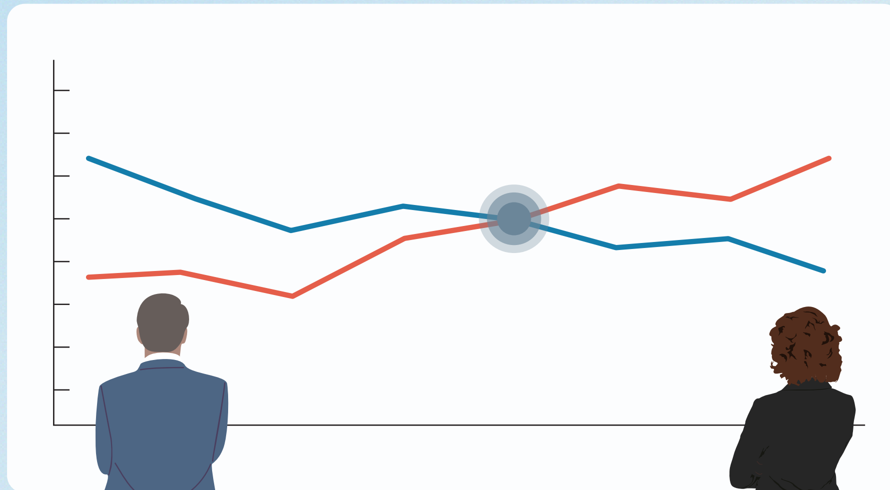
Hamilton Lane

Private vs Public Markets

What Have You Done for Me Lately?



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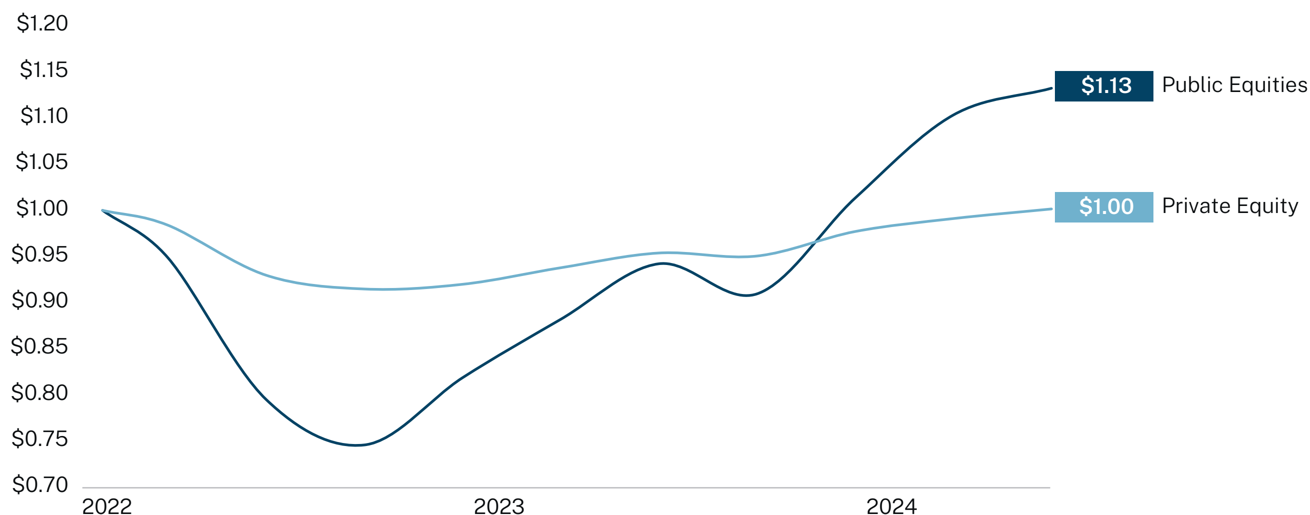
Investors are experiencing a unique inflection point within their investment portfolios where public market indices have outperformed over the past 18 months. Will this continue? The data suggests this is an unsustainable trend over the medium-to-long term and that the return outlook looks most promising for private equities over the next several years.

Breaking news: record highs, again…

In an era of 24-hour news networks, persistent social media overload and a growing desire for instantaneous feedback in most areas of our lives, maybe it is not uncommon for investors to ask for more from their investment portfolios on a daily basis. The regular drumbeat of the S&P 500 closing at a new 'record-all-time high' 57 times thus far in 2024, or more than 20% of the trading days of the year, could be a contributing factor too.

