Remarks to the SEC Asset Management Advisory Committee Private Investments Subcommittee

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Josh Lerner
Harvard Business School

Josh Lerner: Background and experience.

- **About me:**
  - Jacob H. Schiff Professor in Entrepreneurial Management and Finance units, Harvard Business School.
  - Bachelor's from Yale University and Ph.D. from Harvard in economics.
  - Research focuses on the structure and role of VC and PE organizations.
  - Co-director, National Bureau of Economic Research's Productivity, Innovation, and Entrepreneurship Program.
  - Founded the Private Capital Research Institute, a non-profit devoted to encouraging access to data and research about VC and PE.
  - Winner of the Swedish government's Global Entrepreneurship Research Award and Cheng Siwei Award for Venture Capital Research
  - Advises limited partners, general partners and government bodies interacting with private capital.
    - For more information see www.bellaprivatemarkets.com.

Introductory comments.

- **Big questions!**

- **Caveat: Researching PE is difficult due to data constraints.**
  - The "private" nature of the industry means that data can be incomplete or inaccessible in many cases.
  - Further, PE is a newer asset class* with less history to research.

- **With that in mind, I will present a few takeaways from recent research to provide insight on these issues.**

* Compared to assets such as public equity and fixed income.

PE has potential diversification benefits.

- **A recent study shed light on the extent of PE's potential diversification benefits.**
  - Ang et al. (2018) analyzed PE returns over time.
  - The study found "cyclicality" in PE returns.
    - That is, returns fluctuated up and down over time.

- **Importantly, the study found that cyclicality differed based on the type of fund (such as venture capital or buyout).**
  - That is, one type of fund might perform well while another performs poorly.

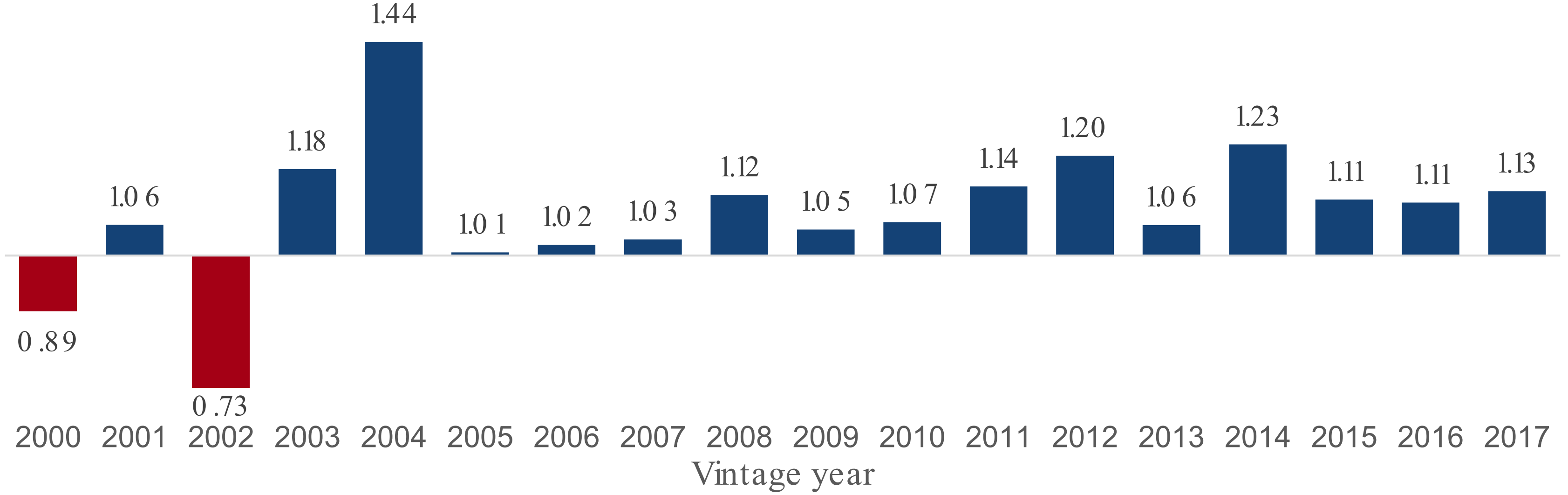
- **Per the authors:** ***"We find that the [private equity] premium is highly persistent and considerable diversification can be obtained within just the PE domain."***
  - Such diversification should make PE attractive to retail investors.

Source: Ang, Andrew, Bingxu Chen, William N. Goetzmann, and Ludovic Phalippou. "Estimating private equity returns from limited partner cash flows." *The Journal of Finance 73, no.4 (2018): 1751-1783.*

However, PE only slightly outperforms public markets.

- **I compare performance of PE and public markets using a PME.**
  - PMEs (Public Market Equivalents) show the relative performance of PE compared to similarly-timed investments in public markets.
- **In recent years, PMEs show only slight outperformance relative to similarly timed public market investments.**
  - PMEs close to 1.0 .

