traded company. The advent of cheap, passively managed mutual funds and exchange-traded funds has made building a diversified portfolio easier and more affordable than ever. ← Note

Moreover, public capital markets are a good thing. Investors who buy publicly traded stocks or bonds get transparency about their investment with ready liquidity. Meanwhile, private capital investments are often opaque and illiquid.

There has been considerable debate about whether private investments generate higher returns. Measuring performance for private equity and private debt is not straightforward. Most industry benchmarks use internal rates of return, which aren't really comparable to traditional performance measures like total return. ← Note

Researchers have examined some of the findings related to this topic. A 2020 paper by Ludovic Phalippou, "An Inconvenient Fact: Private Equity Returns & The Billionaire Factory," argues that net of fees, returns for private equity funds have been in line with those of the public equity markets since 2006.

PitchBook, which is part of Morningstar, has also gathered data on public market equivalent returns for private equity. Based on those metrics, private equity funds with 2020-2023 vintage years did not generate positive excess performance returns, although funds with 2011-2019 vintages fared significantly better.

Semiliquid private equity and venture capital funds

Even if private capital had a performance edge in the past, there's no guarantee that this advantage will continue or that those managers will be the better performers. As Morningstar's Jeff Ptak notes, private equity funds typically have widely dispersed returns, meaning a large gap between the top and bottom performers. Your returns could differ wildly from those of benchmark indexes.

As large private equity firms increasingly tap retail capital, the instruments available to average investors probably won't be the best. Investment sage Bill Bernstein stated: "The first people who invested in private equity got the filet mignon and the lobster tails, and the Vanguards and Fidelities of this world are going to wind up with tuna noodle casserole." ← Note

On the venture capital side, getting access to the next startup unicorn early in the game sounds appealing. But for every SpaceX, thousands of early-stage companies never take off, and there is additional risk from leveraged exposure to privately held companies.

When you hear about the virtues of access to investments that were off-limits, it's worth considering who really benefits. As passively managed funds with rock-bottom expense ratios continue to gain market share, asset management firms are pressed to find new sources of high-margin revenue. That new source of revenue, in many cases, is you.

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