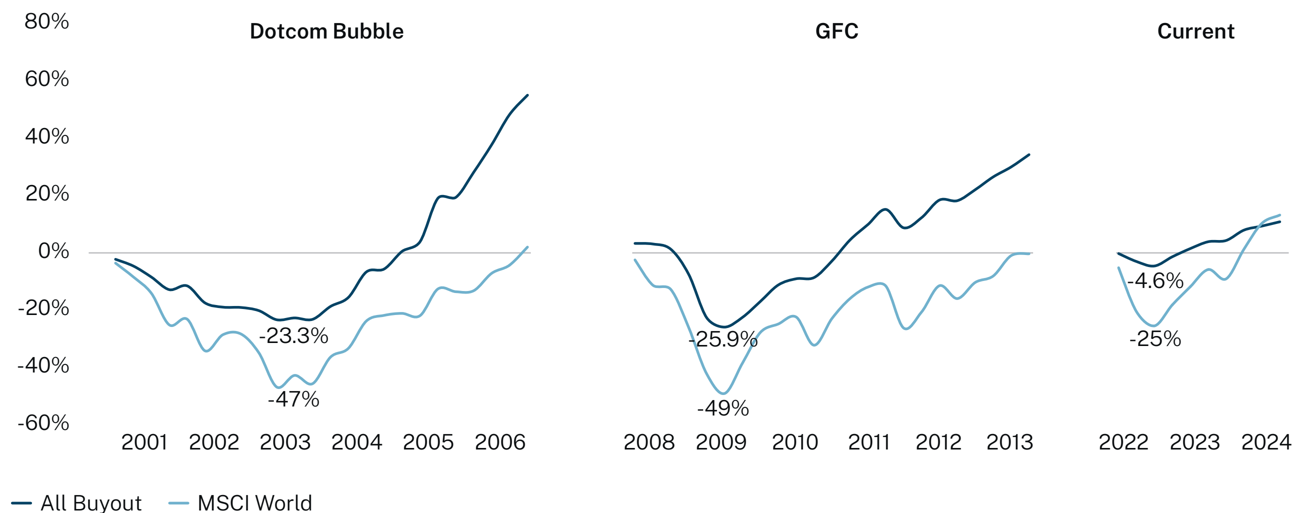
Not surprisingly, corresponding with the enhanced number of record highs, the public equity market has outperformed private equity benchmarks recently. Public equities have been on a tear on both an absolute and relative basis. Just look at average performance since the peak-2021 market. Despite much higher levels of volatility, public indices have crushed it over the past 12 months. This rebound has been more significant than previous downturns as well.

Growth of $1



Source: Hamilton Lane Data via Cobalt, Bloomberg (October 2024)

Cumulative Returns During Equity Market Drawdowns



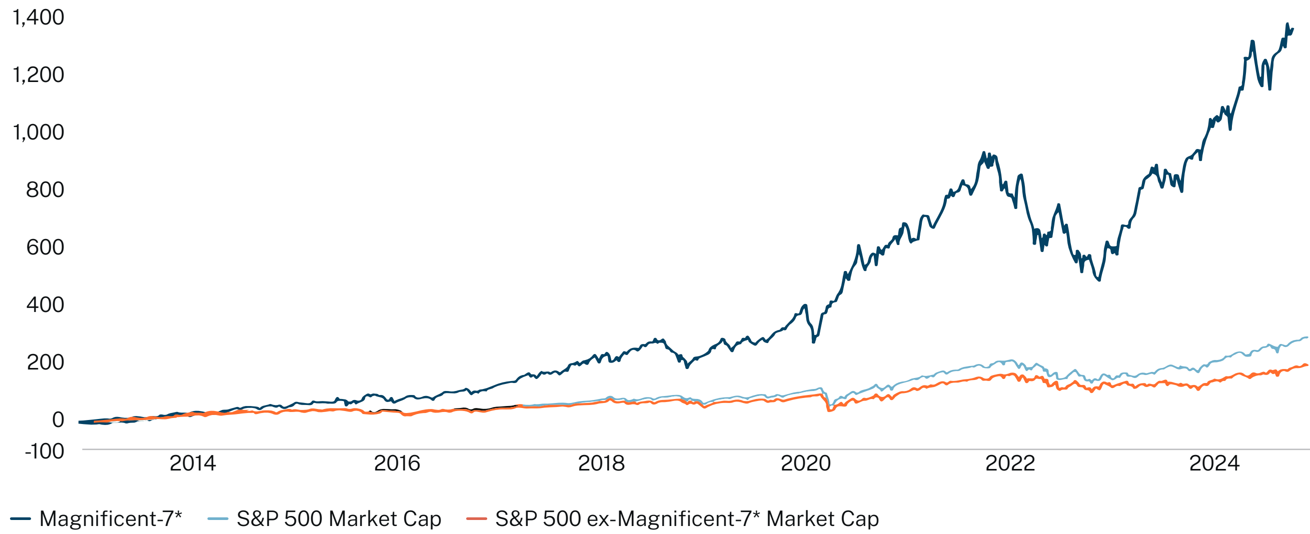
Source: Hamilton Lane Data via Cobalt, Bloomberg (October 2024)

So, that's it. The dominance of private equity over listed markets has come to an end. Head for the exits. Time to go home. Remember to tip your waiter. Well, the context of this performance is also important because it helps to answer the most important question: What comes next?

