Mutual Funds & Unicorns

A fruitless marriage

Morningstar Manager Research

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Key Takeaways

- Mutual fund ownership of private-company equities remains relatively rare. Less than 10% of actively managed US equity funds owned a private company in its latest portfolio, and private-company equities accounted for just 0.3% of total assets invested in active US equity strategies.
- After a big push into private-company equities in 2020 and 2021, new investments in private companies have fallen dramatically in 2023 and 2024 through June.
- Mutual fund managers do not appear to be skilled private-company stock-pickers, and at the very least, they have poor timing, especially after considering lockup periods.
- Mutual funds' private-company positions generated just a 14.1% return on investment over the last 10 years once six-month lockup periods are accounted for.
- The return distribution is not favorable for private companies. Mutual funds' private-company positions both lost value more frequently and saw fewer explosive winners than a cohort of publicly traded peers.
- The lack of big winners is largely due to mutual funds' penchant for investing in later-stage rounds when much of a company's valuation has already been established, thus curtailing their upside.
- SpaceX alone is responsible for mutual funds' net gain on their private-company investments. Absent SpaceX, mutual funds have collectively lost about 1.3% on their private positions.
- Fund companies continue to materially disagree on the valuations of major private-company equities, including ByteDance, parent company of TikTok, which is facing a ban in the United States.
- Broadening access to private-company equities via closed-end funds will face stark liquidity challenges, and the current options available in the space have not impressed.
- Private companies' reluctance to allow secondary trading of their shares creates a large barrier to scaling any portfolio that aims to directly invest in private-company equities.

Scope & Methodology

- This report examines the success of mutual funds' foray into owning pre-IPO private companies.

- It goes back roughly 10 years, from the end of 2013 through June 2024. Prior Morningstar reports contain analysis and information on private-company ownership in mutual funds dating back to 2007.

- This report covers US-domiciled, US-equity-focused funds only. A number of asset managers also own private-company equity in their global and international portfolios; due to data constraints, those are not included here.

- This report examines the ownership of private *companies* only. It does not cover instances where a mutual fund is a limited partner in a private equity or venture capital fund, though mutual funds occasionally gain exposure through that avenue.

- Mutual funds often participate in multiple series of fundraising for a single company, but company-level returns are the focus, as mutual funds generally equally value all share classes of the same company.

- Individual position returns are calculated assuming that funds liquidate their shares at their last posted per-share valuation.

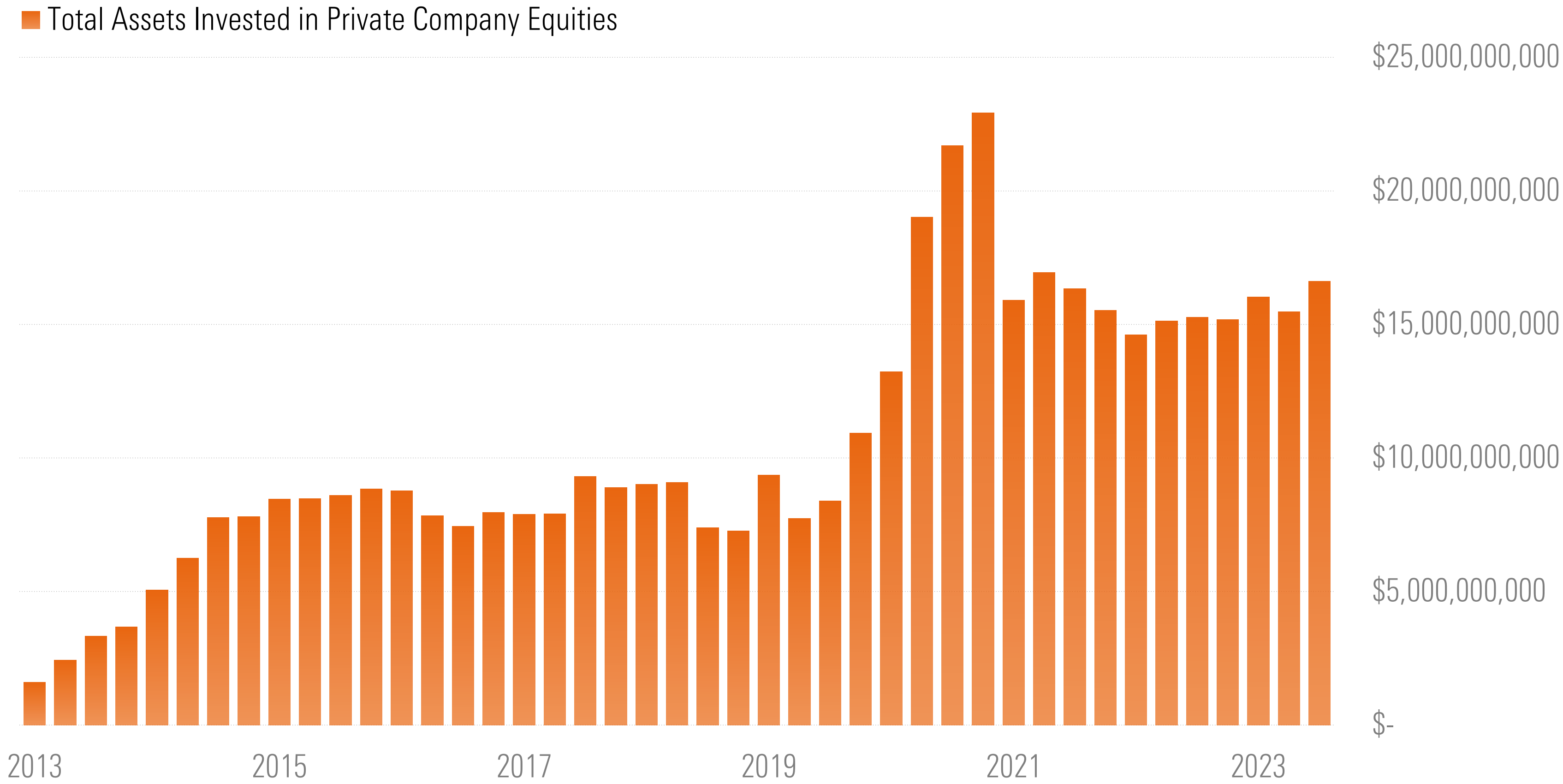
- Aggregated returns are generally calculated as a return on dollars invested, meaning the value of any liquidation proceeds (plus the current value of the position) divided by the amount initially invested and any subsequent investments.

- For companies that IPO'd, returns on the position are calculated through the end of a customary six-month lockup period since pre-IPO owners are generally prohibited from selling prior to the lockup expiration.

Total Mutual Fund Ownership of Private-Company Equities Has Remained Steady Since 2021

Total Mutual Fund Ownership of Private Companies: 2013-24

Following a number of IPOs in late 2021, total mutual fund ownership of private companies has hovered around $16-17 billion



