Private-Market Investments or Private-Market Investors?

The Morningstar PitchBook Developed Markets Listed Private Equity Index is a window into an altered opportunity set for investors.

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What's the better investment—a mutual fund or a mutual fund company? Morningstar analysts tackled this question several times in the 1990s and 2000s, comparing the returns of funds to the share price performance of public fund managers. Data typically favored the latter. This pointed to the asset-light, scalable nature of the investment management business and to what Vanguard founder Jack Bogle called the inherent conflict of serving "two masters"—fund investors and fund company investors.

Times have changed. In "New Era for US Asset Managers," Morningstar equity strategist Greggory Warren pointed to several headwinds facing the industry: fee compression, the shift to passive investing, regulatory changes, distribution costs, and an aging population. [1] Indeed, the Morningstar Global Asset Management Index has lagged the broad equity market over the past decade.

Managers focused on private markets have fared much better. The Morningstar PitchBook Developed Markets Listed Private Equity Index[2] has gained nearly 300% in cumulative terms for the 10 years through 2024's third quarter, compared with 169% for its parent benchmark. Constituent companies like Blackstone, KKR, Partners Group, Ares, and ICG have seen their share prices surge.

Investing in publicly traded managers offers exposure to private markets without the high fees, illiquidity, and regulatory hurdles. But it's an indirect route. Investors may wonder if these managers outperform their private-market investments, what the future holds for private-market investing, and how public markets have changed as a result of their expansion.

Takeaways from this paper include:

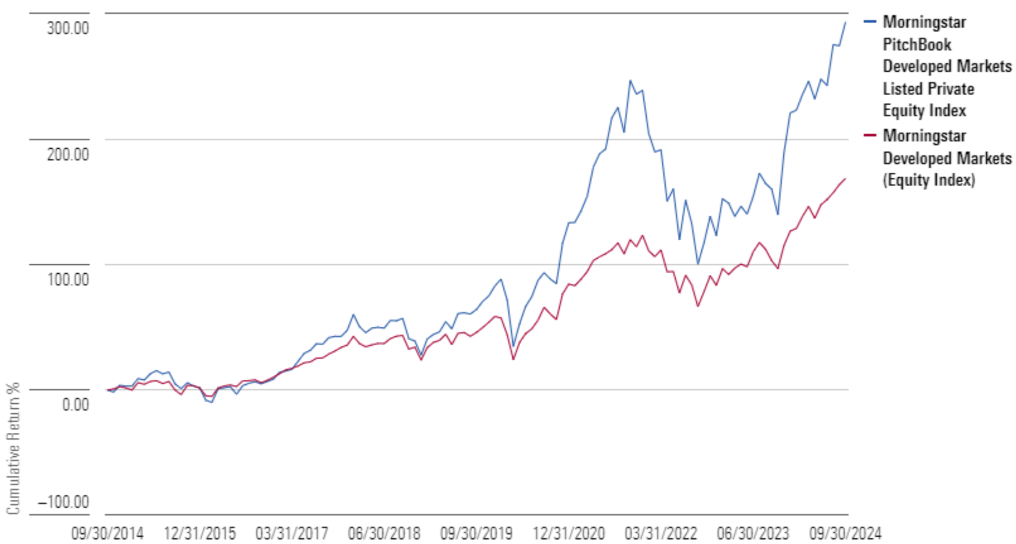
- The Morningstar PitchBook Developed Markets Listed Private Equity Index tells the story of a secular trend: the boom in private markets.
- Measuring private-market performance through private-capital funds, the Morningstar PitchBook Global Unicorn Index, and returns for mutual funds with private holdings reveals a mixed picture.
- Broadening access to private markets represents both an opportunity and a challenge for private-market managers. "Convergence" could grow the market but also increase competition.
- For investors, the rise of private markets has changed the opportunity set. The struggles of small-cap US equities and the dramatic expansion of the leveraged-loan asset class are two ways that private-market growth has affected public markets.

1 Asset Manager Observer. November 2021.
2 Construction Rules for Morningstar PitchBook Developed Markets Listed Private Equity Index. Morningstar Indexes.

The Rise and Rise of Private Markets

The Morningstar PitchBook Developed Markets Listed Private Equity Index, which measures the performance of publicly traded companies with significant private equity exposure, has recorded an average annual gain of nearly 15% for the past decade (the index was launched in 2020, but its track record is backcast to 2013 based on historical PitchBook deal data). That compares with roughly 10% for its broad equities parent index. Share prices for publicly traded private-market companies declined nearly twice as much as the broad equity market in 2022 but rebounded sharply in 2023 and 2024.

