Hamilton Lane®

The Truth Revealed, **Fact 3:**

Private markets beats public markets - even after fees

What you should know

- It is true that headline fees are generally higher in private markets than in other asset classes, though this is only part of the story.
- Management fees for private equity funds average 1.5% - 2% of the committed capital per annum. Managers also earn a performance fee, typically 20% of the realized profits, provided their returns exceed a minimum threshold.
- On a net basis (after all management fees, expenses and performance fees are accounted for) private equity funds have beat public equities over most of the past 20 years — even during the recent bull market for public stocks.

Once considered speculative, private markets occupy a rising share of investor portfolios, especially as the structural hurdles for high-net-worth (HNW) investors have lessened. Investors and advisors who understand private markets are well positioned to make recommendations about how to best incorporate private markets into the portfolios they manage.

This Truth Revealed series explores private market investing with three objectives in mind:

- To dispel some of the incorrect notions about private markets
- To help investors and advisors better understand private markets' potential to outperform public markets
- To assist investors and advisors as they consider how private markets investing may align with their investment objectives

Within investor circles, there's a perception that private markets are an expensive asset class. There is no denying it: headline fees are generally higher in private markets than in other asset classes. All else equal, higher fees create a drag on the net performance. Those fees must make it hard for private markets to outperform other asset classes, right? Or do they?

Let's start by addressing private markets fund fees. Private market managers charge a management fee, which varies over the course of the fund's life. The management fee for closed-end private equity funds is typically 1.5% - 2% of the committed capital during the investment period (usually the first 3 to 5 years) of the fund.

By way of background, a closed-end private equity fund is a type of investment fund that pools investor capital and uses it to invest in private companies or assets. The fund issues a fixed number of shares that typically have a finite lifespan.

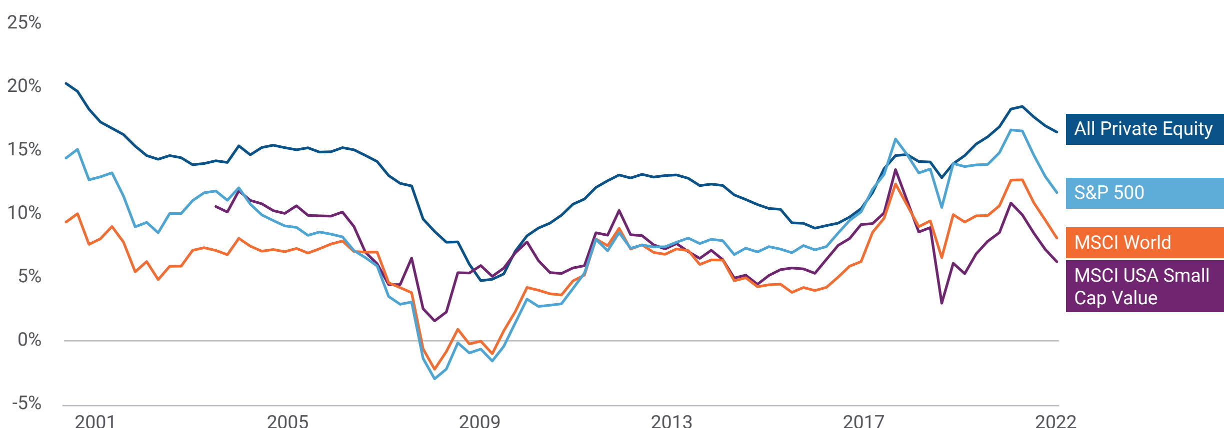
As the fund completes its investment period, the management fee generally decreases. Following the investment period, management fees are customarily charged on net invested capital (often a smaller amount than committed capital). The fee may include a step down. A common stepdown is a 10% fee reduction. Rather than being based on the committed capital, the fee is calculated on a smaller amount – namely, the net invested capital. This is a different construct than mutual fund fees, which are usually assessed on net asset value (NAV).

An additional component of a private markets fee structure is carried interest, sometimes referred to as a performance fee or 'carry'. Carried interest is the percentage of investment profits – typically 20% for private equity funds – that the fund manager keeps for themselves. The manager must exceed a minimum return threshold – usually 8% – to earn their carried interest. While performance fees can be substantial, they are not new to the asset class and they have largely stayed consistent for the past several decades.

So are the high fees justified by high performance? Let's explore private markets performance data in more detail to find out. Hamilton Lane has developed a comprehensive database of private markets fund performance, encompassing over 50,000 funds and more than $16.9 trillion of private capital, as of December 31, 2022. Most importantly, Hamilton Lane tracks the net returns of private markets funds after management fees and carried interest are accounted for.