*North American PE Funds versus Russell 3000 KS-PME**

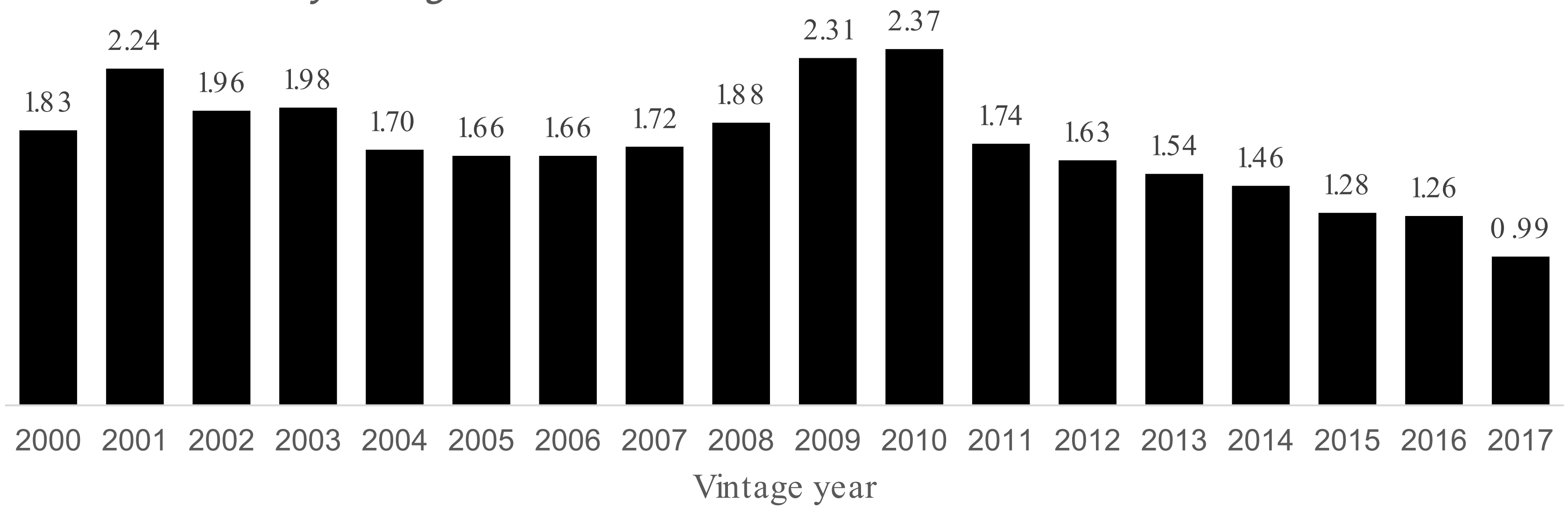


*Kaplan-Schoar PME. The Russell 3000 represents approximately 98% of the US equity market.
Source: Preqin Private Capital Benchmarks. As at December 31, 2019. Accessed on September 3, 2020.

And returns have been falling.

- **The median TVPI of PE funds has fallen in recent years.**
  - The TVPI (total value to paid in) measures the cash returned plus the remaining value of the investments compared to the amount invested.
- **Using this metric, returns show a clear downward trend.**

Pooled net TVPI by vintage for US PE



Source: Cambridge Associates. "Private equity: Index and selected benchmark statistics." March 31, 2020: p. 31.

Further, fees for retail products are high.

- Investors in PE funds (LPs) pay high fees for investment products already.
  - Generally 2% on the capital invested in a PE fund plus 20 % of profits (called "carry").
  - The study noted that buyout fund managers in particular earn high fees on a "per partner" basis.