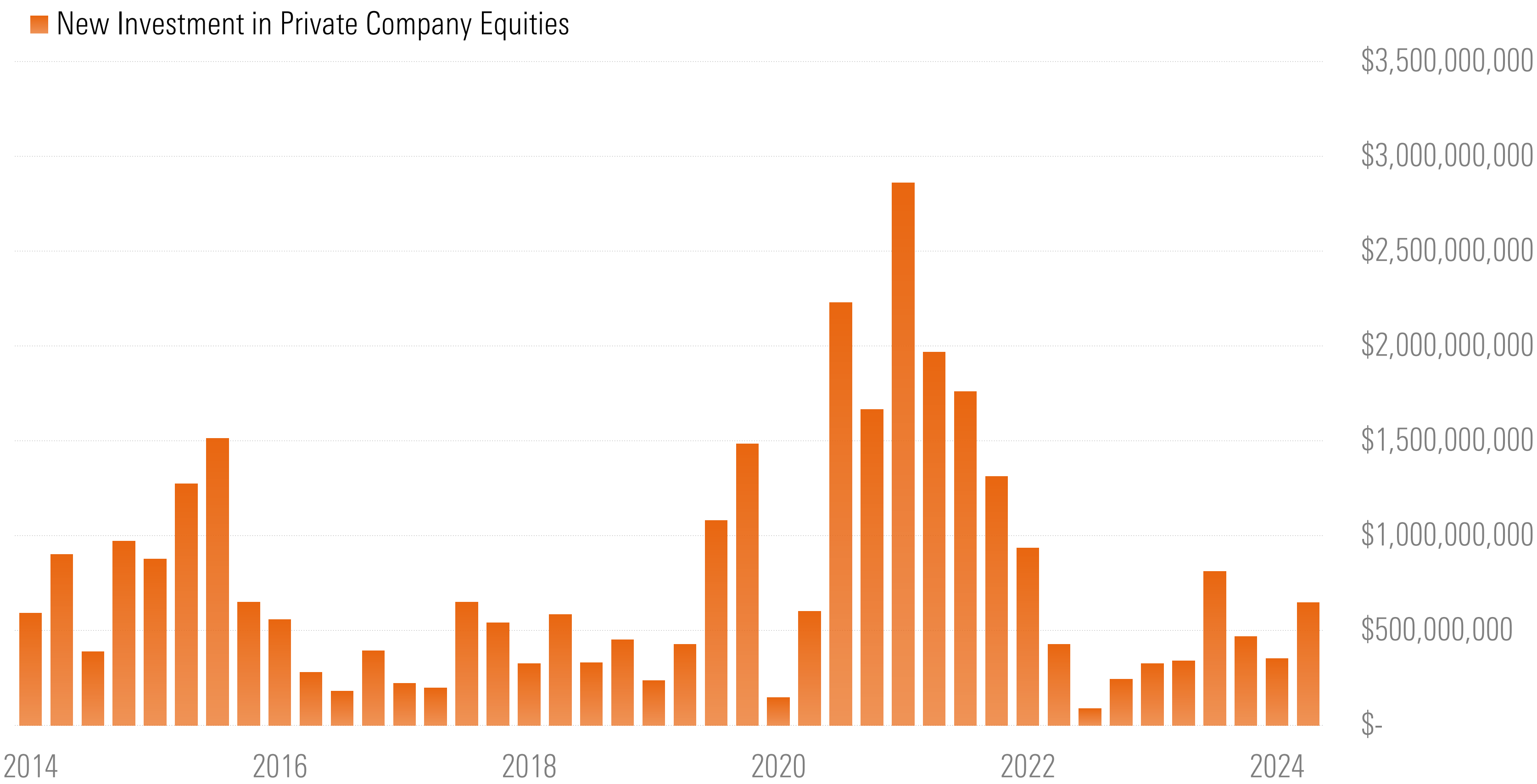
Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

- Since the start of 2014, aggregate mutual fund ownership in private companies has increased nearly tenfold, from $1.6 billion to $16.6 billion as of June 2024.
- The nearly $17 billion was held across 33 fund families, 136 different funds, and 205 distinct private companies.
- Private-company equity ownership is still rare; it accounted for just 0.3% of total assets invested across active US equity strategies.
- The 136 distinct funds represents less than 10% of US-focused active mutual funds.

New Investments in Private Companies Fell Drastically from Covid-Era Highs

New Investments in Private Companies by Mutual Funds: 2014-24

Following a surge in late 2020 through 2021, new private investments by mutual funds have slowed significantly



Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

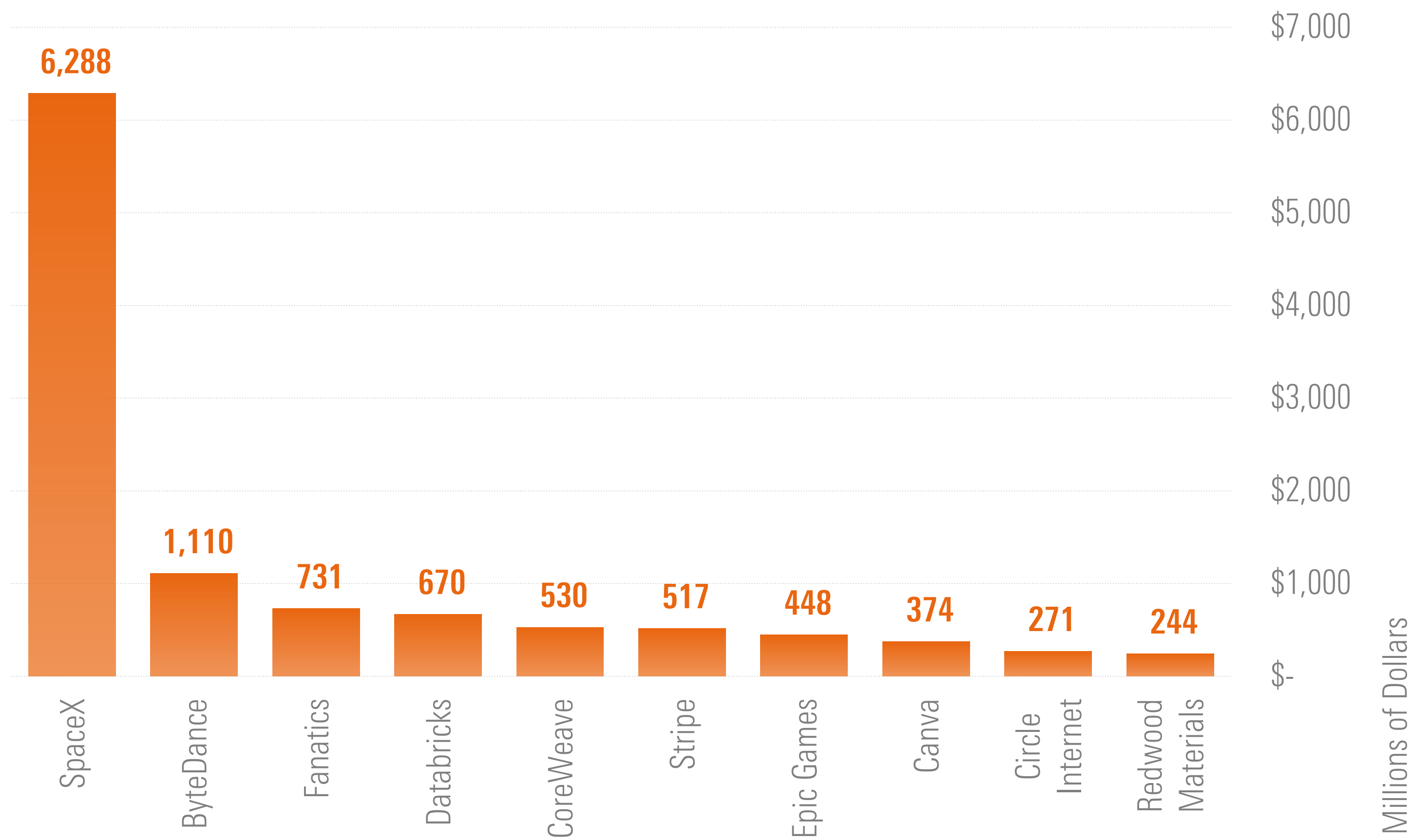
- Since the start of 2014, roughly $34 billion has been invested by US-focused mutual funds in private-company equities.
- More than a third of that occurred in an 18-month stretch between September 2020 and March 2022, a period of exuberance in the private markets, which has since waned.
- New investments have slowed tremendously since March 2022, though, as venture capital fundraising has pulled back in the face of higher interest rates.

The Bulk of Current Private-Company Assets Rests in Just a Handful of Companies—Namely, SpaceX and ByteDance

- The 10 most popular companies account for roughly two thirds of the roughly $17 billion of assets invested by mutual funds in private company equities as of June 2024.
- As of June 2024, SpaceX alone accounted for 38% of all mutual fund assets invested in private companies.
- Funds from Baron Capital, Fidelity, and Neuberger Berman all own stakes in the rocket maker.
- Most of the $6.3 billion of SpaceX is in the form of unrealized gains. Collectively, the three firms have about $1.2 billion invested in the company through various financing rounds.
- The second-most popular holding, ByteDance, is currently mired in litigation in the United States over the banning of its popular social-media app TikTok.

