Private Equity Insights

TWENTY-SECOND EDITION | Q2 2021

CURRENT QUARTER PERFORMANCE SUMMARY

The State Street® Private Equity Index (SSPEI) posted a quarterly return of 11.08% in the second quarter of 2021, continuing the strong recovery since the COVID crisis (2020 Q1 quarterly return -9.99%). Buyout funds rallied 11.69 percent, followed by 11.23 percent return from Venture Capital funds and 5.96 percent return from Private Debt funds (see Exhibit 1).

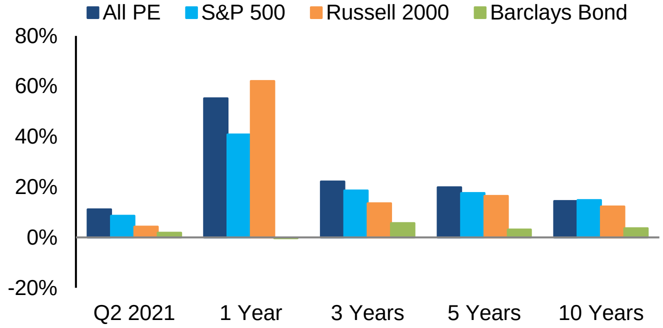
Exhibit 1. Private Equity Performance by Strategy

	All PE	Buyout	VC	Private Debt
2021 Q2	11.08%	11.69%	11.23%	5.96%
2021 Q1	9.76%	8.45%	14.93%	5.95%
YTD	21.81%	21.16%	27.31%	12.32%

Source: State Street®, as of Q2 2021.

As shown in Exhibit 2, SSPEI outperformed the US debt market (proxied by Barclays US Aggregate Bond Index) at all times, while SSPEI exceeded the US public equity market (proxied by S&P 500) in short to mid-term except 10 years. Compared to small-cap stocks (proxied by Russell 2000), SSPEI lagged over 1-year but outperformed over quarterly and mid to longer horizons.

Exhibit 2. Investment Horizon Returns



Source: State Street®, DataStream, Bloomberg Barclays US Aggregate Bond Index (total returns as of Q2 2021).

Continued on page 3.

THE "ENDOWMENT MODEL" REVISITED

Insights from Harvard University and the Private Capital Research Institute

By Leslie Jeng and Josh Lerner

The investing success enjoyed by many university endowments during the fiscal year ending on June 30, 2021 has caught the attention of many observers. The median large endowment reported a return of 34% according a survey by Wilshire Trust, a level not seen since 1986.[1] Some perennial top-performers had even more extraordinary years, such as Bowdoin College's 57% return, Brown's 51%, and Yale's 40%. The equity-heavy orientation of these investors, and in particular their heavy reliance on private equity investments, yielded very attractive dividends.

In the aftermath of the financial crisis, it became commonplace to see critics decrying the strategies commonly employed by endowments. Many observers were dismayed by the losses incurred at many major endowments during the 2009 fiscal year, though in many cases they were less than comparable public market indices. Others critiqued the endowments' reliance on fee-heavy private partnerships. For instance, Malcolm Gladwell, a Yale alumnus and noted "pop-science" author, tweeted "Yale's endowment spent $480 million paying its hedge fund managers last year and $170 million on its students" [2]: never mind that the bulk of these fees were profit-sharing that were only paid out only because the funds had

[1] Janet Lorin, "U.S. college endowments post best annual performance since 1996," Bloomberg, 2021, https://www.bloomberg.com/news/articles/2021-08-03/u-s-college-endowments-post-best-annual-performance-since-1986.

[2] Malcolm Gladwell, 2015, https://twitter.com/gladwell/status/634063584897695744?lang=en.

Continued on page 2.

done so well for Yale. Even in the aftermath of the 2021 performance, some commentators carped that many schools would have garnered similar returns if had placed the entire endowment into low-cost index funds replicating the S&P 500. (Though note that such a strategy would have cost the endowments downside protection, as well as global diversification.).

Thus, much of the commonly encountered criticisms of the endowment model seem ill-considered. At the same time, two real concerns do raise questions about the future sustainability of this approach to investing.