This data suggests the majority of private equity funds have outperformed stocks, especially over the past 20 years. In fact, only in vintage year 2000 was this not the case.[1]

All Private Equity 10-Year Rolling TWRs



Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2023)

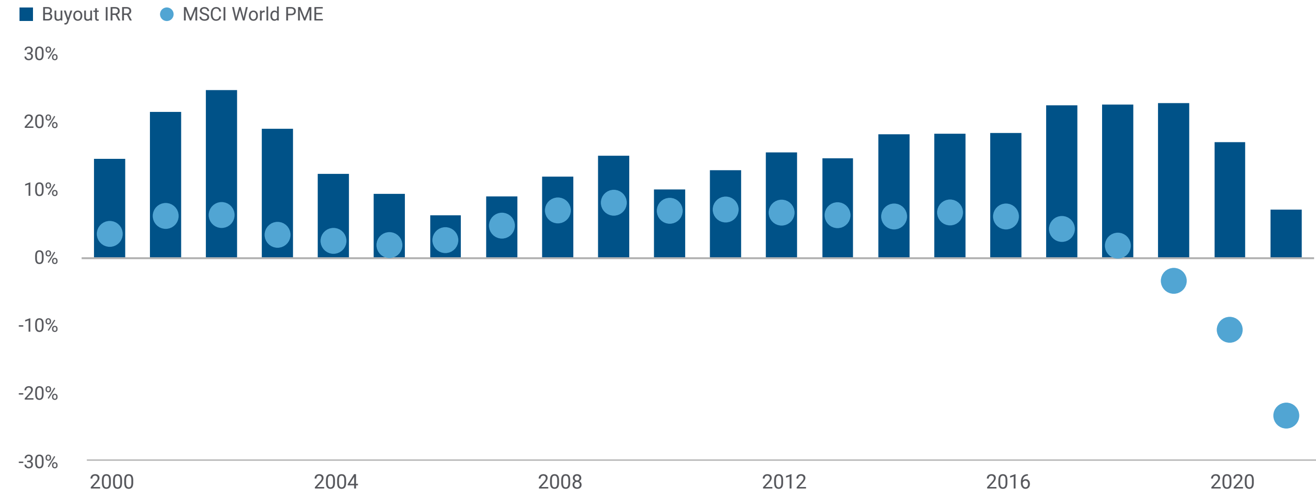
[1] Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2023)

What we've found compelling is private equity's consistent outperformance relative to public markets. Over nearly all 10-year time periods since the turn of the century, private equity has bested traded equities.

We also see that buyout transactions – i.e., when private equity funds completely acquire a company – have outperformed global public equities in every vintage year by an average of 1,079 bps. Private credit has outperformed public leveraged loans in every vintage year by an average of 625 bps. And remember, this is all net of fees and carry charged by fund managers.

Buyout IRR vs. PME

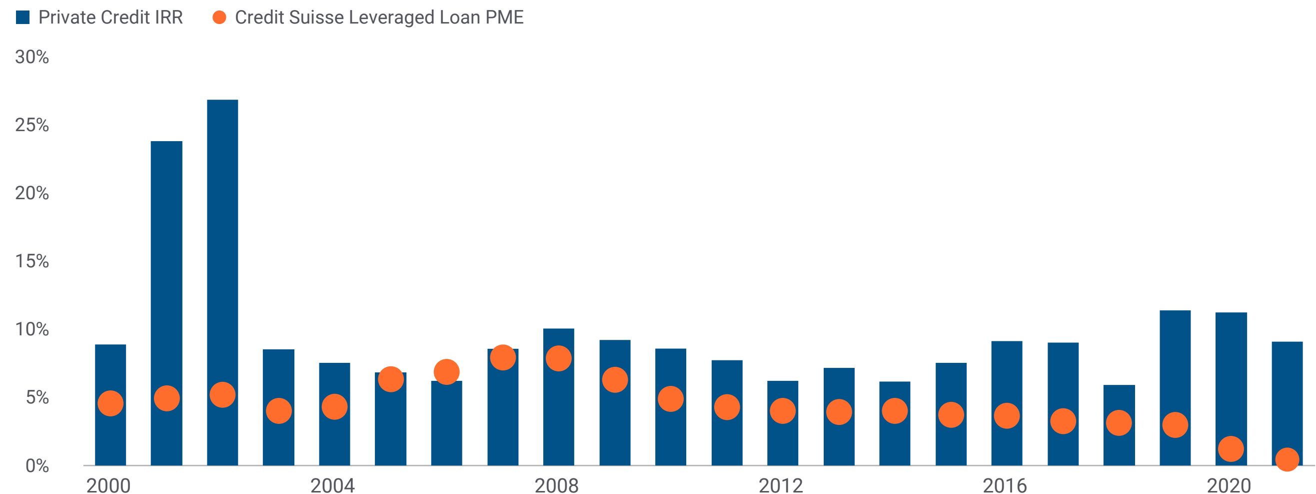
By Vintage Year



Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2023)

Private Credit IRR vs. PME

By Vintage Year



Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2023)

The net result – both figuratively and literally – is that private markets are growing, and with good reason: even on a net performance basis, private equity has an exceptional risk/return profile.

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The following hypothetical example illustrates the effect of fees on earned returns for both separate accounts and fund-of-funds investment vehicles. The example is solely for illustration purposes and is not intended as a guarantee or prediction of the actual returns that would be earned by similar investment vehicles having comparable features. The example is as follows: The hypothetical separate account or fund-of-funds consisted of $100 million in commitments with a fee structure of 1.0% on committed capital during the first four years of the term of the investment and then declining by 10% per year thereafter for the 12-year life of the account. The commitments were made during the first three years in relatively equal increments and the assumption of returns was based on cash flow assumptions derived from a historical database of actual private equity cash flows. Hamilton Lane modeled the impact of fees on four different return streams over a 12- year time period. In these examples, the effect of the fees reduced returns by approximately 2%. This does not include performance fees, since the performance of the account would determine the effect such fees would have on returns. Expenses also vary based on the particular investment vehicle and, therefore, were not included in this hypothetical example. Both performance fees and expenses would further decrease the return.

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