We should be aware of the historical paradigm of public versus private market performance over short-term timeframes. There has always been a 'lag effect' given the impact of less frequent appraisal valuations (and thus lower observed volatility) in illiquid assets. That could be a contributing factor to very short-term performance gaps of a few quarters but may not explain the entirety of the difference over a two-to-three-year period. A more prominent factor has been the public index constituents that have been driving public outperformance recently.

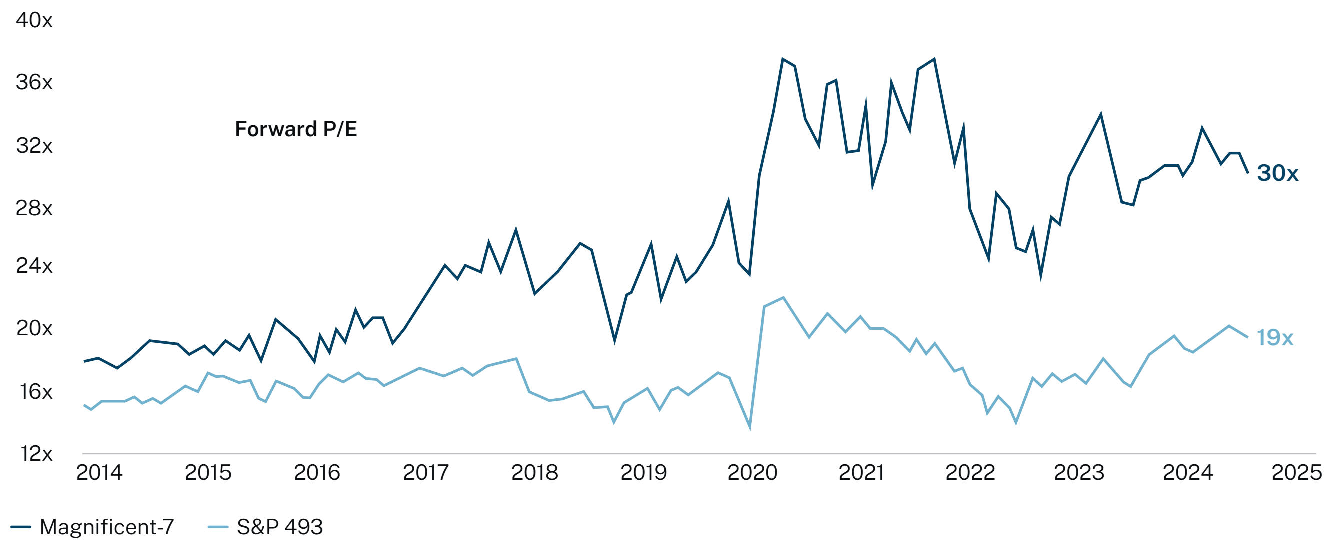
The reality is that a small, concentrated group of companies in the public index has been trading at astronomical price-to-earnings (P/E) multiples. Those seven companies now account for 30% of the total S&P 500 (how is that for concentration risk?) and have driven nearly all of the return performance of that index. The rest of the bunch in that index have been lackluster for the most part. Fundamental earnings growth for the Magnificent 7 this year will be over 30% compared to last year, whereas the other S&P 493 will grow earnings at an anemic 3% comparatively. Not surprisingly, those dynamics are driving P/E premium and outsized performance attribution shown below for the Mag-7.

Magnificent 7 vs. S&P 500 Market Cap Growth



Source: LSEG Datastream and Yardeni Research.
*Magnificent-7 stocks include Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, NVIDIA, and Tesla. Both classes of Alphabet are included.
*Indexed to 0 on 12/28/2012