Exhibit 1 Morningstar PitchBook Developed Markets Listed Private Equity Index



Source: Morningstar Direct. Gross returns are in USD for Morningstar Indexes.

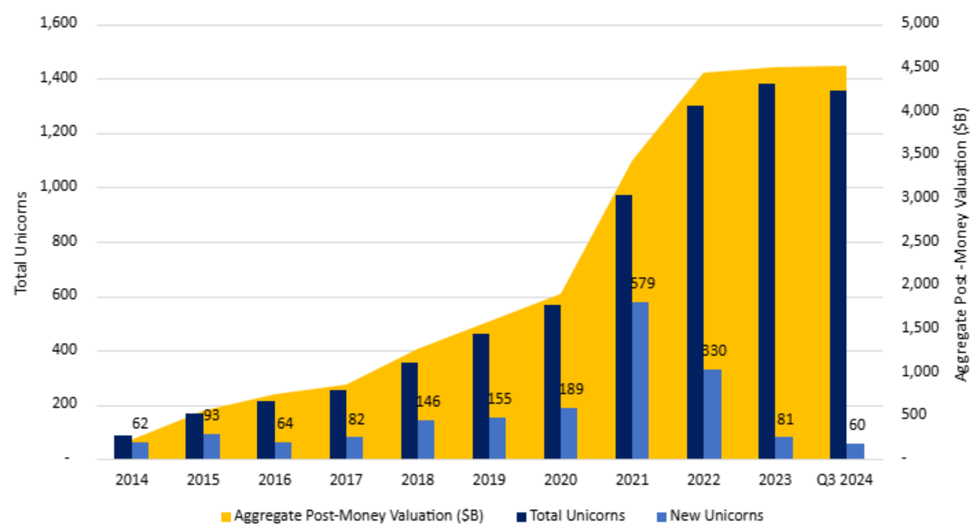
"The tailwind provided by ongoing demand for alternative products by both institutional and retail-advised clients" is how Morningstar's Warren ascribes the growth.[3] Blackstone, the largest "alternative" investment company, manages over USD 1 trillion in assets. That's up from less than USD 300 billion 10 years ago. Blackstone's "fee-related earnings," or profits from management fees, will approach USD 5 billion in 2024.

Beyond the soaring values of private-market managers, many other statistics tell the dramatic growth story of private markets. There's the nearly USD 15 trillion of assets sitting in private equity, venture capital, real estate, real assets, and private-debt-focused funds, according to data in a May 2024 report from PitchBook, Morningstar's private-market research arm.[4] That's up nearly threefold in a decade. On the debt side, there's the USD 1.6 trillion private-credit market, of similar size to the high-yield bond and leveraged-loan markets.

3 Warren, G. Oct. 18, 2023. Alternative Asset Managers Like Blackstone Are Not Immune to Equity and Credit Market Headwinds. Morningstar.
4 Schwartz, N., Carmean, Z., and Akers, A. May 1, 2024. Private Capital's Path to $20 Trillion. PitchBook.

There's also the rise of the "unicorn," venture-capital-backed private companies worth more than USD 1 billion. As displayed in Exhibit 2, the Morningstar PitchBook Global Unicorn Index[5] contained no fewer than 1,351 constituents as of the end of the third quarter, up from fewer than 100 a decade ago. Their aggregate valuations, as of their last funding rounds, surpassed USD 4.5 trillion. While growth has slowed considerably in recent years, unicorns like Ant Group, ByteDance, SpaceX, Shein, Stripe, Databricks, OpenAI, and Klarna remain massive companies.

Exhibit 2 Morningstar PitchBook Global Unicorn Index: 1,351 Unicorns Representing USD 4.5 trillion



Source: Morningstar Indexes. Data as of Sept 30, 2024.

What's driving the private markets boom? The SEC has blamed itself for regulations that have contributed to more capital being raised in private markets than public for several years running.[6] The Jobs Act in the US and the EU's Alternative Investment Fund Managers Directive are also cited as drivers of private-market growth. Jamie Dimon, CEO of JPMorgan Chase, blames the reporting burden faced by public companies,[7] which is not only costly but also competitively compromising. Short-termism in public markets is another common scapegoat.