The first of these has been the growth of the asset classes where the endowments have traditionally relied on. A particularly dramatic illustration of this issue is seen in venture capital, which has been a key driver of returns for many endowments: for instance, Yale's returns here, from its first investment in a venture fund in 1976 through 2020, has been 33.7% per annum. [3] (Yale's target allocation to VC in 2021 was 23.5%.) But the volume of venture activity has exploded: CrunchBase estimates that global venture investments have increased from $48 billion in 2010 to more than half-a-trillion dollars in 2021. [4] Rapidly inflating valuations and intense competition for deals have become commonplace. Larger groups are raising whole product families, which may introduce distraction from their core mission. Investors worry it will be more difficult for funds to achieve the multiplicative returns of years past (though it should be noted that pundits have been predicting the venture sector's demise for much of the 21st century! [5]).

A second concern is the increasing political pressures on large endowments. The Republican-controlled Congress enacted in 2017 the so-called "endowment tax," a 1.4% excise tax on net investment income at private universities. Meanwhile, campus activists on the left have pushed for endowments to divest their holdings in a wide variety of categories, including oil-and-gas, timber, farmland, Puerto Rican bonds, companies or funds active in Israel, and private prisons. Reverend Al Sharpton has pushed major endowments to allocate more capital to funds controlled by diverse minorities.[6] Certainly, a number of the concerns that motivate activists, such as stopping global warming and increasing diversity, are laudable ones. But the proliferation of demands also poses challenges. The academic literature suggests that public pension funds that are excessively politicized—e.g., with many direct political appointees on board—perform more poorly, especially in private investments. [7] It might be worried that as endowments become increasingly involved in directly addressing social problems—rather than generating returns—similar pressures might degrade their performance as well. But in a highly polarized environment where established institutions are viewed with increased suspicion, large university endowments are likely to continue to be targets of criticism from the left and the right alike.

Thus, while the continuing success of university endowments in 2021 is to be lauded, looming issues are likely to pose major challenges in the years to come.

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The Private Capital Research Institute is a not-for-profit 501(c)(3) corporation formed to further the understanding of private capital and its global economic impact through a commitment to the ongoing development of a comprehensive database of private capital fund and transaction-level activity supplied by industry participants. The PCRI, which grew out of a multi-year research initiative with the World Economic Forum, also sponsors policy forums.

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3 Josh Lerner, Jo Tango, and Alys Ferragamo, "Yale Investments Office: November 2020," Harvard Business School Case no. 9-821-074, 2021.

4 Gené Teare, "Global venture funding hits all-time high in first half of 2021, with $288b invested," CrunchBase News, 2021, https://news.crunchbase.com/news/q3-2021-global-venture-capital-report-record-funding-monthly-recap/. and Entrepreneurship in Economic Growth, University of Chicago Press for National Bureau of Economic Research.

5 See, for instance, Mulcahy, Diane , Bill Weeks, Harold S. Bradley, "WE HAVE MET THE ENEMY…AND HE IS US: Lessons from twenty years of the Kauffman Foundation's investments in venture capital funds and the triumph of hope over experience," Ewing Marion Kauffman Foundation, 2012.

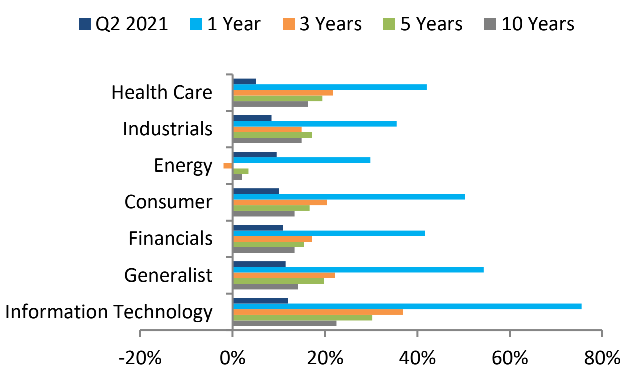
6 Pavilions, Valerie, "Sharpton calls for diversity in endowment," Yale Daily News, April 10, 2020, https://yaledailynews.com/blog/2020/04/10/sharpton-calls-for-diversity-in-endowment/.

7 Andonov, Aleksandar, Yael V. Hochberg, and Joshua D, Rauh, "Political representation and governance: Evidence from the investment decisions of public pension funds," Journal of Finance, 73 (2018): 2041-2086.