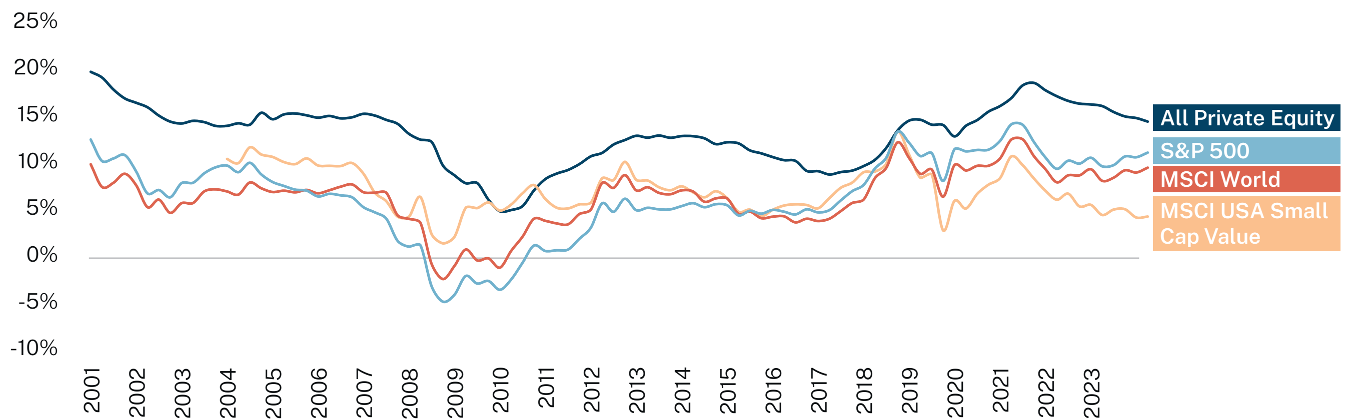
Magnificent 7 Valuations



Source: Goldman Sachs Global Investment Research

With that in mind, looking at time-weighted returns, over the past two decades there are very few periods measuring the trailing 3, 5 or 10-year performance in which the public market has sustained its outperformance over private equity. See the chart below showing the trailing 10-year time-weighted return performance plot as one example (the three and five-year charts look similar). At very few points during this 20+ year period does the longer-term trailing public market performance rise above the net average performance of private equity.

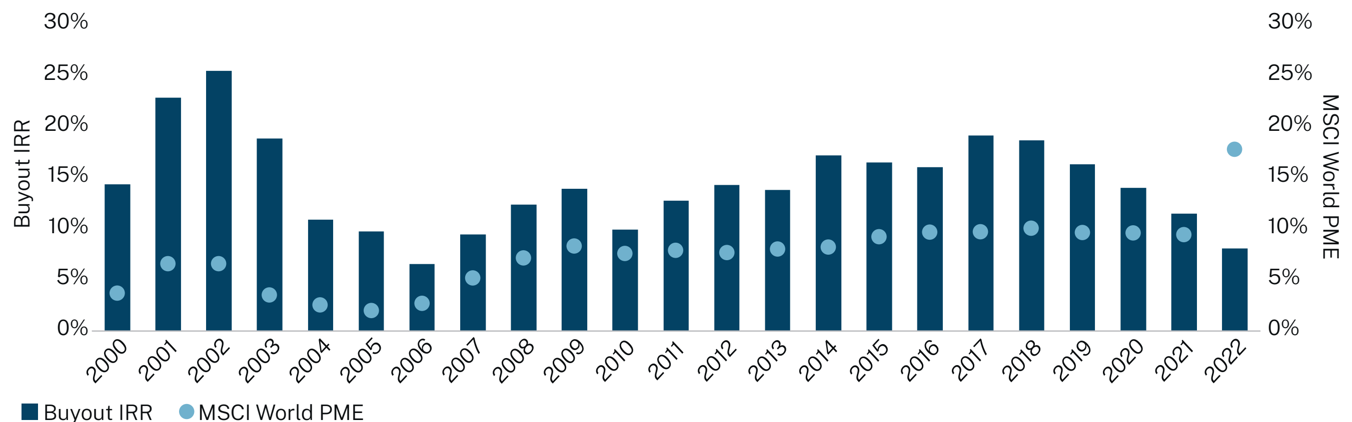
All Private Equity 10-Year Rolling Time-Weighted Returns



Source: Hamilton Lane Data via Cobalt, Bloomberg (October 2024)

The long-term performance results also hold when we look at since-inception returns by vintage year. It's worth noting that most of the outperformance on the lefthand side of this chart is now substantially realized (prior to the 2016 vintage).

