Remarks to the SEC Asset Management Advisory Committee
Private Investments Subcommittee

September 16, 2020

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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.

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*

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*

<table>
<thead>
<tr>
<th>Vintage year</th>
<th>Net TVPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>1.83</td>
</tr>
<tr>
<td>2001</td>
<td>2.24</td>
</tr>
<tr>
<td>2002</td>
<td>1.96</td>
</tr>
<tr>
<td>2003</td>
<td>1.98</td>
</tr>
<tr>
<td>2004</td>
<td>1.70</td>
</tr>
<tr>
<td>2005</td>
<td>1.66</td>
</tr>
<tr>
<td>2006</td>
<td>1.66</td>
</tr>
<tr>
<td>2007</td>
<td>1.72</td>
</tr>
<tr>
<td>2008</td>
<td>1.88</td>
</tr>
<tr>
<td>2009</td>
<td>2.31</td>
</tr>
<tr>
<td>2010</td>
<td>2.37</td>
</tr>
<tr>
<td>2011</td>
<td>1.74</td>
</tr>
<tr>
<td>2012</td>
<td>1.63</td>
</tr>
<tr>
<td>2013</td>
<td>1.54</td>
</tr>
<tr>
<td>2014</td>
<td>1.46</td>
</tr>
<tr>
<td>2015</td>
<td>1.28</td>
</tr>
<tr>
<td>2016</td>
<td>1.26</td>
</tr>
<tr>
<td>2017</td>
<td>0.99</td>
</tr>
</tbody>
</table>

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.

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.

However, co-investments can be challenging.

- Using data for 1980-2017, the same study found that alternative 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)

<table>
<thead>
<tr>
<th>Year of Formation</th>
<th>N</th>
<th>Weighted avg.</th>
<th>p-value</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980-2017</td>
<td>1,467</td>
<td>-0.0582</td>
<td>0.010</td>
<td>0.002</td>
</tr>
<tr>
<td>2009 -2014</td>
<td>486</td>
<td>+0.058</td>
<td>0.009</td>
<td>0.005</td>
</tr>
</tbody>
</table>

*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.
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.
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