CURRENT QUARTER PERFORMANCE SUMMARY – CONTINUED FROM PAGE 1

Among sectors, Information technology continues to lead with a 11.95% quarterly return, followed by Generalist funds with a 11.46% quarterly return. Healthcare funds become lagging for the first time since the Covid-19 pandemic (from 2020 Q1), albeit the quarterly return increased to 5.08% in Q2 from 4.91% in 2021 Q1. Consumer boosted with a strong 10.04% in 2021 Q2, largely increased from 3.07% quarterly return in Q1 (see Exhibit 5).

Exhibit 5. Returns of Sector Focused Private Equity Funds



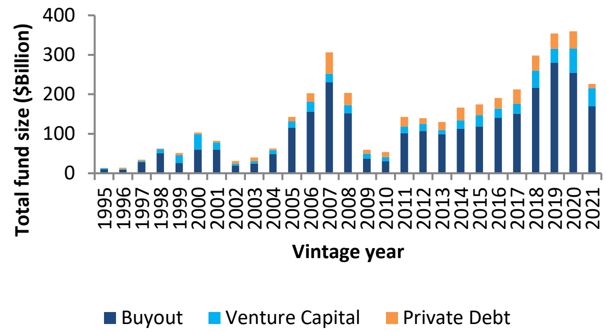
Source: State Street®, as of Q2 2021.

Fund Raising

Fund-raising activities in 2021 Q2 were mixed among the three private equity strategies. Buyout and Venture Capital fund posted strong fundraising results with $169.17 billion and $46.57 billion raised in the first two quarters of 2021 respectively, equivalent to 66.40% and 75.87% of the total capital raised in the full year of 2020. However, Private Debt fundraising slowed to approximately $10.05 billion in the first half of the year or only 23.25% of their previous year's total capital raised (see Exhibit 6(A)). Similarly, the average fund sizes were different among the three strategies. Buyout funds posted a record high of $3.25 billion, which is 36.6% larger than the 2020 average fund size of $2.33 billion. Venture Capital funds slightly decreased to $0.72 billion in 2021 Q2 compared with the $0.76 billion average fund size in 2021 Q1. Private Debt average fund size decreased to $0.77 billion, marginally lower than $1.31 billion in 2020 (see Exhibit 7).

Among regions, fundraising in the Rest of World stands out with $62.29 billion, almost 81.3% of total funds raised in 2020. US and Europe funds collected $138.33 billion and $25.17 billion respectively, counting for 58.8% and 52.8% of the totals from last year (see Exhibit 6(B)).

Exhibit 6. Total Fund Size (USD Billion)
(A) By Strategy



(B) by Region

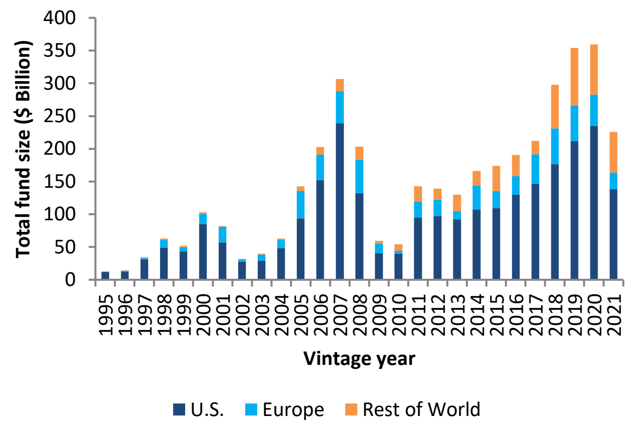
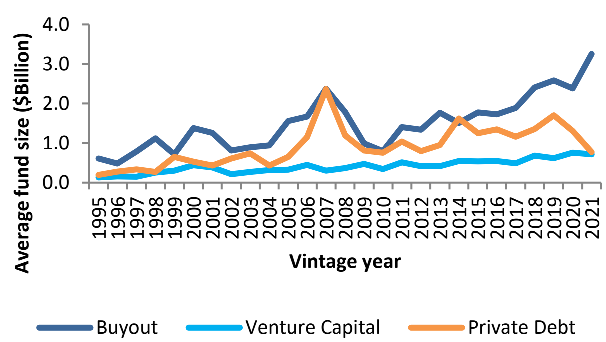


Exhibit 7. Average Fund Size (USD Billion)



Source: State Street®, as of Q2 2021.