Most Popular Private Companies in Mutual Funds

Mutual funds held more than a $1 billion worth of both SpaceX and ByteDance



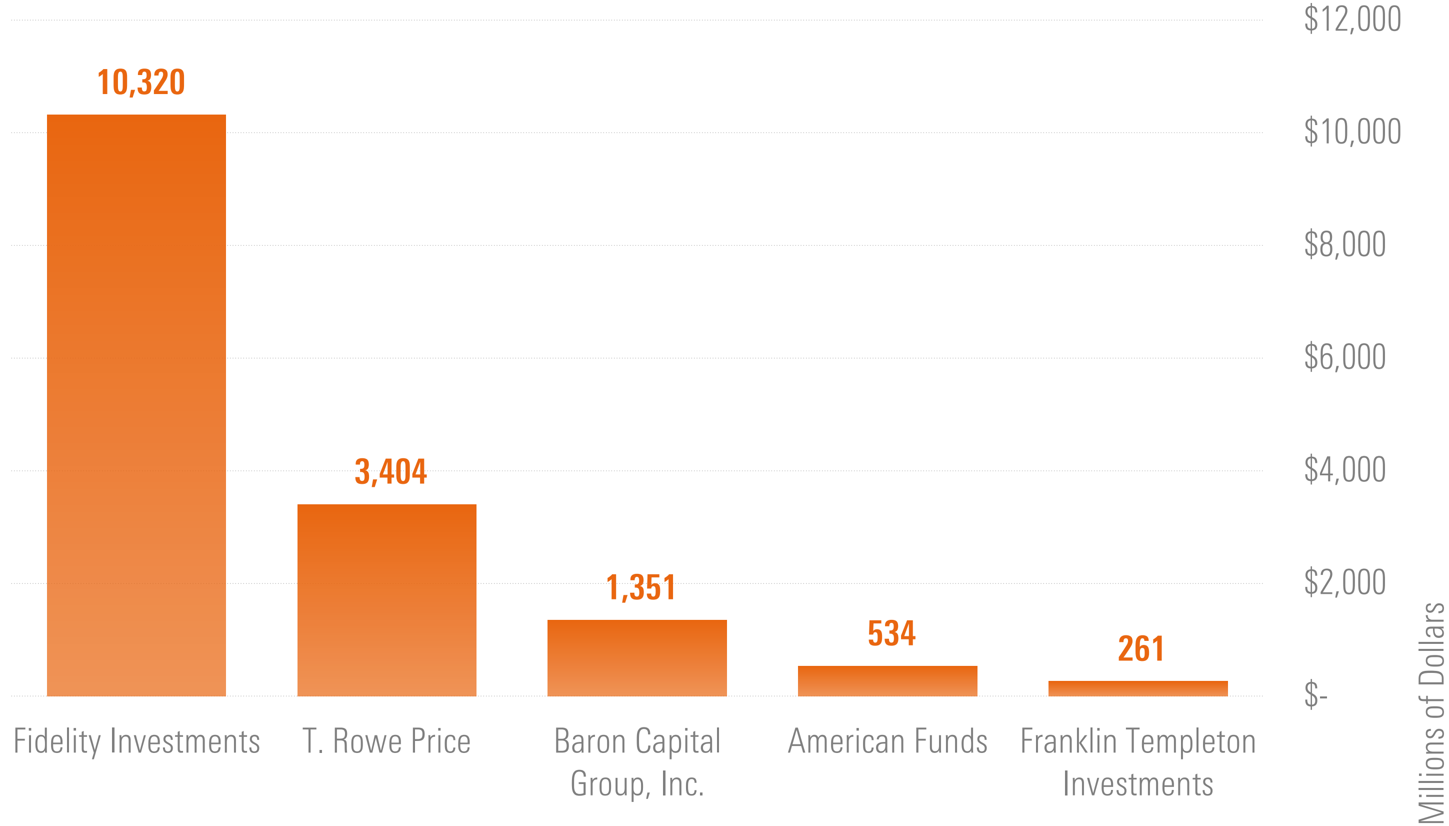
Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

Fidelity Accounts for the Majority of Assets

- Fidelity is by far the biggest owner of private-company equities in mutual funds as of June 2024, holding more than $10 billion across its lineup of US-focused equity portfolios.
- T. Rowe Price and Baron Capital are the only others with more than $1 billion invested in private-company equities.
- Nearly all of Baron's private-company stake is an unrealized gain in SpaceX, which Baron first invested in 2015.

Total Private-Company Equity Ownership by Fund Family as of June 2024

Fidelity and T. Rowe remain the biggest players, while Baron Capital is bolstered by a large SpaceX position



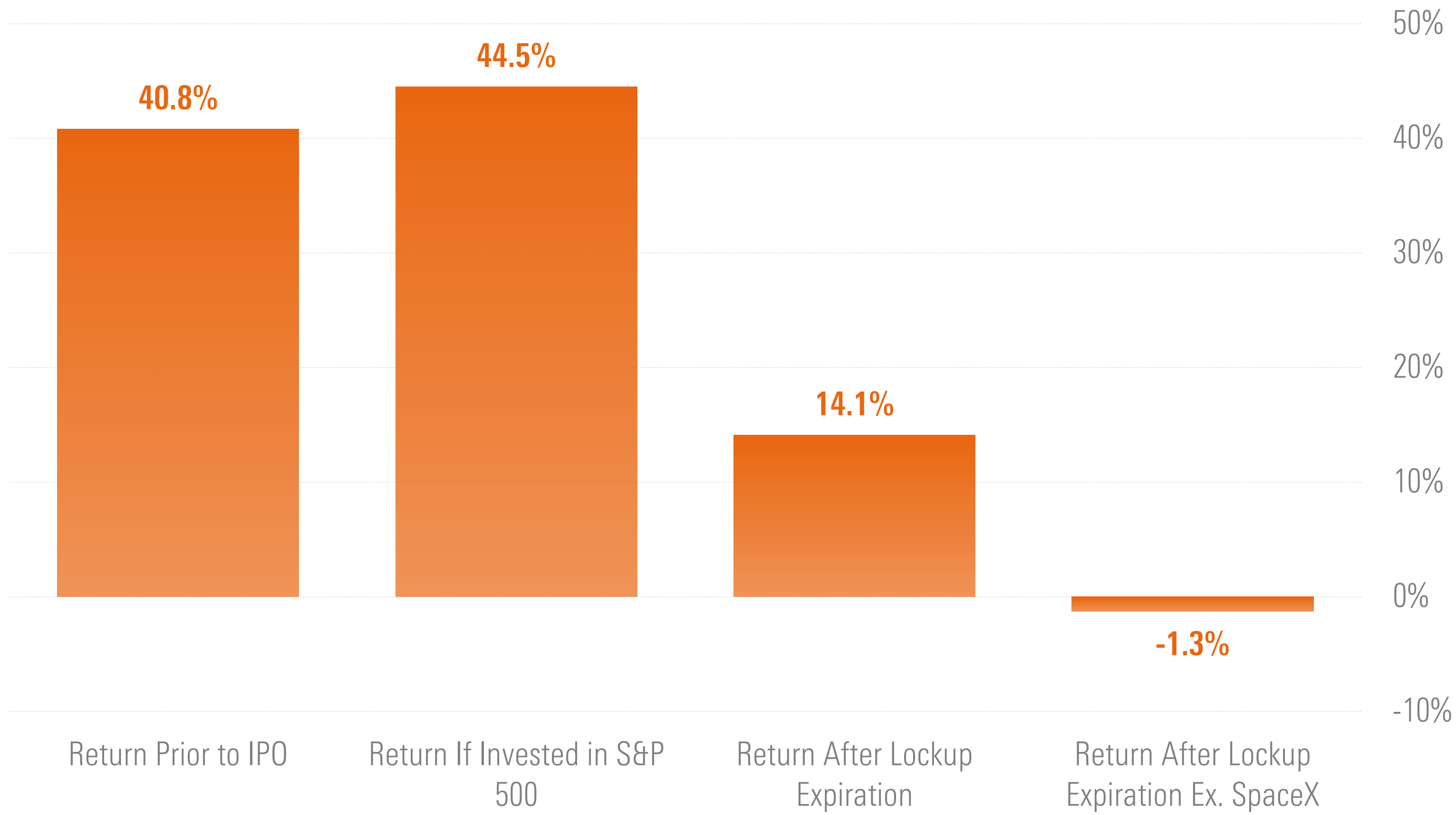
Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

Mutual funds have very little to show for tens of billions invested

- Since 2014, roughly $34 billion has been invested by US-focused mutual funds in private companies
- If measured strictly in their pre-IPO phases, mutual fund private stakes' generated around a $14 billion gain, not bad given the timing and duration of the investments, but still less than what they would've earned had those allocation instead been placed in the S&P 500
- However, mutual funds are subject to lockup provisions and cannot sell at IPOs. Taking lockup periods into account, the positions gained just $4.8 billion, a 14% gain
- SpaceX, though accounts for $5.2 billion of the gain, and, absent SpaceX, mutual funds have collectively lost 1.3% on their private company investments

