Research

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Integrating private equity with traditional portfolios: Manager dispersion favors a diversified approach

Fidelity's multi-manager approach to private equity, supported by research, offers access to a broader investment universe and significant potential to add value through manager selection.

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KEY TAKEAWAYS

- Private equity offers the prospects of enhanced returns relative to public equity and diversification for investors with a longer-term time horizon, moderate liquidity needs, or a specific legacy goal.
- The universe of private companies has continued to expand, offering investors the potential for higher returns and greater diversification by strategies, sectors, size of investments and funds, vintage years, and geographies.
- Higher dispersion among private equity managers showcases that robust manager research can add value; Fidelity's approach seeks to invest in managers that outperform median returns.
- Fidelity's private equity team brings over 50 years of combined experience investing in private equity, with established networks and relationships with leading private equity sponsors.

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Potential benefits of private equity

Private equity has long been favored by institutional investors for higher return potential, known as an illiquidity premium, averaging 5% to 8% annually above public equities over the past 20 years.[1] While it has been challenging in the past for individual investors to access and diversify such exposure given high minimums and other barriers, the emergence of multi-manager solutions and registered vehicles may open the door to wider adoption.

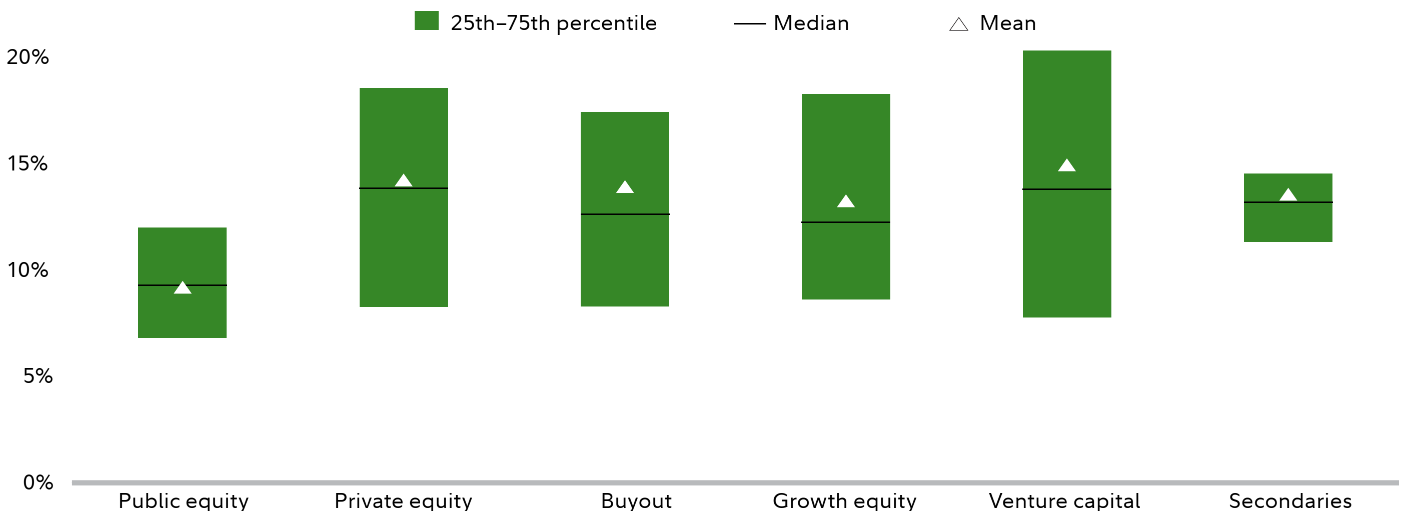
Currently, there are more than 275,000 companies with over 50 employees in the United States.[2] The number of publicly listed companies constitutes a fraction of that total and has declined by 40% over the past 20 years.[3] The evolution of private markets has led to many companies staying private longer or indefinitely, offering a larger universe of investment opportunities and access to value creation before a potential exit event.