Buyout IRR vs. PME
By Vintage Year

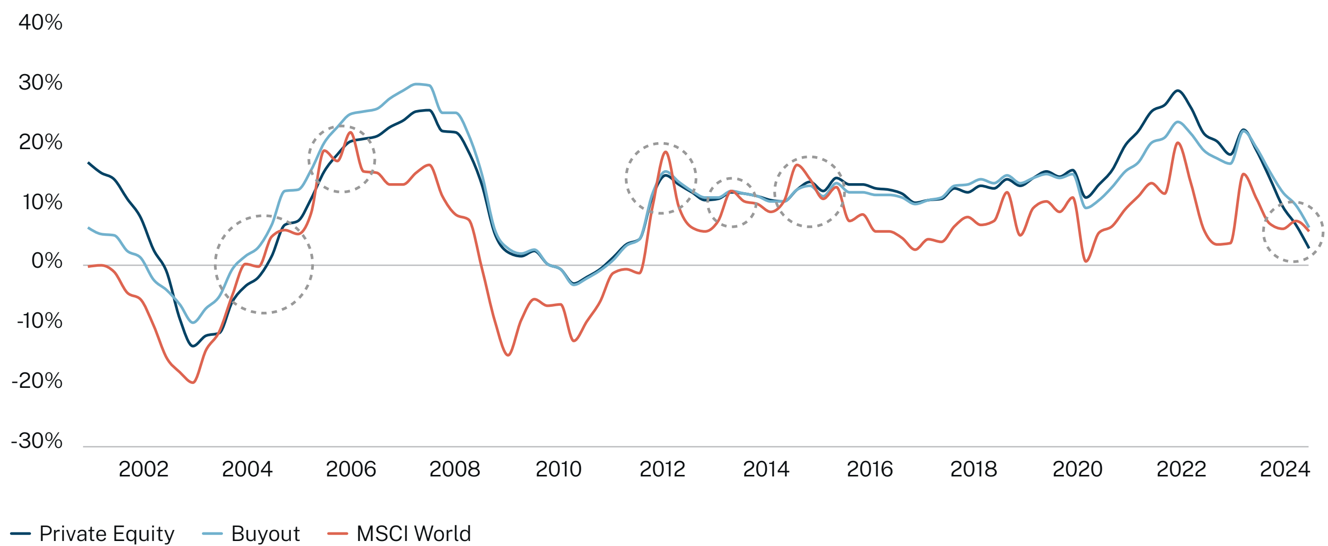


Source: Hamilton Lane Data via Cobalt, Bloomberg (October 2024)

A fleeting moment in time

Since 2000, there have been five occurrences in which public markets have generated a three-year trailing performance interval that outperformed private equity. That public market outperformance was typically fleeting, with private equity returns most often reverting ahead in the year that followed. And that is the punchline: On average, the subsequent three-to-five-year periods following the stronger public market performance interval produced an average outperformance for private equity that ranged between 850-1,050 bps in the go-forward results. See the summary of these dynamics in the charts below. Not too shabby for the private equity outlook.

3-Year Rolling Public and Private Performance



Source: Hamilton Lane Data via Cobalt, Bloomberg (November 2024)

Average/Median Private Forward Outperformance Post Public Outperformance

Metric	Private Equity		Buyout	
	3Y Return	5Y Return	3Y Return	5Y Return
Average	855 bps	846 bps	1,070 bps	946 bps
Median	804 bps	794 bps	1,193 bps	901 bps

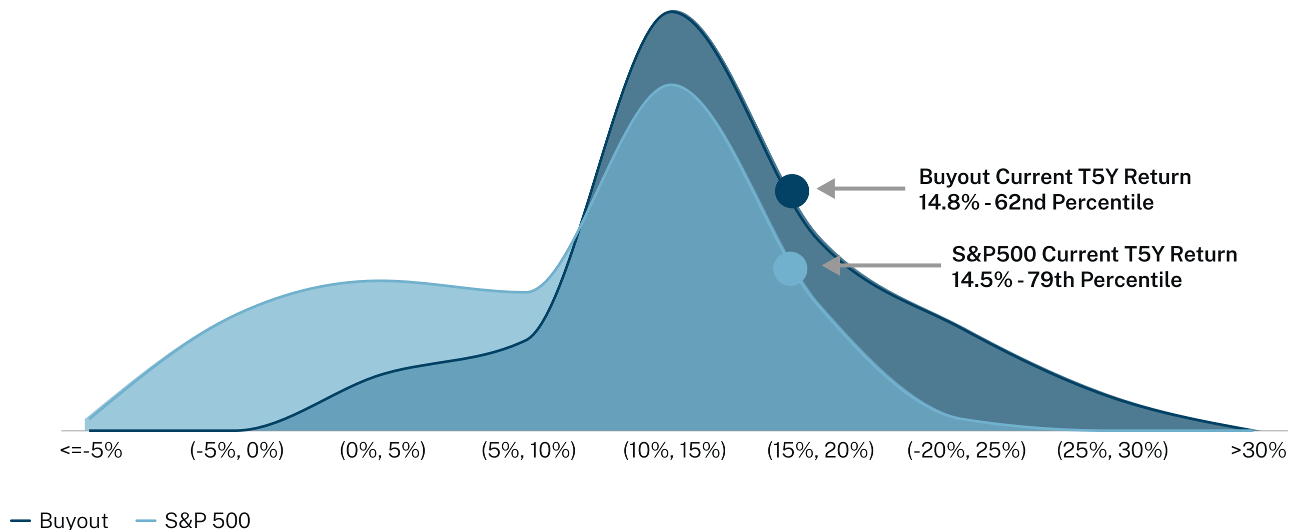
Source: Hamilton Lane Data via Cobalt, Bloomberg (November 2024)

