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PERUSING PRIVATE EQUITY

Experience and past performance count when exploring your options.

The private equity industry—particularly venture capital (VC) and leveraged buyout (LBO) investments—has grown tremendously over the last decade. While investors committed less than $10 billion to private equity partnerships in 1991, more than $180 billion was committed to this asset class at the peak in 2000. Despite the heightened interest in the private equity asset class and the potential importance of private equity investments for the economy as a whole, we have only a limited understanding of the dynamics of fund returns, and the flow of capital into the industry overall and individual funds. One of the main obstacles has been lack of available data, because private equity firms, as their names suggest, are largely exempt from the disclosure requirements that public firms are subject to.

"PRIVATE EQUITY FIRMS ARE LARGELY EXEMPT FROM THE DISCLOSURE REQUIREMENTS THAT PUBLIC FIRMS ARE SUBJECT TO."

We make use of a data set of individual fund performance collected by Venture Economics. The Venture Economics data set is based on voluntary reporting of fund returns by the private equity firms (or general partners) as well as their limited partners. This data set allows us to study three issues that have not been closely examined previously.

First, we investigate the characteristics of fund performance in the private equity industry. We find large heterogeneity in returns across funds and time periods. On average, LBO fund returns (net of fees) are lower than those of the S&P 500; VC fund returns are lower than the S&P 500 on an equal-weighted basis, but higher than the S&P 500 on a capital-weighted basis. These results combined with previous evidence on private equity fees, however, suggest that on average, both types of private equity returns exceed those of the S&P 500, gross of fees.

Second, we document substantial persistence in fund performance in the private equity industry, both for LBO and VC funds. General partners (GPs) whose funds outperform the industry in one fund are likely to outperform the industry in the next; GPs who underperform are likely to repeat this performance as well. We find strong persistence not only between two consecutive funds, but also between the current fund and the second previous fund. These findings are markedly different from the results for mutual funds, where persistence has been difficult to detect and, when detected, tends to be driven by persistent underperformance rather than over-performance.

Third, we study the relation of fund performance to capital flows, fund size and overall fund survival. We analyze how a fund's track record affects capital flows into individual partnerships and the industry overall. We document that fund flows are positively related to past performance. In contrast to the convex relationship in the mutual fund industry, the relationship is concave in private equity. Similarly, we find that partnerships are more likely to be started in periods after the industry has performed especially well. However, funds that are raised in "boom times" (and partnerships which are started during booms) are less likely to raise follow-on funds, indicating that these funds likely perform poorly. The marginal dollar that flows into the industry in these times, therefore, does not appear to go to the top funds, but to funds that have a lower probability of being able to raise a next fund. Finally, we also show that the dilution of overall industry performance in periods when many new funds enter is mainly driven by the poor performance of new entrants. The performance of established funds is less affected. ▮