Is Private Equity the Perfect Investment for Your SIPP?

Investing in private equity can be complex, with investment trusts the best way to gain exposure

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The start of the new tax year brings new ISA and SIPP allowances for investors to play with, with big rewards for being an early bird borne out by the figures.

For those with their core exposures already invested, there are myriad options to add diversification to their portfolio. One of these could be private equity. It's "a pretty perfect asset for SIPPs and ISAs", according to Andrew Lebus, manager of private equity investment trust Pantheon International (PIN). Public stock markets around the globe have been shrinking. Since 1996, the number of listed US companies has more than halved, while in the UK number has declined by more than a quarter.

The consequence of this, says Lebus, is that investors have less sources of equity exposure for their pensions. But the private equity has blossomed and Lebus claims investors that continue to ignore the sector are "shooting themselves in the foot".

"Not only are the returns even better, but investors are shrinking their opportunity to invest in equity. That is, over a 40-year investment frame, disastrous," he says.

What is Private Equity?

Put simply, private equity is the process of investing in companies that are not listed on a public stock market. But it does get more complicated than that. It can be "a bit of a black box", admits Charlotte Edgar, marketing & communications manager at HarbourVest Global Private Equity (HVPE).

Funding usually comes in the form of collective funds, run by private equity experts. These funds pool investors' cash together and form a large portfolio of companies aimed at providing an attractive rate of return over, typically, a 10-year period.

It’s a great way to back some of the future household names before they’re famous. “Some of these companies might be the next FTSE 100 companies,” says Edgar. “Google (GOOGL) and Amazon (AMZN) started off as venture capital and now they’re some of the biggest companies in the world.”

Elsewhere, Spotify (SPOT) has only just become public after years in private hands. Uber, Airbnb and Deliveroo still remain in private equity portfolios.

Risks of Private Equity Investing

Private equity has gained a bad rep over time, with a perception of an asset stripping culture pervading for many. Morningstar analyst David Holder says the private equity fund managers tend to win more than investors. Though Lebus counters that “if the managers are doing well out of it, it’s because investors are also doing well.”

Private equity deals can also involve a higher amount of leverage, particularly in an environment where debt has become so cheap. This weighed on the sector during the financial crisis, but Lebus says things have improved since and capital is now being invested with more discipline.

Valuations are also elevated currently, though that’s true, too, of public markets. Dry powder – the amount of capital that has been raised but not yet invested – is also currently at similar levels to those seen in 2006 to 2008.

However, Richard Hickman, manager of HVPE, doesn’t see this as a problem, as there’s a “broadening opportunity set” out there. “The industry’s much larger and has much more scope to deploy that capital”.

How to Access Private Equity

Althouth it is difficult for retail investors to get into private equity funds at the ground level, there are listed investment trusts that offer access. These include HarbourVest and Pantheon, which are funds of funds investing directly into the underlying private equity funds.

Investments are made in three different stages: primary, which is there the trust will provide seed capital for a new offering; secondary, where it will buy into an existing fund; and direct co-investment, where it invests directly into a company alongside a private equity fund manager.

Only long-term investors need apply for these vehicles, though the trusts do receive a steady stream of distributions each year. The secondary investments mean the trusts will have exposure to more mature 'vintages'. For example, a third of Pantheon's portfolio was initially invested before 2008.

There are alternative ways to access private equity-style investing. The Henderson Alternative Strategies Trust (HAST) invests in these funds alongside other alternative investments.

Meanwhile, even more mainstream trusts are now offering exposure to what they term "unlisted companies". These include Woodford Patient Capital (WPCT), Scottish Mortgage (SMT), RIT Capital Partners (RCP) and Foreign & Colonial (FRCL).

Should Investors Have Exposure to Private Equity?

A recent survey of institutional investors by Natixis found almost three-quarters cite private equity as their top alternative investment choice for generating alpha for clients.

That's no surprise. Data from Morningstar Direct show the Red Rocks Global Listed Private Equity index would have turned a £10,000 investment into £82,500 over the course of the past 20 years. That compares to £32,000 from the FTSE World.

Going back to Lebus's point at the start of this piece – should investors be allocating to private equity? Richard Troue, head of investment analysis at Hargreaves Lansdown, says private equity exposure is not necessarily something all retail investors need. However, for those with larger portfolios, it provides "something different".

Jason Hollands, managing director at Tilney, says the sector can add extra diversification "and partially immunise it from the day-to-day, sentiment-driven volatility of public markets".

For the funds of funds approach, it's important to pay attention to discounts. Morningstar Direct data show that these trusts have traded on big discounts to net asset value ever since the financial crisis.

During those ructions, discounts of 60%-plus weren't uncommon. Holder says these discounts can move aggressively, due to NAV being subject to revision. Currently, HVPE and Pantheon are trading on discounts of 20.12% and 13.14% respectively.

Of course, discounts can offer attractive entry points. But investors must be careful to take them on face value, and Holder says while PE trust discounts have narrowed in recent years, he doubts they currently offer value.

Hollands says the fund of fund approach has the further benefit of achieving diversification both geographically and to different underlying strategies. For instance, HarbourVest has over 7,500 underlying companies in its portfolio.

However, another factor investors need to consider, Hollands continues, is their fees. "The pitfalls are high total costs through multiple layers of fund costs and performance fees."

Troue says the best time to buy the likes of HarbourVest and Pantheon is when they are out of favour and their discounts have widened. Unlike Holder, he does think there are some attractive discounts currently, but says his first port of call would be a broader multi-asset trust that invests in private equity like RIT or F&C.