Return on Private Company Equity Positions Held by Mutual Funds

Without SpaceX, aggregate returns would be negative after accounting for lockup periods



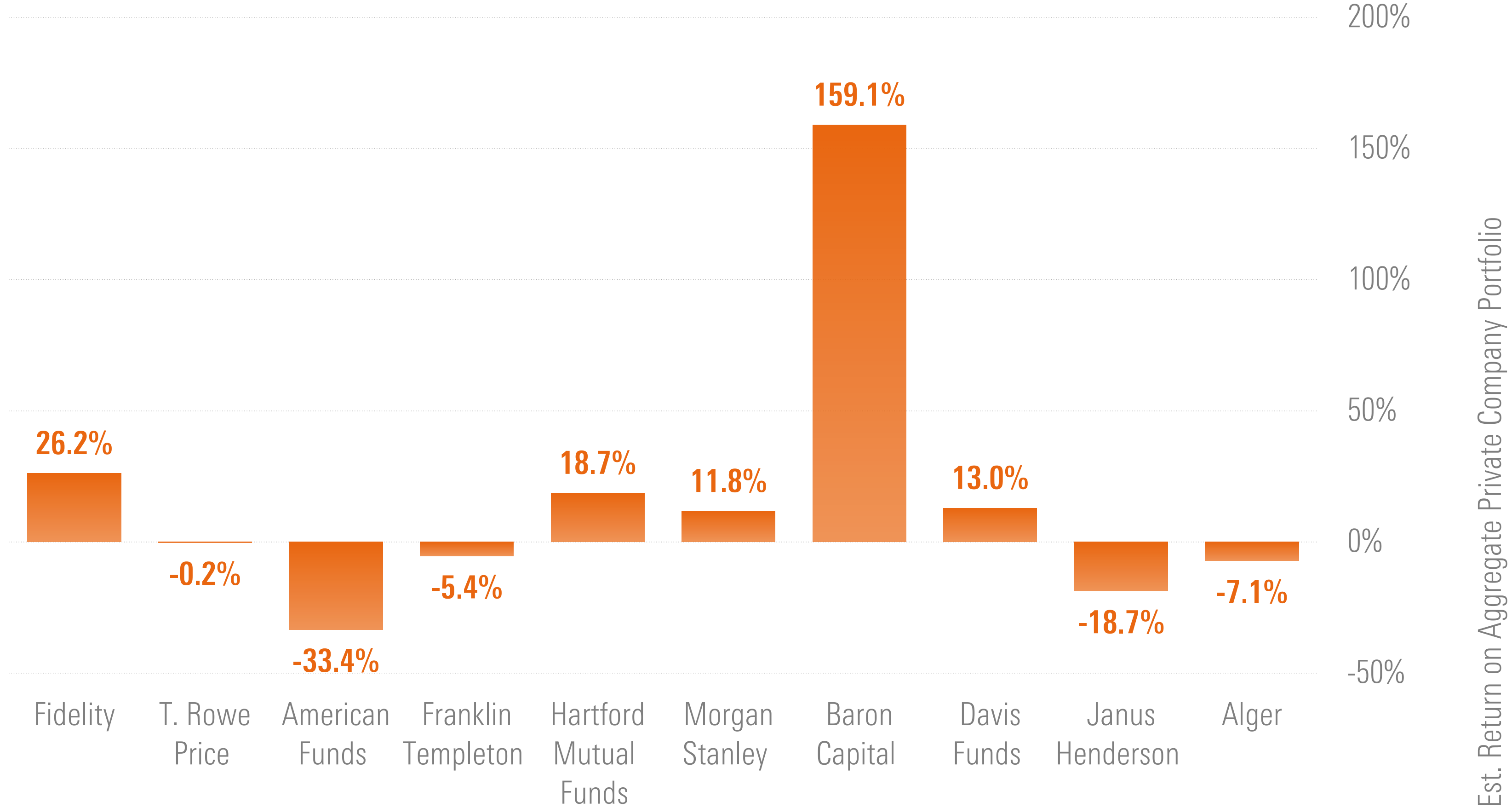
Source: Morningstar Direct; analyst's calculations. Data as of June 2024. Returns are returns on invested capital assuming each liquidation period scenario. Lockup periods are assumed to be 6 months from the IPO date.

Some Firms Have Fared Far Better than Others

- Baron Capital's SpaceX position powered its nearly 160% return on its private company positions
- American Funds, on the other hand, suffered from particularly bad timing. It invested $120 million into Juul, the electronic cigarette maker, right before its products were banned by the FDA in 2019
- Other investments have fallen flat, too. A $95 million investment in GM Cruise was down 75% through June 2024. Similarly, a $50 million stake in Checkout Payments was down 71%, and a $99 million position in Chime Financial was down 69%

Estimated Returns on Private Company Equity Positions by Firm

Outside of Baron Capital, few fund companies can boast about their chops in private markets

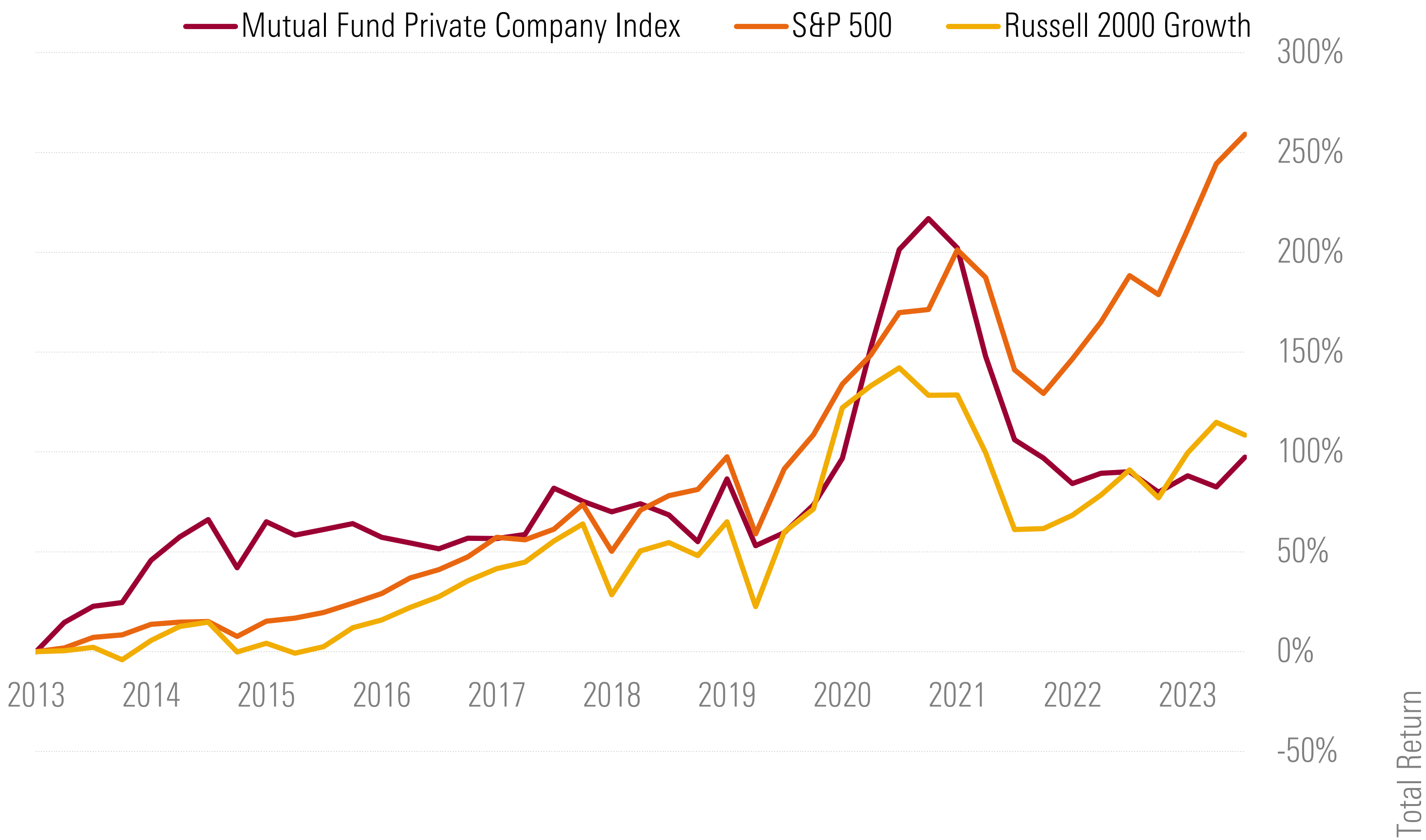


Source: Morningstar Direct; analyst's calculations. Data as of June 2024. Returns on capital are calculated as the total proceeds of any share sales plus the current market value divided by the total amount invested