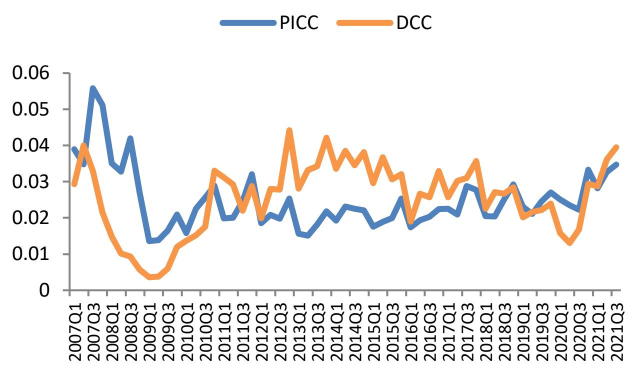
Cash Flow Activity

We observed continuous cash flow recovery in the third quarter since 2021 Q1 (see Exhibit 8(A)). Both investment and exit activities continue to rise through Q3 2021.

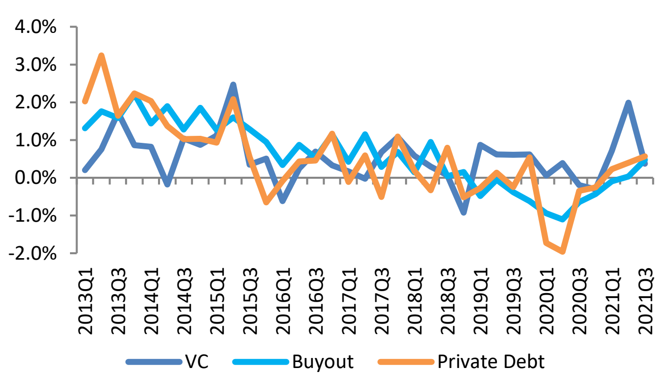
The net cash flows for Buyout and Private Debt remain increasing in 2021 Q3 with 0.5% and 0.6% respectively, while the Venture Capital funds reverted to the normal range with 0.4% (see Exhibit 8(B)).

Exhibit 8. Quarterly Cash Flow Ratios Normalized by Commitment

(A) Contribution and Distribution of All PE



(B) Net Cash Flow By Strategy (2013Q1 – 2021Q3)



Source: State Street ®, as of Q3 2021.

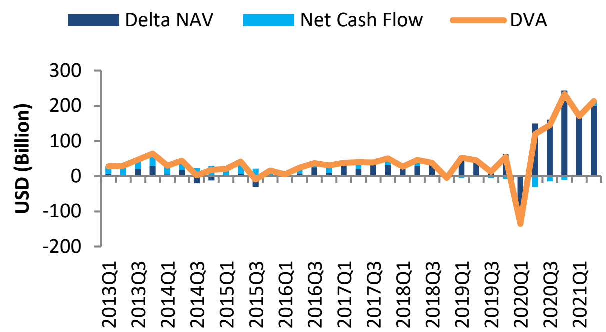
Valuations

The Dollar Value Added (DVA) is the sum of NAV changes and net cash flows. It measures the realized and unrealized gain and loss in dollar amounts.

$$DVA = EndingNAV - BeginningNAV + Distribution - Contribution$$

In 2021 Q2, the trend of strong positive DVA since 2020 Q2 remains and it was driven almost entirely by valuation increases. SSPEI DVA posted $213 billion in 2021 Q2, which increased from $171 billion in 2021 Q1 (see Exhibit 9).

Exhibit 9. Dollar Value Added (2013 Q1 – 2021Q2)



Source: State Street ®, as of Q2 2021.

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Participants in private capital markets need a reliable source of information for performance and analytics. Given the non-public nature of the private equity industry, collecting comprehensive and unbiased data for investment analysis can be difficult. The State Street Private Equity Index ("SSPEI") helps address the critical need for accurate and representative insight into private equity performance.

Derived from actual cash flow data of our Limited Partner clients who make commitments to private equity funds, SSPEI is based on one of the most detailed and accurate private equity data sets in the industry today. These cash flows received as part of our custodial and administrative service offerings are aggregated to produce quarterly Index results. Because the SSPEI does not depend on voluntary reporting of information, it is less exposed to biases common among other industry indexes. The result is an index that reflects reliable and consistent client data, and a product that provides analytical insight into an otherwise opaque asset class.

- Currently comprises more than 3,500 funds representing more than $3.9 trillion in capital commitments as of Q2 2021
- Global daily cash-flow data back to 1980.
- The Index has generated quarterly results since Q3 2004.
- Published approximately 100 days after quarter-end.

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