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Why Private Equity Matters (Part Five)

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Modern portfolios are largely shaped around public markets, which are influenced by public sentiment as much as underlying fundamentals. However, most US businesses are privately held and accessible only through private equity. The merits of PE as an asset class are manifold, including benefits beyond returns. This week we discover why private equity is an essential element in any private wealth portfolio.

First, there's diversification and reduced portfolio volatility. Unlike public equities, whose valuations jump with every news headline, PE values are marked quarterly based on performance. PE returns depend more on manager skill and business fundamentals than macros. Instead of daily price swings, expect gradual shifts reflecting revenue and cash flow growth. This characteristic has a stabilizing effect on a portfolio, particularly during periods of public market turbulence. Diversification is heightened in the short and medium term.

Private equity also offers exposure to high-growth middle market companies whose return engines are different than large cap publics. Smaller companies, many less than $40 million of EBITDA, can have more upside potential. Many are still founder-owned and have never had the benefit of professional management. That can improve operations, optimize capital structures, and develop strategic growth initiatives. Investors in PE can access that value creation at early stages in a company's lifecycle before it's available to the broader public market.

Finally, enhanced return potential is one of the most compelling arguments for private equity allocation. PE investments have historically outperformed public market equivalents over full cycles. This advantage stems from active management, alignment of interests between investors and management teams, and the ability to take a long-term view. The illiquid nature of private equity is a feature, not a bug! It discourages managers from short-term thinking and allows them to invest through choppy markets and economic downturns.

Private equity is not a replacement for public market exposure. It is not an asset class for investors who have an abbreviated time horizon or need liquidity on demand. By emphasizing active ownership and long-term value creation over daily price movements, it offers exposure to return drivers that aren't available in liquid markets.

For those with patience and the right liquidity planning, private equity can play a durable and meaningful role in a well-constructed portfolio.