Belief in higher returns from private equity may be misplaced

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New research at the Luxembourg School of Finance suggests that investor belief in higher returns by investing in private equity investment funds may be misplaced, calling into question their rising popularity.

Many investors believe that higher returns can be achieved by investing in funds which buy firms not listed on stock markets (so-called private equity investment funds) rather than those funds that invest in listed companies. Private equity funds have become increasingly popular recently with large institution (particularly pension funds and insurance companies), as well as wealthy individuals seeking high returns in an era of low interest rates.

But are they making a mistake? Previous academic studies would suggest not, but doubt has now been cast about the higher profitability of private equity funds by research carried out by Dr Roman Kräussl of the Luxembourg School of Finance (University of Luxembourg) together with Narashim Jegadeesh (Goizueta Business School, Emory University and NBER) and Joshua M. Pollet (College of Business at the University of Illinois at Urbana-Champaign).

"Existing studies are susceptible to selection bias," explained Dr Kräussl. "They rely on information reported by the funds' general partners or from large investors, but their experiences are often different from those of the typical private equity investor. We found a way to avoid this selection bias," he said.

Dr Kräussl and his colleagues studied the stock market performance of funds that hold portfolios of private equity limited partnerships. This is a reliable proxy for measuring private equity investment returns because these firms' share prices fluctuate with the performance of their investment portfolios.

Using this measure suggests that expectations of long-term performance of private equity investments would vary little from the performance of normal stock market indices (between -0.5 per cent and +2.0 per cent). In other words, expected returns are very similar to those of holding listed securities on the major exchanges. Also, the systematic risk of start-ups (i.e. private equity investment) was found to be similar to investing in publicly traded stocks of small and medium-sized companies

The paper is due to be published in the prestigious academic journal *The Review of Financial Studies*.

Provided by University of Luxembourg

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