If Treated as Its Own Portfolio, Mutual Funds' Private Company Stake Lagged the S&P 500 and Russell 2000 Growth

Return Comparison: Mutual Funds' Private-Company Equities vs Public-Traded Indexes

Relative to the public opportunity set, privately held companies in mutual funds have delivered lackluster returns



Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

- This methodology calculates quarterly aggregate returns based on realized sales and valuation changes over the preceding quarter.
- This reflects the long-term return if a theoretical investor was able to hold all mutual funds' private-company equity positions on a dollar-weighted basis and compound it over time.
- Returns in this methodology are *inclusive* of lockup periods, as the lockup period is a necessary hurdle for mutual funds to clear.
- In the aggregate, over the last 10 years, mutual funds' private stakes have failed to generate a return higher than what public markets returned, both against a broad benchmark like the S&P 500 or a closer peer comparison, the Russell 2000 Growth.
- This differs from the return on capital calculations citied previously in that this compounds the returns over time rather than discretely measuring each position.

The Past Two Years Have Been Unkind to Most Private Companies Held by Mutual Funds

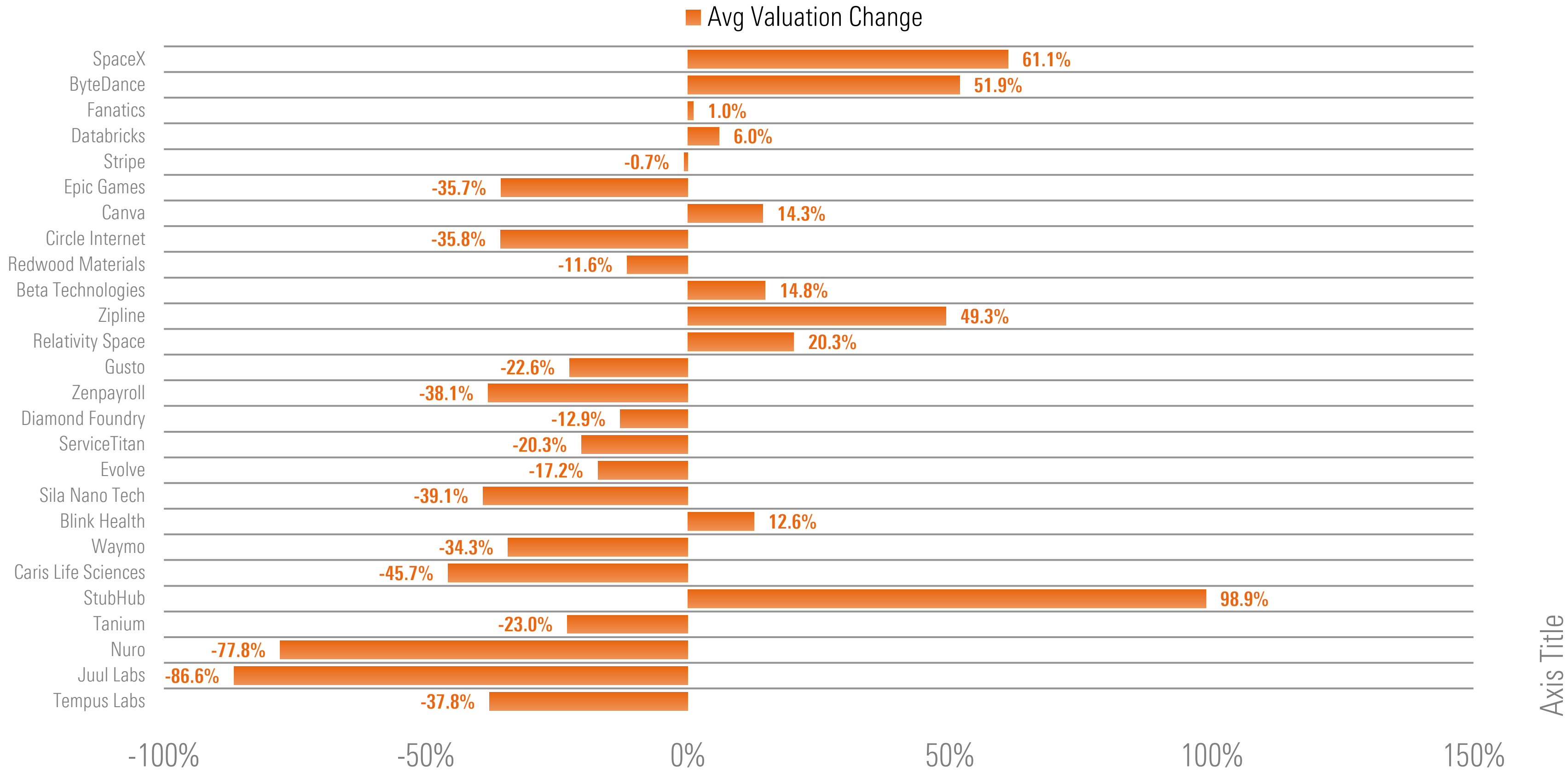
- Rising interest rates in 2022 and 2023 proved to be a major headwind for private-company valuations, as higher rates tend to hurt high-valuation, low-profitability companies—as most of these are—the most .

- As fundraising rounds slowed and companies were reluctant to raise money in "down rounds," fund companies were forced to generate their own valuation, absent observable prices.

- These periods create the potential for wide valuation differences between fund companies, as, in the absence of an observed price, reasonable minds can disagree in good faith.

Average 2-year Valuation Changes: Top Private-Company Holdings

Since June 2022, most of the largest private companies held by mutual funds have been written down significantly



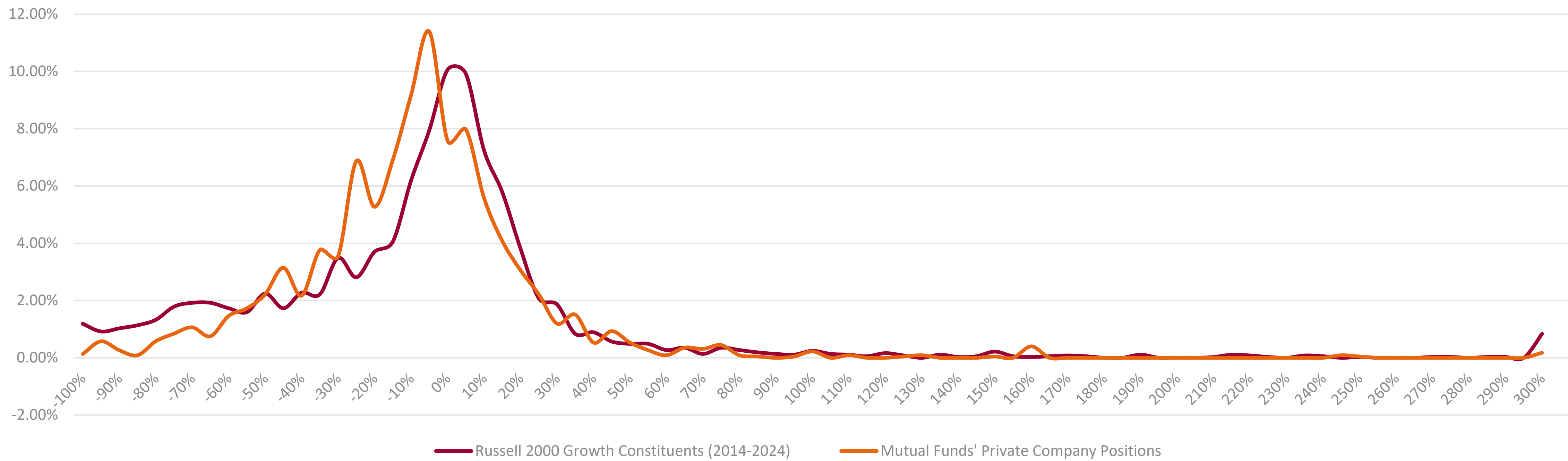
Source: Morningstar Direct; analyst's calculations. Data as of June 2024. Percentage changes are based off the average per-share price of each company held on June 2022 and June 2024.

