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Good morning. Investors have long assumed that private equity produces the best returns. In today's newsletter, we examine how the industry's recent performance stacks up against public markets — and the often-misleading way in which it calculates returns.

Is private equity overrated?

By Michelle Celarier

Since 2017, investors have poured more than $1 trillion into global private equity buyout funds. That amount dwarfs the cash directed to venture capital, real estate funds, private debt, hedge funds and just about any other form of alternative investment, according to McKinsey.

It's not hard to see why: Investors have been told over and over again that these private equity funds produce the best returns, far outperforming the stock market (and just about everything else). As a result, private equity has become the hottest home for institutional money, whether that of pension funds, endowments or sovereign wealth funds. Lately, retail investors have also bet big on the strategy.

But private equity's returns increasingly may not provide the stellar performance that investors have been sold — and the returns can be misleadingly calculated in a way that overstates success.

As of September 2020, private equity funds had produced a 14.2 percent median annualized return, net of fees, over the previous 10 years, compared with 13.7 percent for the S&P 500, according to an analysis of indexes by the American Investment Council, a lobbying group for the industry, using the latest numbers offered. Public pension funds invested in private equity actually had worse returns than from the S&P 500 — 12.8 percent, net of fees. (These returns, and others quoted in this article, do not include venture capital, which is typically viewed as a separate asset class.)

Private equity firms have long engaged in contentious practices, including loading companies with debt and laying off workers. And calls for more transparency have arisen in Congress and the Securities and Exchange Commission. In October, Senator Elizabeth Warren, the Massachusetts Democrat who is one of Capitol Hill's most vocal critics of private equity, reintroduced legislation that would, among other things, require more disclosure of returns and fees by private equity funds. The S.E.C. chair, Gary Gensler, has said the agency is taking a look at the same issues.

Regardless, private equity is sitting on a mountain of cash. At the end of the first quarter this year, U.S. private equity funds had $841 billion in so-called dry powder, or money that was still to be invested, according to PitchBook.

The deluge of dollars, which has continued apace in 2021, might be enough to make returns harder to come by. "Private equity is still outperforming public equity, but this outperformance is narrowing as all markets benefit from nonstop monetary and fiscal stimulus, and as private acquisition multiples rise," Michael Cembalest, the chairman of market and investment strategy at J.P. Morgan Asset Management, wrote in a report this summer.

Since 2009, Mr. Cembalest said in an interview, the median annual outperformance of private equity buyout funds has been "bouncing around on a median and average basis from 1 to 5 percent." That's down from around 15 percent in outperformance 20 years ago, according to his report, which also shows that private equity returns peaked in the early 1990s.

“Since the financial crisis the industry has had a tougher time outperforming public equity benchmarks,” Mr. Cembalest noted. He also asked if today’s returns were high enough “given the illiquidity of private equity.”

Ludovic Phalippou, a professor of finance at Oxford’s Said Business School, came to a harsher conclusion in a 2020 research paper that looked at North American private equity performance for funds launched between 2006 and 2015. It found that investors could have done just about as well with a stock index fund during that period, while the fees paid to private equity firms came to at least $230 billion, enabling the number of private equity multibillionaires to jump to 22 in 2020 from three in 2005.

“The big picture is that they’re getting a lot of money for what they’re doing, and they’re not delivering what they have promised or what they pretend they’re delivering,” Mr. Phalippou said in an interview.

The topic is so fraught that some people don’t want to discuss it. The American Investment Council declined an on-the-record interview, as did the Institutional Limited Partners Association, which represents institutional investors in private equity. The California Public Employees’ Retirement System, which recently announced it was adding about $25 billion to its $40 billion private equity portfolio, also declined to comment.

The debate over private equity performance is contentious for a number of reasons, including what type of investments to include — some analyses have excluded laggard oil and gas investments but added in loftier venture capital funds — and which benchmarks to use for comparison. And of course the overall median performance statistics show the midpoint of returns, which by definition means that some funds do outperform, just as some public equities do better than the indexes.