Manager dispersion – greater potential to add value

Public equity mutual funds typically own the same mega-cap stocks due to their large weights in benchmarks, leading to high overlap in holdings across those funds. This may result in a tighter band of outcomes, or less dispersion between top and bottom quartile returns. In contrast, private equity funds typically have little to no overlap in investments across managers, which increases the amount of idiosyncratic or "non-market" risk in private market investments and may also result in greater dispersion between top and bottom quartile returns. As a result, private equity may have greater potential to add value through careful manager selection and portfolio construction. Exhibit 1 outlines this opportunity by showing manager dispersion for public equity relative to private equity, as well as buyout, growth equity, venture capital, and secondaries.

EXHIBIT 1: Performance among top-, median-, and bottom-quartile equity managers shows higher returns among private managers, with wider dispersions between winners and losers.

Fund returns by asset class, annualized



Past performance is no guarantee of future results. Source: Fidelity Investments, SPI by StepStone, Morningstar. Private fund categories from SPI by Stepstone: private equity – buyout, growth equity, venture capital, and secondaries; returns data utilize seven years since inception, internal rates of return (IRR) for each fund. Vintage years: 2005–2016; Morningstar data utilized average annual return for a horizon of seven years; minimum fund life of seven years, for public equity-actively managed mutual funds. Analysis conducted using data as of Oct. 24, 2024, to measure performance through the end of 2023. See the Appendix on page 7 for full methodology.

Diversification research supporting a multi-manager approach

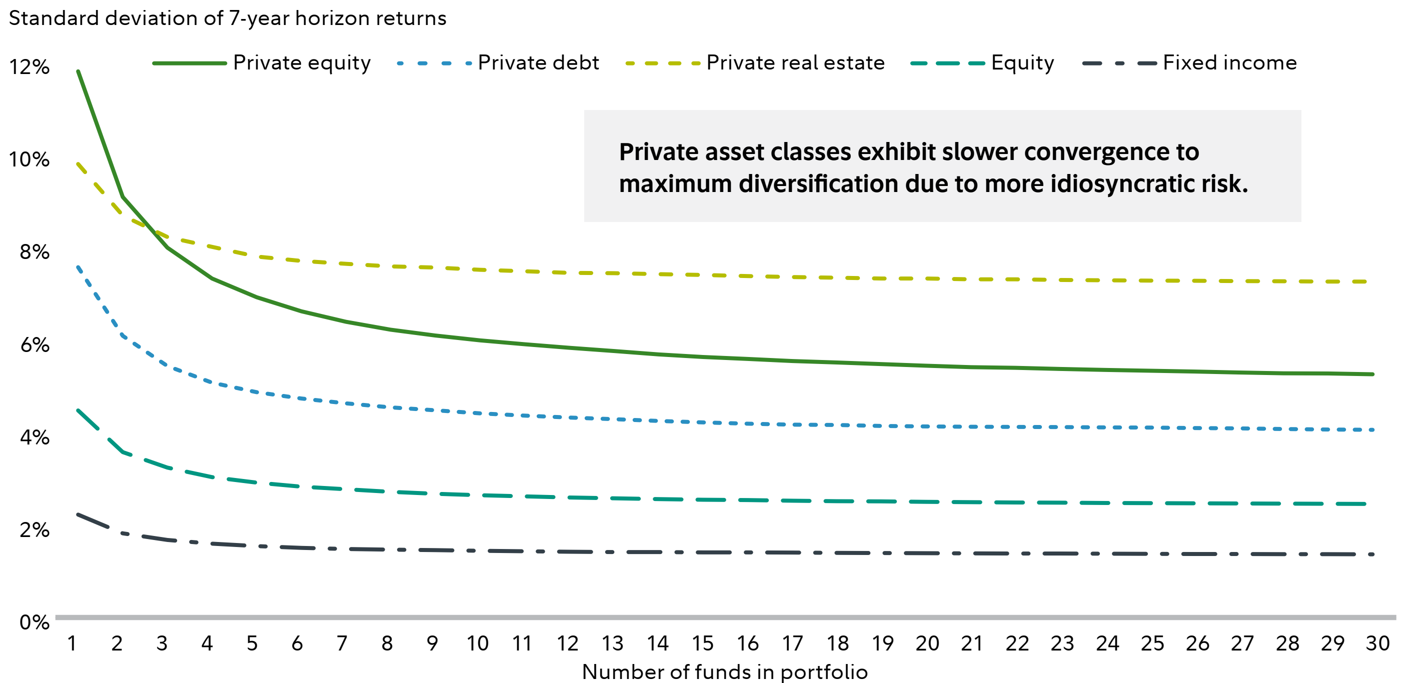
Private equity funds often own relatively concentrated portfolios of private companies, which can increase the risk that underperformance of a single company would significantly impact the fund's overall returns. Building a well-diversified portfolio using multiple private equity funds would help to mitigate this company-specific risk. New research by Fidelity Institutional Wealth Adviser (FIWA) sought to quantify this approach and identify how many funds could be required to achieve a sufficient level of diversification.