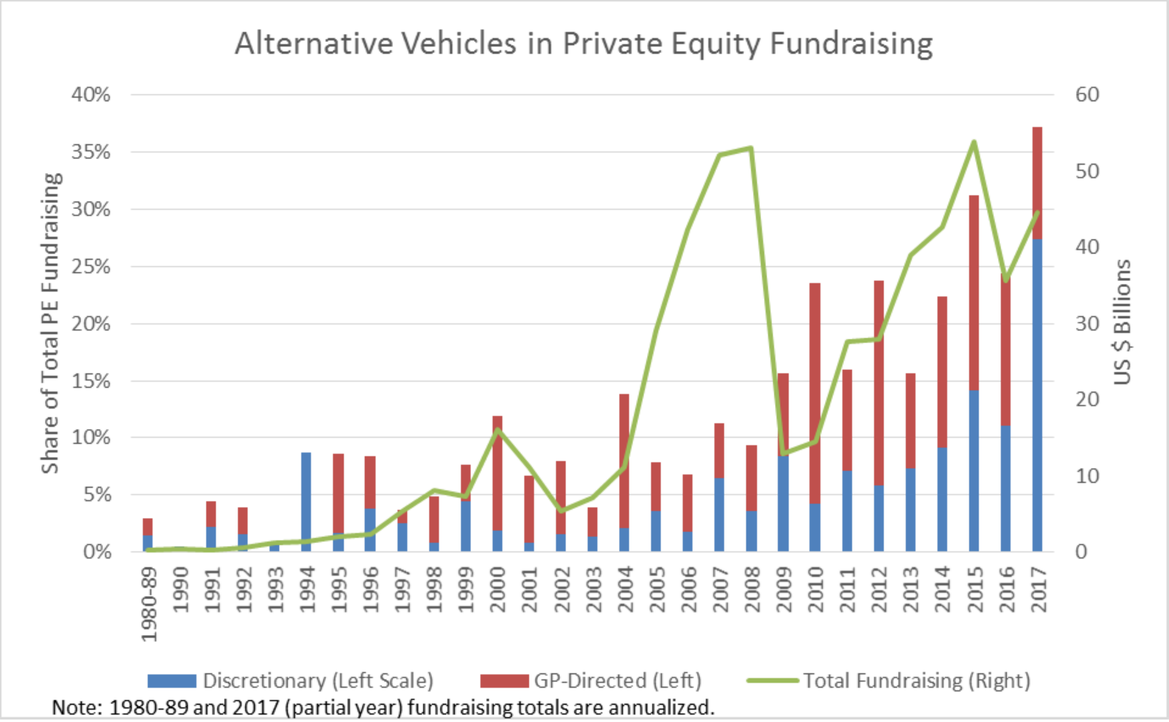
- Retail-focused PE products have typically had an additional layer of fees.
  - In addition to the underlying "2 & 20" fees associated with PE funds.
  - A few examples of such additional fees from past/ existing products:
    - 1.2% management fee, sales load of up to 3.5%, and redemption fee of 2.0 %.
    - 1.75% in management fees and operating expenses.
    - 2.31% expense ratio for a PE mutual fund product.
      - *Much higher than the 1.32% average for mutual funds in the same category (World Small/Mid Stock funds).*
  - May negate all of remaining alpha.

Source: Metrick, Andrew and Ayako Yasuda. "The economics of private equity funds." *The Society for Financial Studies* (2010). Strauss, Lawrence C. "The problem with private-equity funds for the masses." *Barrons*, March 26, 2016. https://www.barrons.com/articles/ pitching-private-equity-to-the-masses-1458970075. Accessed September 9, 2020.; "ALPS | Red Rocks listed private equity fund class A: LPEFX." *Charles Schwab.* Generated September 9, 2020.; Papagiannis, Nadia. "Private equity funds for the masses: What investors should know before they dive in." *Morningstar.* April 11, 2013. https://www.morningstar.com/articles/591832/private-equity-funds-for-the-masses. Accessed September 9, 2020.

Some see co-investments as a solution.

- Co-investments are made alongside a fund.
  - Rather than through the fund itself.
  - They generally have lower fees than investing in the fund.

- A recent study found that co -investments are increasingly popular.



Note: Alternative vehicles include both discretionary and GP-directed vehicles.
Source: Lerner, Josh, Jason Mao, Antoinette Schoar, and Nan R. Zhang. "Investing outside the box: Evidence from alternative vehicles in private equity." *Harvard Business School Entrepreneurial Management Working Paper No. 19-012, Harvard Business School Finance Working Paper No. 19-012* (2020).

However, co-investments can be challenging.

- **Using data for 1980-2017, the same study found that alterative vehicles (i.e., co-investments) underperformed the main fund.**
  - Driven by large negative investments.

- **However, alternative vehicles formed between 2009 and 2014 were shown to outperform the main fund on average.**
  - The improvement was driven by discretionary investments by LPs.*
    - Rather than investments directed by the fund managers.
    - This signals that LPs are learning (or a forgiving market).

Adjusted excess PME performance of alternative vehicles (i.e. co-investments)

Year of Formation	N	Weighted avg.	p-value	Median
1980-2017	1,467	-0.0582	0.010	0.002
2009 -2014	486	+0.058	0.009	0.005

*Limited partners (LPs) are the groups that commit capital to a PE fund that is then invested by the fund manager into companies/ deals.
Note: Alternative vehicles include both discretionary and GP-directed vehicles.
Source: Lerner, Josh, Jason Mao, Antoinette Schoar, and Nan R. Zhang. "Investing outside the box: Evidence from alternative vehicles in private equity." *Harvard Business School Entrepreneurial Management Working Paper No. 19-012 Harvard Business School Finance Working Paper No. 19-012* (2020).

Final thoughts

- There are reasons that PE can be attractive to retail investors.
  - Such as potential diversification benefits.
- There are also reasons that PE might not be an appropriate investment for some retail investors.
  - Data on fees and recent performance suggest potential drawbacks.
- I hope these remarks are helpful to the committee in its deliberations.

Thank You!

Josh Lerner

Jacob H. Schiff Professor
Entrepreneurial Management Unit
Harvard Business School
Boston, MA 02163 USA

josh@hbs.edu
www.people.hbs.edu/jlerner