But the most vexing problem is simply that figuring out returns isn’t easy. Investors in private equity typically have to tie up their capital for 10 years. Unlike the almost instantaneously published price changes of publicly traded stocks, the value of private holdings can’t be independently verified.

“You can’t see how a fund actually performs until it liquidates at the end of 10 years, so you are going by what the general partner says the companies in that fund are worth,” said Eileen Appelbaum, a co-director of the Center for Economic and Policy Research, who has written extensively on private equity.

Long-time critics like Ms. Appelbaum and Mr. Phalippou say the typical methodology used to report results to investors, known as the internal rate of return, or I.R.R., is easily gamed.

“It’s certainly highly misleading, Mr. Phalippou said.

But, Ms. Appelbaum said, “the private equity guys love it.” For example, she said, if a 10-year private equity fund buys 10 companies, and decides to sell the best one early on, the I.R.R. looks great.

“You got a lot of money when you sold it, so you have a very high rate of return,” she said. That’s because the I.R.R. assumes that until the fund liquidates, the profit from that sale can be reinvested at the same high rate.

The I.R.R. methodology may be why some funds look better in their early years, especially if they have borrowed money to add to the investments — a growing trend. Cambridge Associates, an investment and advisory firm, estimates that such borrowings, which are basically short-term loans that are called subscription lines, can boost returns as much as three percentage points.

Blackstone Total Alternative Solutions funds, which contain buyout, credit, real estate and growth strategies, provide an interesting snapshot. According to internal marketing documents reviewed by The New York Times, BTAS 2014, the first fund in the series, had a net I.R.R. of 7.7 percent as of March, after calling 84 percent of its investor capital. But BTAS V, which was launched in January 2019 and had called only 51 percent of its capital, showed a much higher net I.R.R. — 42.9 percent.

A Blackstone spokeswoman said these performance numbers were “cherry-picked and misleading figures for our BTAS program, which has delivered 16 percent net returns since inception in 2014.”

Both of the BTAS funds are still active, and returns could change for the better (or worse) before liquidation, but the marketing document shows a similar pattern for three of the four additional BTAS funds. The fund that was launched in 2020 shows a 100.5 percent net I.R.R., with only 14 percent of its capital called.

Private equity returns also look better on an overall I.R.R. basis during the past few years. PitchBook data as of March shows private equity with an annualized net I.R.R. of 19.2 percent over three years, compared with 16.8 percent for the S&P 500.

Those numbers have led at least one critic to change his mind — sort of. “I have been saying that private equity was overvalued and that I was worried about prospective returns since 2016,” said Dan Rasmussen, a former Bain Capital analyst and the founder of Verdad, a hedge fund. He judged the situation prematurely, he said: “The risk has not manifested itself yet in actual bad outcomes.”

But he argues that much of the outperformance in recent years is due to private equity funds’ investments in technology companies, which have surged, combined with increased levels of leverage. With the average purchase price to earnings ratio for a portfolio company now close to 12, the leverage is so high that banks have shied away. Instead, much of the investment comes from the shadow banking system of unregulated credit funds, often set up by private equity firms themselves.

“As long as everything looks good, nobody cares, right?” Mr. Rasmussen said.

Meanwhile, private equity funds have been finding other ways of goosing their returns and taking their fees. One is the practice of flipping portfolio companies among one another if the holding can’t be sold in the public markets for a better price. One famous example involves MultiPlan, a health care cost management company that finally went public last year via a special purpose acquisition company, or SPAC, after being traded among four private equity firms. The stock has since lost more than 50 percent of its value, and investors are suing.

Another technique involves “continuation” vehicles, a booming segment of private equity where a fund can park companies that it isn’t ready to sell as the fund’s liquidation date approaches. Also known as secondary funds, they are highly leveraged, making Mr. Cembalest sceptical about their success. “This stuff is hyper risk,” he said.

In the end, of course, the return is what an investor takes home when a fund is liquidated. Mr. Phalippou, the Oxford professor, said that gain in recent years had been about 1.4 times the initial investment. And how does that compare with the stock market? Shrugged Mr. Phalippou: “The same.”