Reversion to the mean

How do current levels of performance in public and private indices compare to longer-term averages? In other words, if we are close to an inflection point as the trailing data above suggests, should we expect the asset classes to fall back in line closer to their long-term averages over the next three to five years? If they do, that also bodes well for average private market performance. Specifically, on a trailing one year basis, the S&P 500 is performing in the 85th percentile of its long-term annual average performance distribution. The same statistic for average buyout performance clocks in at the 24th percentile.

Looking at performance over the past five years, it tells a similar story. As shown below, while on an absolute basis the average net returns are similar between the asset classes, the public markets (current five-year trailing return performance in the 79th percentile) are more elevated relative to their historical average. Comparatively, buyouts are performing in the 62nd percentile on this basis.

Rolling 5-Year Return Distributions
2000-2024

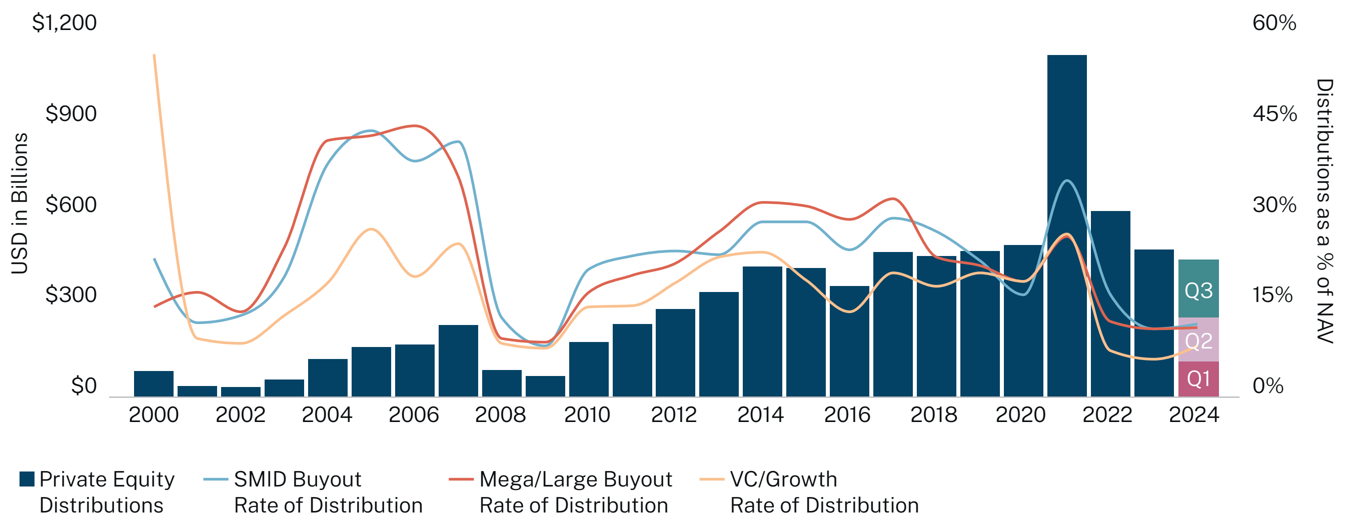


Source: Hamilton Lane Data via Cobalt, Bloomberg (October 2024). Rolling returns on a quarterly basis.

Heading for the exits

The M&A markets have awakened, although they have been somewhat quiet relative to the noisy rebound in public stocks (call it a single shot of espresso versus an extra-large coffee). This goes for PE-backed M&A as well. While 2024 will likely end the year holding the silver medal for the second-best year of distributions on record by dollar value, it will disappoint investors looking at distributions as a percentage of the growing NAV of their portfolio. On a rate of distribution basis, distributions are closer to lows than they are highs. Not to worry; you should still feel the pickup soon as more opportunities to merge with or acquire competitors increase.