Where Is the Upside? Managers May Be Better Served by Staying in Public Markets

Using annualized return figures to normalize for different holding period lengths, mutual funds' private company stakes lost value more frequently than public peers. On top of that, the big winners have proven elusive to mutual fund managers as well. While 5.7% of Russell 2000 Growth constituents gained 50% or more annualized over the study period, only 3.4% of private-company equity positions did. Mutual funds tend to invest in later-stage rounds, which cuts their upside, as private companies generally see big valuation jumps by then.

Annualized Return Distributions 2014-24: Mutual Funds' Private-Company Positions vs Russell 2000 Growth Constituents

While the distributions are close to each other, mutual funds lost value more frequently and saw fewer big winners on their private company positions than publicly traded peers



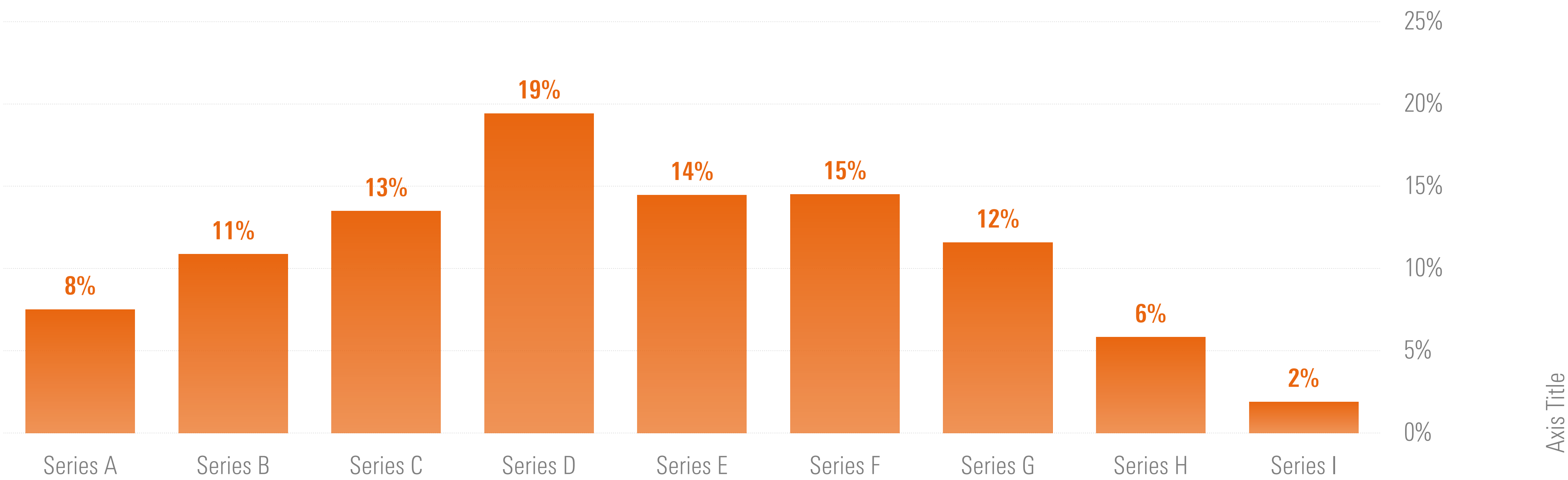
Source: Morningstar Direct; analyst's calculations. Data as of June 2024. Data represents the annualized return over the holding period of each position.

Late to the Party? Mutual Funds Invest in Later-Stage Round, Limiting Their Upside

One major reason for the lack of explosive winners among private companies held by mutual funds is that mutual funds tend to invest in later-stage rounds when the private companies already have appreciated significantly. In the venture capital world, Series C is considered "late stage," which is when companies should have stable customer bases and revenues and a clear growth outlook. Over 80% of mutual fund investments in private companies occurred in Series C or later, with two thirds occurring in Series D or later.

Dollars Invested by Mutual Funds in Private-Company Equities by Financing Round

Data is only for holdings that specify the financing round; includes roughly 50% of the total dataset



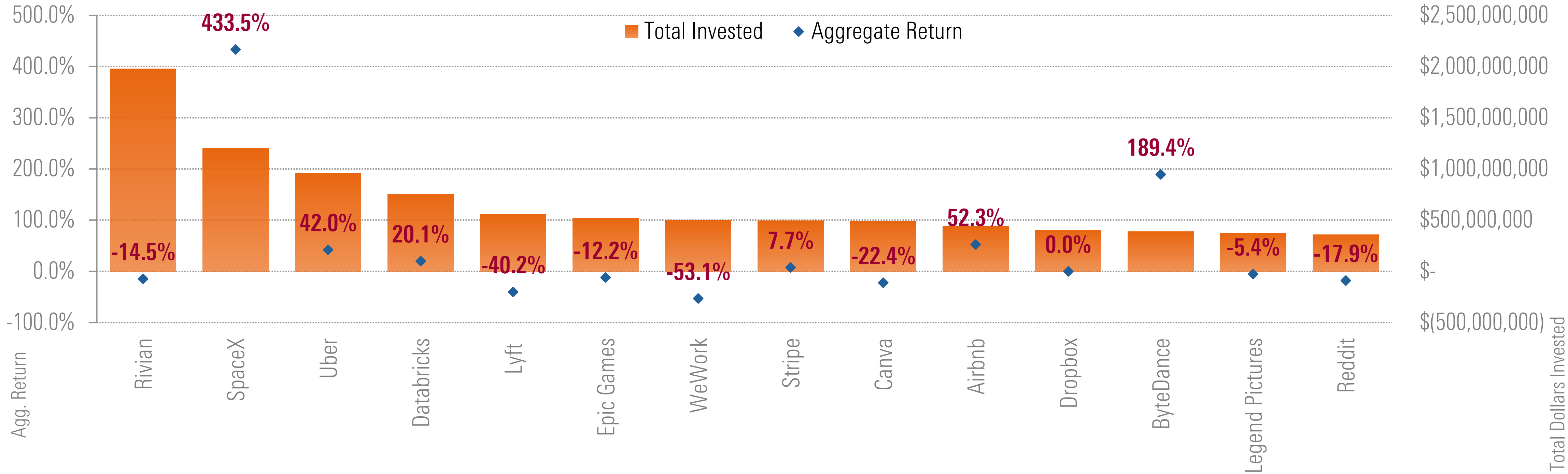
Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

Outside of SpaceX, few Outsize Winners Amongst the Largest Investments

For the most part, the companies that mutual funds have invested the most money in have not produced eye-popping returns. While Rivian looked like a big winner when it IPO'd, the stock tanked during its lockup period, erasing any gains. Mutual funds are sitting on massive gains in SpaceX, however, these gains are almost exclusively of the paper variety; that is, mutual funds have not actually turned any of that investment into cash.

While SpaceX has been a big winner, few other private-company investments produced sizable gains for mutual funds

Stock declines during post-IPO lockup periods eroded large gains in multiple companies



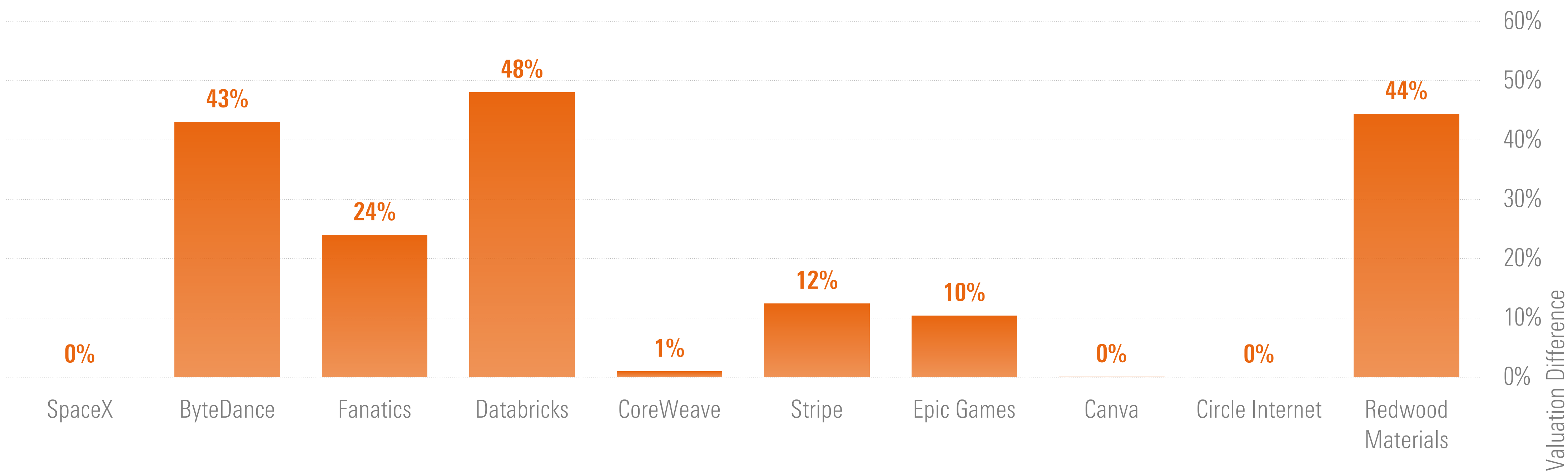
Source: Morningstar Direct; analyst's calculations. Data as of June 2024. Gain/Loss is calculated as any historic realized gains plus any current market value in each position.