To tackle this question, FIWA constructed equally weighted portfolios varying from one to 30 funds, randomly drawing from a pool. FIWA simulated the portfolio construction process 1,000 times to generate an adequate number of samples. The average of standard deviations across all simulations was taken to develop a central tendency. For this analysis, a seven-year return period was utilized for every private market fund, as these funds typically generate most of their returns by the seventh year of a vintage. Similarly, comparable seven-year annualized returns were used for public market funds.

Exhibit 2 illustrates average standard deviation of a portfolio of funds for a variety of asset classes: private equity, public equity, private debt, public fixed income, and private real estate. The single-fund portfolios of private asset classes have a significantly higher standard deviation than public asset classes. For example, a single-fund private equity portfolio (green line) has a 12% standard deviation compared to 5%

EXHIBIT 2: As the number of funds in a portfolio increases, risks as measured by standard deviation decline because diverse funds with potentially less correlated return profiles helps to mitigate volatility.

Average n-fund portfolio standard deviation



For illustrative purposes only. Source: Fidelity Investments, SPI by Stepstone, Morningstar. Private fund categories from SPI by StepStone. Public equities and fixed income: active mutual funds from Morningstar. Colored lines represent portfolios across each of the asset classes, with 1 to 30 funds that were equally weighted and selected at random from a pool. Portfolio construction process was simulated 1,000 times to generate an adequate number of samples. The average of standard deviations for each portfolio (1–30 funds) across all simulations were noted. Returns of seven years were utilized for private funds as private funds have typically generated most of their returns by the seventh year of a vintage. Morningstar returns data utilized average annual return for a horizon of seven years; minimum fund life of seven years, for public equity & public fixed income mutual funds. Vintage years from 2005-2016, with performance through the end of 2023. See Appendix on page 7 for more on the methodology.

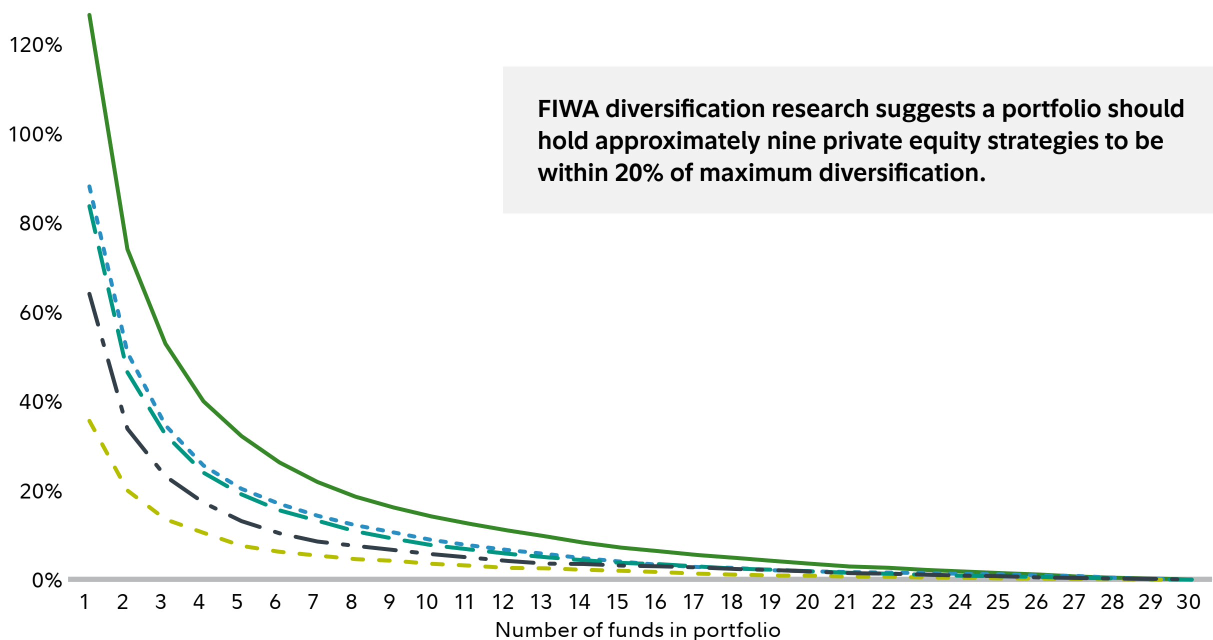
for a single-fund public equity portfolio. Risk is highest for the single-fund private equity portfolio because of its company-specific risk. But as the number of funds in the portfolios increases, the overall risk decreases. Risk declines because diverse funds with potentially less correlated return profiles help to smooth out fluctuations and lessen the impact of any single fund's volatility on the overall portfolio.

