

Private Equity

Private equity is a broad term for any investment that involves the purchase of shares in a private company. For example, Debenhams is a large company but it is privately owned. Its shares cannot be bought and sold on a public stockmarket.

As you will have noticed private equity is in the news again. Perhaps the venerable Sainsbury's is vulnerable to a bid from a consortium of venture capitalists. Investors can be tempted by the Footsie beating records of some private equity indices. Should you be investing in private equity?

We have long been of the opinion that investors should hold diversified portfolios exposed to virtually all forms of business ownership. Further the large institutional funds in the UK and US are investing in private equity. For the time being, and with a few exceptions, we remain lukewarm.



Data on private equity is complicated. Exits can take between 12 months and never – how are un-exited investments accounted for? By its nature it is an extremely illiquid investment compared to more familiar publicly listed shares. But even if clients are willing to tolerate this illiquidity, is private equity a good investment for private clients? The largest dataset comes from the US. The benchmark run by the US National Venture Capital Association (USNVCA) and Thomson Financial is the best known. The European Venture Capital Association and the British Venture Capital Association also publish authoritative data.

All the recent data suggests that the returns achieved by private equity investors are rather better than the returns available from the mainstream indices such as the FTSE All Share and S & P 500. A study in America [Commonfund Benchmark Study, published in Pensions and Investments January 2007, please edit to provide proper referencing] showed that the average US educational endowment achieved 10.6% in the year to June 2006 compared with a return of 4.57% for a traditional 60% equity 40% fixed interest portfolio.

Hillier Hopkins LLP (Aylesbury)

2a Alton House Office Park
Gatehouse Way
Aylesbury
Bucks
HP19 8YF
T 01296 484831
F 01296 437157
DX 4154 Aylesbury 1

Hillier Hopkins LLP (Hemel Hempstead)

Charter Court
Midland Road
Hemel Hempstead
Herts
HP2 5GE
T 01442 269341
F 01442 219517
DX 8810 Hemel Hempstead 1

Hillier Hopkins LLP (Watford)

64 Clarendon Road
Watford
Herts
WD17 1DA
T 01923 232938
F 01923 817159
DX 51522 Watford 2

www.hillierhopkins.co.uk

info@hhllp.co.uk

These educational endowments hold substantial alternative investments. Their portfolios also outperformed the traditional portfolio in four out of the last five years. The US NVCA data gives a return of 23.6% over the 12 months to 30 September 2006. The ten year return is a commendable 8.8%.

But the picture becomes more complicated if we delve deeper. It is reasonable to expect higher returns over time in exchange for the higher risk that private equity entails. You will know that we believe that over the long run smaller firms will outperform the main market and that value firms are also likely to outperform the main market over the long run. The Russell 2000 index of smaller firms rose by 10% over the ten year period. The Russell 2000 Value index rose by 13.3%. The portfolios such as the ones that we recommend – 80% equity and 20% fixed interest or 60% equity and 40% fixed interest with tilts towards small and value companies outperformed the educational endowment funds over four of the last five years. Also our portfolios were uniformly liquid.

We still consider private equity for some clients. Some clients are just keen to invest in private equity because it reflects the way in which they amassed wealth during their careers. There are also significant income tax, capital gains tax and inheritance tax advantages to some private equity investments.

But overall there are still too many difficulties and unanswered questions for private equity to form part of our mainstream recommendations. Fundamentally why are the returns not far higher? The conditions of cheap credit should surely allow substantially higher returns. The fees are in absolute terms far higher than more conventional investments. And it seems that a portfolio tilted towards small and value companies has produced a better net result for private clients.



This is a contentious areas, we continually review our position and look forward to further research. In the meantime private equity does not form part of our mainstream recommendations.

We look forward to your comments

Ben Sherwood

Partner

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For more information on any of the issues raised your current Hillier Hopkins contact will be happy to assist you. Alternatively, please call us on 01442 220788 to speak to one of our advisers. Hillier Hopkins LLP are registered to carry on audit work by the Institute of Chartered Accountants in England & Wales and authorised and regulated by the Financial Services Authority.

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