



Private equity investment may increase returns

By Don Martin, Special to the Town Crier

Private equity (PE) investing is a type of alternative investment that may be used to reduce your portfolio's volatility while enhancing returns. However, the true value of the investment may be more volatile than it appears because a lack of current data can create the mistaken appearance of a "smoothing" effect on returns.

Venture capital and leveraged-buyout funds are the two main areas of private equity. Leveraged-buyout funds are used to take a publicly traded company private. The advantages are cost savings, flexibility and the ability to make rapid decisions - for example, allowing a firm to buy distressed property quickly at fire-sale prices, which can be crucial to making an above-average profit.

The higher risk of PE investment could mean a higher expected return - sometimes as much as 50 percent or more. For example, if stocks return 5 percent, then PE may return 7 percent to 9 percent.

The biggest risk in PE investment is the illiquidity factor. When you invest in PE, you cannot access your money for years. Investors who are comfortable with risk should hold between 2 percent and 5 percent of a portfolio in private equity.

Getting into a fund run by the best managers is extremely important. The difference in the returns realized by managers in the top quartile compared with those in the third quartile over the last 10 years has been 26.4 percent for venture capital and 24.6 percent for the buyout sector.

PE was originally used by private partnerships among the wealthy and by university endowment funds. Hedge funds have recently begun to use this strategy as well. Returns can't be tracked on a daily or even monthly basis, and the Securities and Exchange Commission (SEC) does not require funds to disclose performance. Tracking the value of a privately held asset on a daily basis is too difficult.

Private equity funds do not register with the SEC. Rather, they comprise investments in privately held companies and are illiquid. Only individual investors with significant net worth who meet certain suitability requirements have access to private equity. The asset class typically requires a substantial minimum investment. It may be difficult to gain permission to invest in the top PE firms.

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