However, it is important to keep in mind that there is a limit to which diversification can reduce risk in any given asset class, as seen in how the lines of all asset classes level off. As the number of funds increases, the portfolios reach a level of sufficient diversification where adding more funds to the portfolios does not materially impact their standard deviation. Notably, the slower convergence in private asset classes relative to public asset classes means it takes more private funds to reach that point of sufficient diversification.

Exhibit 3 reconfigures the same data, assuming a 30-fund portfolio provides maximum diversification across all asset classes. This view concludes that a portfolio should hold approximately nine private equity strategies to be within 20% of maximum diversification.

EXHIBIT 3: For any given asset class, there is a limit to which diversification can reduce risk in a portfolio; slower convergence in private asset classes means it takes more private strategies to reach sufficient diversification.

Level of diversification



For illustrative purposes only. Source: Fidelity Investments, SPI by StepStone, Morningstar. Portfolios constructed using the same fund categories and process as in Exhibit 2, but this exhibit assumes that saturation limit of maximum diversification is same across all asset classes and demonstrates better that private asset classes convergence to maximum diversification is slower. Returns of seven years were utilized for private funds as private funds have typically generated most of their returns by the seventh year of a vintage. Seven-year annualized returns were used for the public funds. Vintage years from 2005–2016, with performance through the end of 2023. See Appendix on page 7 for more on the methodology.

Fidelity's approach to multi-manager private equity investing

Many of the world's most experienced investors with a long-term focus on capital appreciation have made meaningful allocations to private equity. As part of Fidelity's focus on strengthening and securing the financial well-being of its clients, Fidelity has developed a private equity multi-strategy fund series to provide investors diversified exposure to the asset class through a single investment. Each of Fidelity's multi-strategy funds targets an allocation to 10 to 12 leading primary and secondary private equity funds, representing hundreds of underlying private companies, thereby reducing idiosyncratic manager- and company-specific risks.

The investment process seeks to identify asset classes with the strongest risk-adjusted return potential and private equity fund managers with the greatest potential to outperform their peers. Top-down portfolio construction targets diversification across investment type (primary/secondary/co-investments), asset class (small buyout/large buyout/growth equity), and vintage years. Bottom-up manager selection seeks to add value by investing capital with fund managers expected to outperform their peers in each target asset class. This process focuses on identifying durable franchises with stable investment teams, well-defined investment edge, and industry expertise among other factors. Operational due diligence on the fund managers' compliance and operations programs helps reduce risks. Fidelity's private equity team has longstanding manager relationships and strong established networks as a result of decades of experience of investing in private equity on behalf of pension plans, endowments, foundations, and other asset managers.

> A multi-manager approach to private equity may have greater potential to add value through careful manager selection and portfolio construction.