Fund Company Valuations Can Differ Widely on the Same Companies

Mutual fund companies are left to their own devices to value their private-company equities. For investors, this has real consequences, as it directly affects the NAV they pay or receive upon buying or selling a fund. ByteDance, for instance, is held by Fidelity at a 43% higher per-share valuation than where BlackRock holds it. An investor at Fidelity, through the NAV they transact at, is paying (or receiving) 43% more for the same asset as an investor at BlackRock.

Difference between highest and lowest fund company valuation for major private holdings

Reasonable minds can disagree, but fundholders are paying the difference



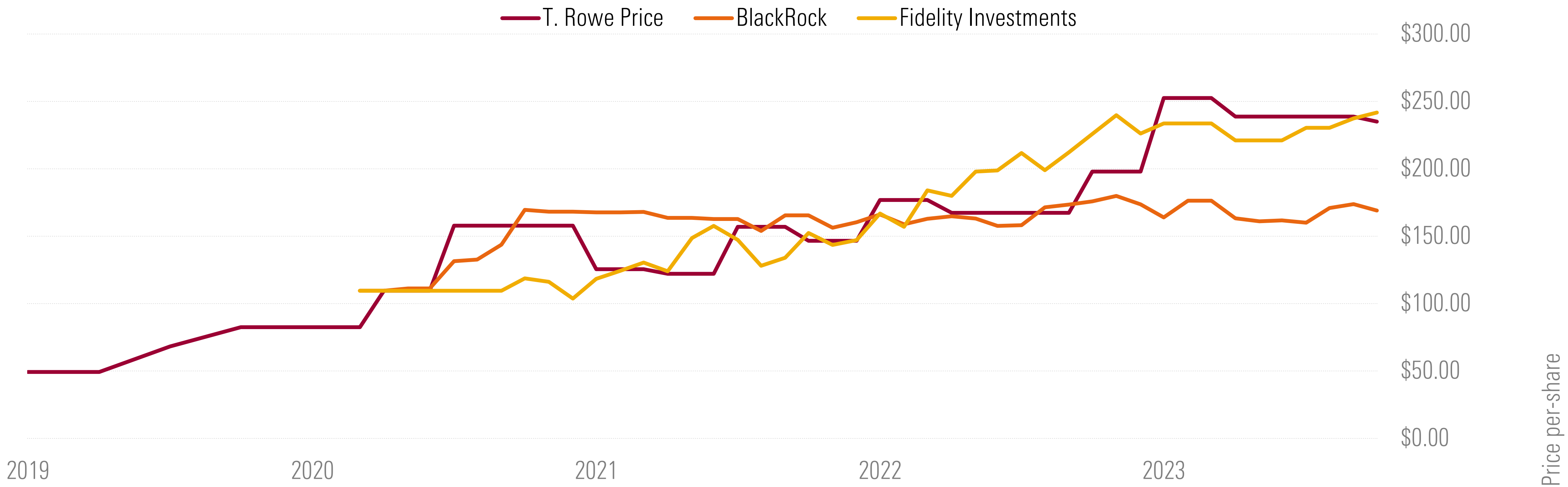
Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

ByteDance Valuations Haven't Budged Despite TikTok Ban in United States

In April 2024, President Biden signed a bill that would force a sale of TikTok—the popular ByteDance-owned social-media company—to a US company or face an outright ban. Beijing-based ByteDance is currently fighting the ban in court, but the company made it clear it has no intentions of selling. Despite the very real possibility of losing access to a massive advertising market, fund companies barely budged their valuations, implying that the fund companies do not believe access to the US market is critical to ByteDance's value.

ByteDance Per-Share Valuations

Since the April 2024 legislation was passed, Fidelity's valuation of ByteDance increased 4.9%, T. Rowe's valuation declined 1.5%, and BlackRock's fell 1.1%



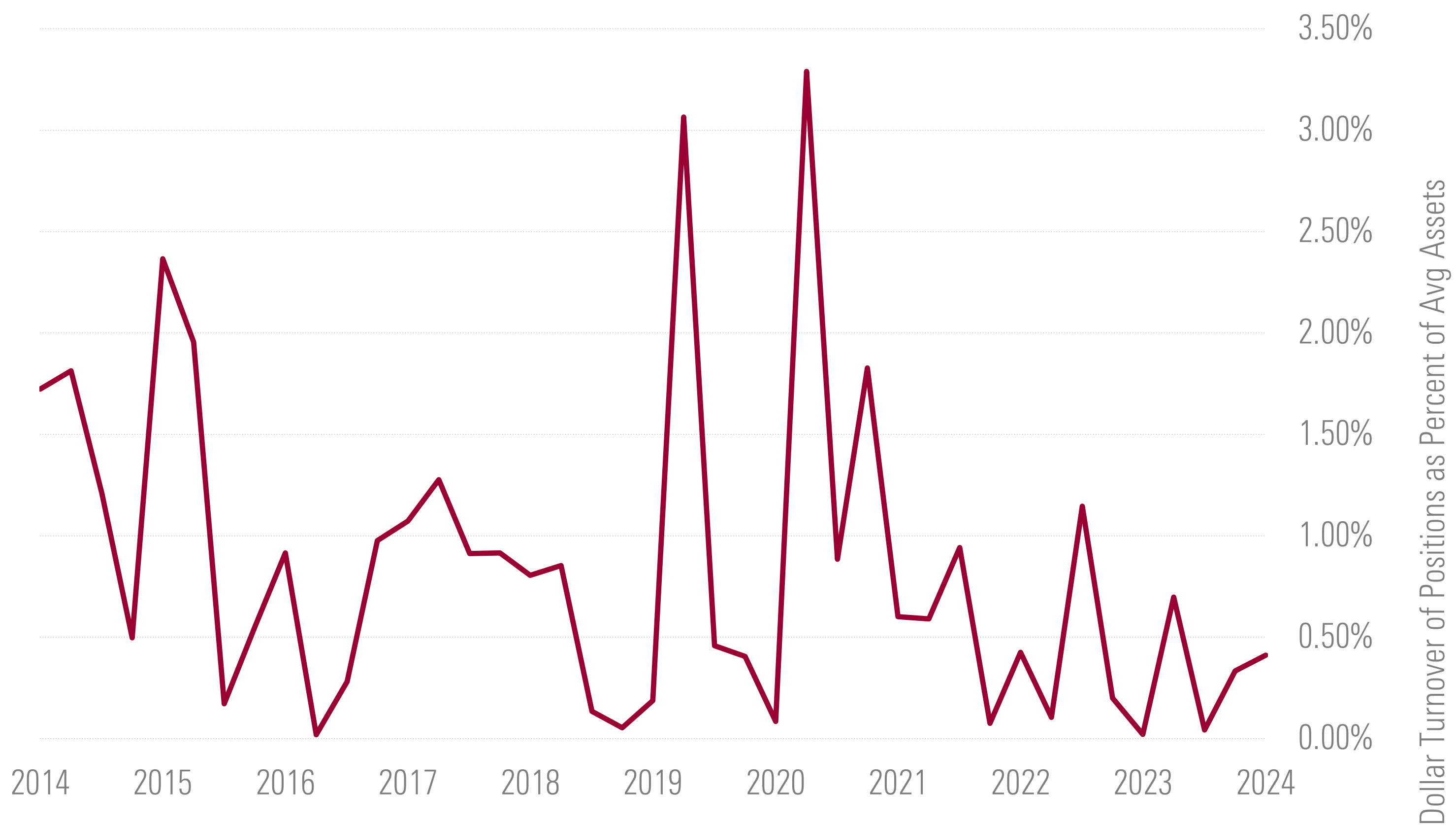
Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

Broadening Investor Access to Unicorns Will Face Stark Liquidity Challenges

- Liquidity will be a major constraint on any portfolio dedicated solely to private-company equities.
- The companies themselves largely control the secondary trading market, as they want to control ownership of the firm and limit shareholder count.
- SEC regulations can force private companies to publicly register if they have more than 2,000 shareholders or 500 or more unaccredited investors.
- Thus, they typically maintain right-of-first-refusal on any secondary transaction as well as the power to prevent secondary sales of equity altogether.
- Mutual funds virtually never trade their private-company equities; less than 1% of positions generally turn over in a given quarter.
- Even semi-liquid structures like interval funds will be challenged; private-company equities are only as liquid as the companies allow them to be.