Distributions
Annual Private Equity Distributions

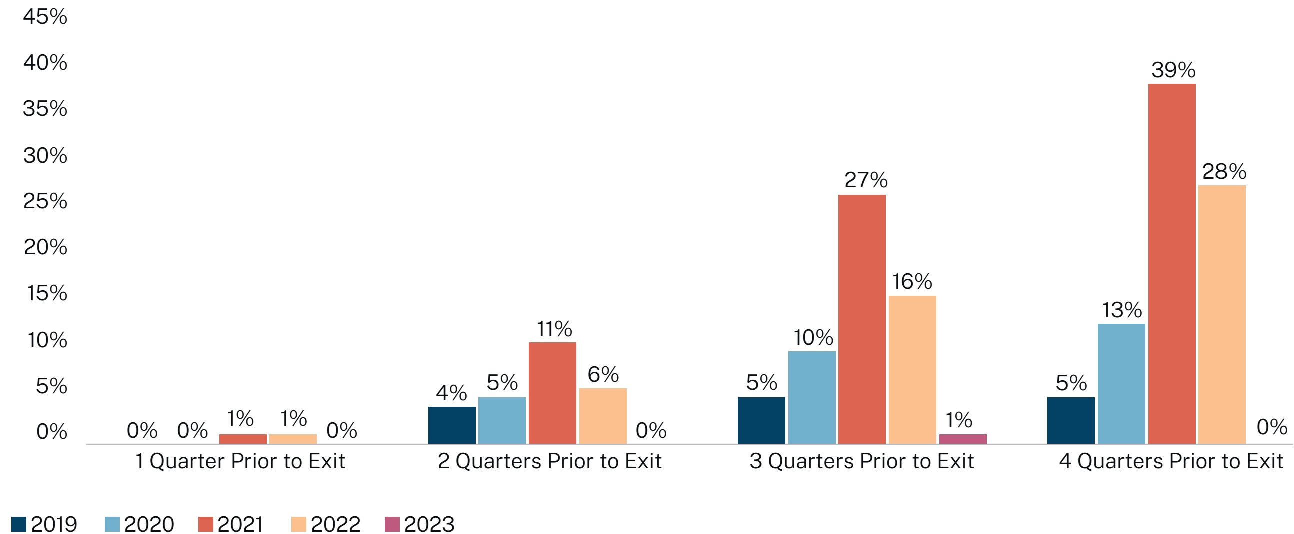


Source: Hamilton Lane Data via Cobalt, Bloomberg (November 2024)

Finally, the deals that have exited have been healthy performers but haven't provided the uplift at exit that we've come to expect. Historically, private equity deals have exited at a 10-20% premium to holding value just a few quarters prior to exit. In 2023 and early 2024, that premium evaporated, putting further downward pressure on private equity returns. Think of it as the foam in your Starbucks latte that ran out of steam recently: The cup is still (more than) half full; there's just less on top.

Median Exit Markups During the Year Prior to Exit

Global Buyout Deals Exited from Q1 2019-Q4 2023



Source: Hamilton Lane Data via Cobalt (October 2024)

What is the outlook for performance?

The key forward-looking question is whether the recent trend is indicative of a paradigm shift that will lead to lower (relative) PE returns going forward. While a pivot in performance expectations going forward doesn't necessarily mean a reversion to peak vintage return euphoria (think: the mid-2021 experience), we are bullish on the case for PE performance. We think there are good reasons to be optimistic:

- While there has been much consternation about PE valuations, valuations have gotten even richer in public markets. The P/E of the Magnificent 7 stocks is in the 40s and the P/E of the Russell is in the high 20s.
- There are signs that M&A / exit activity is beginning to recover. We'd wager that there will be a more substantial recovery in exits during Q1/Q2 2025 and would expect to see a lift in returns as exits occur.
- The well-documented declining opportunity set in public markets is unlikely to reverse any time soon. High-growth companies are choosing to stay private for longer and the largest tech companies are now in regulatory crosshairs. The opportunity set in PE is much larger (see the charts showing number of companies with > $100M of revenue that are privately held) and spans more of the global economy.

- We believe that governance and alignment are better in PE. There is little doubt that GPs have an impact on portfolio companies once they assume ownership. GPs have better access to capital markets and, despite their reputation in the press, studies show that they tend to provide support to portfolio companies during tough times.

There are some risks to this thesis. It is possible that gains could continue to accrue disproportionately to the largest technology companies, which tend to be listed. A very sharp hike (e.g., SOFR goes to 7-8%) in interest rates could lead to debt service issues for levered companies. We view these as low probability events. The most likely risk that we expect to see is, after a decade of strong performance lifting all PE managers, there will be a widening in the dispersion of outcomes amongst PE managers. Selection will once again be critical to success.

Tactical considerations

As usual, it all starts with the outlook for interest rates. We continue to reiterate our previous expectation of a 'slower-to-lower' interest rate environment ahead in the United States, partially reflective of the new presidential policy that is likely to create some upward pressure on pricing. That said, we think a pivot to meaningfully higher rates is unlikely through the medium term. However, there is increasing potential for a decoupling of central bank policy globally, particularly with the potential risks of global economic decoupling. While we may still see similar trends directionally, the potential for greater-than-expected rate cuts by the ECB and others remains on the table.