Investment implications

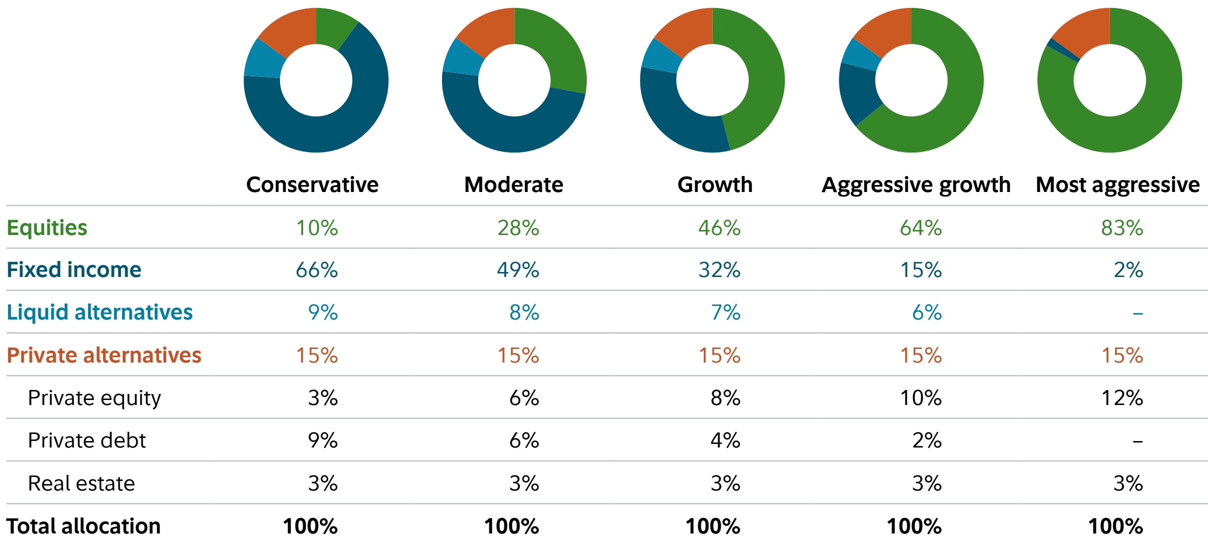
Private equity offers the prospects of enhanced returns relative to public equity and diversification for investors with a longer-term time horizon, moderate liquidity needs, or a specific legacy goal. Historically, implementation has been challenging for individual investors. Through a multi-strategy fund structure, investors are able to gain access to institutional-quality managers at a much lower minimum, with professional manager selection and continuous oversight. Investors have the flexibility to maintain or grow their exposure over time by allocating across multiple vintages.

Moreover, the administrative burden of managing multiple commitments is reduced in a multi-strategy structure with consolidated capital calls, performance reporting and schedule K-1 tax reporting. We believe that rigorous due diligence and specialized expertise are critical to help evaluate alternative investments that may serve to improve the overall efficiency of a portfolio.

Within a multi-asset class portfolio, investors with medium liquidity needs may want to consider potential allocations of up to 15% to private markets across conservative to aggressive target asset mixes (Exhibit 4). These hypothetical portfolio mixes (as outlined in "Building portfolios with alternatives," 2024) suggest private equity allocations ranging from 3% for conservative investors to 12% for most aggressive investors.

EXHIBIT 4: Potential allocation ranges for private equity for medium liquidity-need investors, from conservative to most aggressive portfolios.

Target asset mixes for medium liquidity needs



	Conservative	Moderate	Growth	Aggressive growth	Most aggressive
Equities	10%	28%	46%	64%	83%
Fixed income	66%	49%	32%	15%	2%
Liquid alternatives	9%	8%	7%	6%	–
Private alternatives	15%	15%	15%	15%	15%
Private equity	3%	6%	8%	10%	12%
Private debt	9%	6%	4%	2%	–
Real estate	3%	3%	3%	3%	3%
Total allocation	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Fidelity Investments. Based on target asset mixes developed in "Building portfolios with alternatives," 2024. Potential allocation ranges are intended solely as a guideline for investors to consider and does not take into account individual situations or tax implications of funding the alternative investment allocation, nor is this a recommendation on how to implement. Alternative investment strategies may not be suitable for all investors and are not intended to be a complete investment program for any investor. Some of the risks associated with alternative investments are: Alternative investments may be relatively illiquid. It may be difficult to determine the current market value of the asset. There may be limited historical risk and return data. A high degree of investment analysis may be required before buying. Costs of purchase and sale may be relatively high.