Average Dollar Volume of Private-Company Equity Shares Traded

Outside of a few exceptions, mutual funds rarely trade their private company stakes



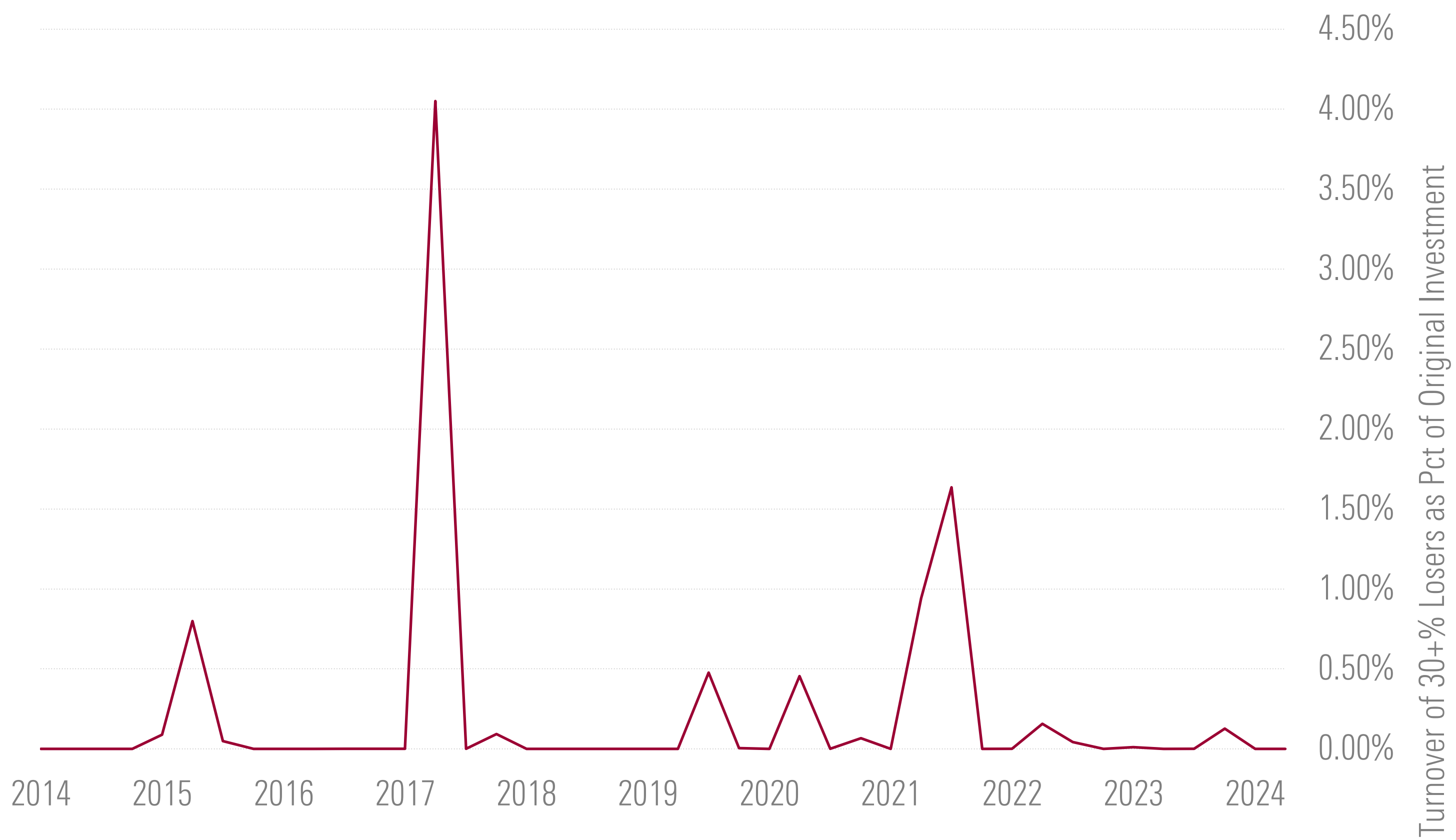
Source: Morningstar Direct; analyst’s calculations. Data as of June 2024. Excludes adds that were part of new financing rounds.

Liquidity on the Downside Is Hard to Find

- Outside of a few exceptions, mutual funds largely have to hold onto losing positions, as there are few exit ramps.
- This is partly structural, as the startups themselves often limit shareholders' rights to secondary sales.
- New financing rounds are a major source of liquidity for existing shareholders, but startups are often reluctant to raise new money at lower valuations.
- However, there have been some instances where funds have been able to cull losing positions.
- In 2017, Wellington, through a handful of Hartford mutual funds, was able to sell a slug of its Tory Burch stake, which was marked down about 45% since they first invested in it.
- In the second and third quarters of 2021, some Fidelity and T. Rowe funds were able to sell some of their WeWork exposure prior to the company going public via SPAC in October of the same year.

Quarterly Trims of Positions Down 30% or More as Percentage of Original Investment

Outside of just a couple of instances, mutual funds are generally stuck with losing positions



Source: Morningstar Direct; analyst's calculations. Data as of June 2024.

Outside of Mutual Funds, few Palatable Options for Investors Seeking Direct Access to Private-Company Equities

- Outside of mutual funds, everyday investors seeking direct access to private-company equities face a limited menu, and most of the options are unsavory.

- Interval funds provide an appealing structure, as redemptions are limited, which helps prevent fire-sales of assets due to elevated redemption requests.

- However, there are drawbacks. These funds typically will commit to repurchasing 5% of the shares outstanding in any given quarter, meaning investors will not be able to redeem the full amount they wish if requests exceed that amount.

- Exchange-traded closed-end funds afford investors daily liquidity, but it also burdens them with the risk of not transacting at the fund's net asset value.

- Scalability is still a question; the ability to buy or sell at larger asset levels without materially changing the portfolio composition or affecting pricing remains a key unknown.

- New investor proceeds may not be able to be timely deployed if there is low fundraising activity in the venture capital market.

Closed-end funds that directly invest in private-company equities available to nonaccredited investors

While conditions have not been ripe for the asset class, these CEFs have produced poor performance

- **Primark Meketa Private Equity Investments Fund PMPEX**
  - This $226 million interval fund invests in primarily middle-market private companies and not the well-known unicorns featured in this report.
  - Since its August 2020 inception through September 2024, it has lagged the S&P 500 by almost 30 cumulative percentage points.
- **Destiny Tech100 DXYZ**
  - This $56 million exchange-traded closed-end fund claims to invest in the hottest 100 tech startups, though it really owns about 25.
  - In early 2024, its value grew grossly disconnected from its NAV.
- **ARK Venture ARKVX**
  - Run by Cathie Wood, this $68 million interval fund invests in well-known unicorns like SpaceX and Epic Games.
  - Performance has not impressed: Since its September 2022 inception through September 2024, it lagged the S&P 500 by nearly 30 percentage points.
- **The Private Shares Fund PRLVX**
  - Launched in 2018, this is one of the oldest CEFs investing in private-company equities and the biggest at $909 million in assets.
  - It too has failed to beat the S&P 500, lagging by more than 80 cumulative percentage points since inception through September 2024.
- **Sweater Cashmere SWTRX**
  - This $14 million interval fund explicitly claims to be "democratizing access to venture capital" by providing investors with exposure to early-stage startups.
  - It has lagged the S&P 500 by 25 cumulative percentage points since its April 2022 launch.

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