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Understanding liquid private equity investment strategies

Originally published on [BenefitsCanada.com](https://www.benefitscanada.com), May 6, 2021

It's likely that investors seeking the potential higher returns and the lower downside risks of private equity in their diversified portfolios already know that, historically, private equity has outperformed stock market indices by two-to-three per cent per year. They might also know that, from 2007-2020, the S&P 500 was up 9.5 per cent per year over the period, compared to an estimated 11.5 per cent per year for the Cambridge Associates US Private Equity index (Legacy Definition).¹

Despite mainstream interest in the benefits associated with private equity allocations, it can be out of reach for investors with liquidity or fee concerns. Initial minimum investments are significant, capital call schedules span many quarters, assets are locked up for years and transparency is limited. Building a diversified portfolio among several private equity managers is also challenging and requires significant resources.

Liquid private equity strategies are designed to overcome these obstacles by replicating holdings and portfolio characteristics via a liquid public market equity portfolio. This approach removes the significant barriers to entry to private equity and offers a way to stay invested until capital is called for in direct private equity investment. Indeed, investors of all sizes may find private equity replication to be the preferred entry route.

Understanding the private equity return drivers critical for replication

Effective liquid private equity can be achieved by understanding and isolating the individual component drivers of returns. Four of the six major sources of private equity alpha can be replicated through techniques that rely on public markets and the use of strategic portfolio management. A liquid private equity portfolio can take advantage of sector selection and allocation, choosing the correct characteristics of companies, using leverage and having a downside protection strategy. We can't take advantage of informational advantages or operational improvements.



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Private equity drivers can generally be broken down into six key categories:

1

Sector selection and allocation

Private equity excels at selecting industries that will outperform. According to 2015 research by Kritzman, Kinlaw and Mao, mimicking private equity sector allocations will generally outperform a market index. Private equity can calculate relative strengths between industries and move into the more attractive offerings. The liquid strategy can rely on a compilation of publicly available deal information in various industries to capture this source of alpha by matching private equity's industry weightings.

2

Characteristics of private equity companies

The underlying characteristics of holdings in private equity portfolios generally outperform as well. Private equity investors favour companies with high profitability, high payout ratios that can support the addition of leverage and those that are attractively priced. This alpha is captured by actively selecting public companies whose stocks replicate the characteristics of the private equity company.

3

Use of leverage

The leverage that private equity employs is an advantage because stocks tend to outperform the borrowing costs for leverage. Since their leverage is modest, it's fairly easy to replicate in public markets and limited only by the constraints of the fund. Leverage at a modest level up to 1.5-times adequately represents the leverage in a private equity portfolio.

4

Downside protection strategies

Private equity uses mark-to-model accounting to deliver a smoother performance curve — specifically, smaller drops in crashes — than public market portfolios. This smoothing may be achieved with the purchase of protective puts and the selling of out-of-the-money calls, at a modest cost. This hedge helps provide the insurance against crashes because they pay off positively when the market drops a great deal in a short time.

5

Information advantage

The fifth driver of private equity alpha is the advantage gained by access to "inside information" from months inside a company to learn and assess trade secrets, quality of management, performance nuances and innovations. In liquid private equity, this advantage can't be replicated.

6

Operational improvements

The sixth driver of private equity alpha arises from the operational and strategic business improvements made in portfolio companies owned by management. Private equity buyout firms can roll up a series of companies in an industry to create scale and market power, take regional companies to a national or global market and implement new best practices. Without full ownership, this source of alpha can't be replicated.



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Competition and fees reduce private equity's advantage

Private equity is an intensely competitive space with multiple potential buyers for each target firm. This can lead to bidding wars and winner's curse. Moreover, there are significant costs associated with operating that liquid private equity will completely avoid.

While direct private equity adds sufficient value to overcome these costs and generates higher gross performance, investors don't experience gross performance, they experience net. The sum of these costs and fees appears to be of similar magnitude to the two sources of alpha that can't be accessed by liquid private equity.

Consequently, liquid private equity replication seeks to offer net returns similar to, but likely no worse than, average traditional private equity. However, replication strategies are less likely to outperform the top ranked private equity firms with direct investment and full exposure to the illiquidity premium. I believe that a more liquid approach to private equity through replication can aim to match the average performance of a basket of private equity funds. Using replication strategies is a better fit for investors that couldn't otherwise access the full direct experience and seeks to deliver or exceed the return profile of the average private equity manager.

1 Source: Bloomberg, Cambridge Associates.

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Please note that Mackenzie Private Equity Replication Fund does not invest directly in private equity, but seeks to replicate the performance and risk characteristics of US private equity through the use of publicly traded securities including (but not necessarily limited to) stocks and options.