For more about investing in private equity or alternative investments, please contact your Fidelity representative.

Appendix

Analytical methodology for Exhibit 1: Starting in 2005 and utilizing a seven-year horizon return for every fund within each asset class, we calculated the 75th, 50th, and 25th percentile returns for each asset class in each calendar year through 2016. Our starting point was 2005 due to insufficient fund data available for certain private asset classes prior to that year. We utilized a seven-year period, as that is when illiquid private market funds typically have realized most of their performance. And to maintain alignment across, we calculated a custom seven-year return for each public equity fund. Using this data, we then calculated the median of the cross-sectional percentiles for all the years, as opposed to combining them all together and calculating return percentiles from that aggregated stack of returns. Importantly, this approach equal weights every year.

Analytical methodology for Exhibits 2 and 3: Like Exhibit 1, FIWA used a seven-year horizon return for every fund in alternative asset classes – private equity, private debt, and private real estate – and a seven-year annualized return from Morningstar for every actively managed fund in traditional asset classes – equity and fixed income. The oldest share classes is US domiciled funds with currency as the dollar were chosen. As with Exhibit 1, Exhibits 2 and 3 use vintage years from 2005-2016, with performance through the end of 2023.

Since this data lacked volatility information, the next step was to create 1,000 hypothetical funds for each asset class by randomly selecting returns. For example, a hypothetical private equity fund would have twelve return datapoints. The first return would be generated by randomly selecting a PE fund from the first vintage year. Similarly, the second return would be generated by randomly selecting a PE fund from the second vintage year, and so on. In this way, a hypothetical fund would have a series of twelve return datapoints, and hence its standard deviation could be evaluated.

Next, FIWA constructed equally weighted portfolios varying from one to 30 funds, randomly drawing from pool of hypothetical funds for each asset class. FIWA simulated the portfolio construction process 1,000 times to generate an adequate number of samples. The average of standard deviations across all simulations was taken to develop a central tendency.

To avoid potential misinterpretation, it is important to remember the annualized fund return figures are across a seven-year horizon. It is not measuring the standard deviation of fund returns within one year.

Across the exhibits, there may be an element of survivorship bias within the public equity/fixed income due to their open-ended nature and the minimum fund life requirement of seven years used within the analysis. While the true impact is unknown, it could contribute to lower dispersion within these asset classes, as underperforming funds may close before attaining a seven-year track record.

Sources

The StepStone Group: Private equity – buyout, growth equity, venture capital, and secondaries. Returns data utilize seven years since inception IRR for each fund.

Morningstar: Public equity – actively managed mutual funds. Returns data utilize average annual return for a horizon of seven years; minimum fund life of seven years.

Definitions

Median and mean: The median represents the middle of a data set, while the mean represents the sum of a set of values divided by the number of values.

Standard deviation: The statistical measure of market volatility, measuring how widely prices are dispersed from the average price. If prices trade in a narrow trading range, the standard deviation will return a low value that indicates low volatility. Conversely, if prices swing wildly up and down, then standard deviation returns a high value that indicates high volatility. Standard deviation rises as prices become more volatile. As price action calms, standard deviation heads lower. Price moves with increased standard deviation show above average strength or weakness.

Internal rate of return (IRR): A common metric to evaluate private manager performance, and a standard calculation. It represents the rate at which a historical series of cash flows are discounted so that the net present value of the cash flows equals zero. Any remaining unrealized value in the fund is treated as a distribution in the most recent reporting period.

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Thought Leadership Vice President Martine Costello Duffy provided editorial direction for this article.

Endnotes

[1] Source: MSCI Private Assets, Morningstar, trailing 20-year period as of June 2024. Private equity returns represent pooled returns net of fees of U.S. equity funds (investing in private companies) across all vintages in buyout, venture capital, and expansion capital categories. Public equity returns represented by the Russell 2000 Index.

[2] Bureau of Labor Statistics, distribution of private sector firms by size class, March 31, 2024.

[3] World Bank – World Federation of Exchanges, 2024.

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U.S.: 1174281.1.0 CAN: 322100-v202526 FCI 2313650 02/25

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