Investors also cannot ignore several 'wildcard' and unknowable risks. Today, these reside mainly on the geopolitical spectrum and are hard to predict at this stage (particularly with a changing government leadership dynamic in the U.S.). These events could have a meaningful impact on the near and medium-term outlook. That backdrop creates the likelihood that elevated listed market valuation volatility continues. We also continue to expect a further pick-up in distribution activity across private market portfolios, and 2024 has already shown a notable rebound. Below are some portfolio construction considerations and more tactical deployment opportunities for that market context:

- **More mid**
  The outlook for risk assets looks to be at a desirable inflection point. In particular, middle-market buyout opportunities have demonstrated a resiliency of performance via stronger relative growth characteristics, attractive entry valuations and better exit optionality to fuel distributions. For investors who can find effective ways to access a very dispersed company landscape in this segment of the market, the data suggests that it will pay off in the coming years. Not to mention a more challenging fundraising environment has crystallized the value of strategically important co-investment partners, particularly across harder-to-find middle-market transactions.

- **Secondary crossing**
  The attractiveness of secondary investments as a strategy is now well-documented and accepted by most investors, especially as a focus on secondaries has created much desired, albeit somewhat 'synthetic,' liquidity for investors in need of distributions. The secondary landscape is also a part of the private market ecosystem that has continued to evolve rapidly. This includes an increase in opportunities to apply secondary structure and transaction dynamics to a wide range of investment strategy areas. Pay particular attention to the intersection of venture capital, growth equity and real estate, where there is a growing amount of secondary volume. Today, these strategy verticals offer potentially strong 'value' plays given where pricing currently resides and because many funds and managers in these areas are less loved than four or five years ago .

- **Electrified tailwinds**
  Areas like private credit and infrastructure have rightfully seen increased appetite from investors during the past four years. Their risk-adjusted returns have remained compelling. On the infrastructure side, it is hard to ignore the macro tailwinds supporting energy transition investments and the global need to 'electrify' the grid. Private capital will need to fill a sizable gap in funding needs, particularly with the anticipated increase in capacity demands from growing trends like hyper-scaling, the near shoring of supply chains and the ripple effects of AI and chip development. Look for additional return upside within North American infrastructure opportunities, in particular.

- **Broken record**
  (Still) don't sleep on Europe. While the broader growth outlook for much of Europe looks less compelling than a roaring U.S. economy, the composition of country and industry-specific investment opportunities has shown purchase price multiples representing attractive entry points more recently (e.g. at a discount to similar businesses within the U.S.). Geopolitical risks – including recent governmental shifts in Germany and France – still carry weight; however, the potential for more accommodating monetary policy can provide a potential benefit through the next part of the cycle. The private markets, with their typical long-term lens, tend to reward those who can see opportunities in what comes next, while prudently gauging the risk criteria. Expect the horizon for Europe to be ripe with opportunity.

DEFINITIONS

All Private Markets: Hamilton Lane's definition of "All Private Markets" includes all private commingled funds excluding fund-of-funds, and secondary fund-of-funds.

Corporate Finance/Buyout: Any PM fund that generally takes control position by buying a company.

Credit: This strategy focuses on providing debt capital.

Mega/Large Buyout: Any buyout fund larger than a certain fund size that depends on the vintage year.

Private Equity: A broad term used to describe any fund that offers equity capital to private companies.

Real Estate: Any closed-end fund that primarily invests in non-core real estate, excluding separate accounts and joint ventures.

SMID Buyout: Any buyout fund smaller than a certain fund size, dependent on vintage year.

VC/Growth: Includes all funds with a strategy of venture capital or growth equity.

INDEX DEFINITIONS

MSCI World Index: The MSCI World Index tracks large and mid-cap equity performance in developed market countries.

S&P 500 Index: The S&P 500 Index tracks 500 largest companies based on market capitalization of companies listed on NYSE or NASDAQ.

OTHER

PME (Public Market Equivalent): Calculated by taking the fund cash flows and investing them in a relevant index. The fund cash flows are pooled such that capital calls are simulated as index share purchases and distributions as index share sales. Contributions are scaled by a factor such that the ending portfolio balance is equal to the private equity net asset value (equal ending exposures for both portfolios). This seeks to prevent shorting of the public market equivalent portfolio. Distributions are not scaled by this factor. The IRR is calculated based on these adjusted cash flows.

Time-weighted Return: Time-weighted return is a measure of compound rate of growth in a portfolio.

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As of December 12, 2024

Contact Us

About Hamilton Lane

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*As of September 30, 2024

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