Low interest rates in the many years following the 2008 global financial crisis are another key factor. “Leveraged buyout” was a popular term in the 1980s “before some marketing genius fastened on ‘private equity’ as a way to disguise the fact that the business still rests on a mountain of debt,” in the inimitable words of venture capitalist Michael Moritz. [8] It's no coincidence that sharp rate hikes starting in 2022 slowed private-market deal activity. As will be discussed later, however, they have acted as a speed bump, not a stop sign.

5 Construction Rules for Morningstar PitchBook Global Unicorn Indexes. Morningstar Indexes.

6 Lee, A.H. Oct. 12, 2021. Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy.

7 https://www.jpmorganchase.com/ir/annual-report/2023/ar-ceo-letters

8 https://www.venturecapitaljournal.com/end-of-an-era-as-moritz-steps-away-from-sequoia/

Are Private Markets Really All That? What About Performance?

How does the near 15% average annual gain for the Morningstar PitchBook Developed Markets Listed Private Equity Index compare with the returns managers generate by investing their funds in private assets? One way to answer this is through PitchBook Benchmarks, which measure the average performance of groups of funds investing in private assets. As displayed in Exhibit 3, the average internal rate of return for all funds with a 2014 vintage is 12%, which is on the low side for recent vintages. Breaking it down by asset class, private equity funds launched in 2014 performed best, followed by funds of funds and venture capital. Real estate, real assets, and private debt were all in the 7%–9% range. An important caveat is that this data is self-reported. The returns are net of fees though. Also noteworthy is that dispersion between top- and bottom-performing funds can be large.

Exhibit 3 PitchBook Benchmarks: Private Fund Returns

PitchBook Benchmarks

Metric: IRR by Vintage **End vintage:** 2018 **Data as of:** 2024 Q2

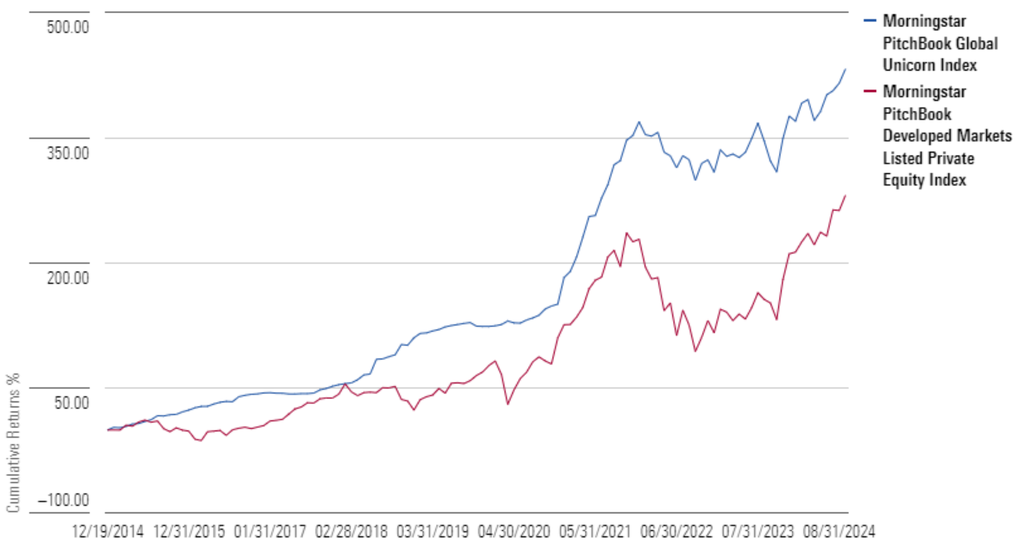
Private Capital

	2012	2013	2014	2015	2016	2017	2018
All Private Capital	12.09%	12.42%	12.00%	13.57%	13.80%	14.59%	13.10%
Private Equity	14.73%	15.00%	17.99%	17.00%	17.92%	18.70%	16.90%
Venture Capital	17.60%	17.60%	15.62%	16.67%	16.48%	16.46%	16.58%
Private Debt	8.00%	7.73%	7.20%	8.34%	9.15%	8.55%	9.57%
Real Estate	11.20%	10.88%	8.95%	10.10%	9.09%	9.10%	9.00%
Real Assets	6.95%	5.70%	8.36%	10.06%	8.05%	11.85%	10.57%
Fund of Funds	12.86%	14.62%	16.33%	17.30%	16.61%	17.69%	16.06%
Secondaries	13.47%	14.70%	12.36%	16.13%	15.99%	16.60%	20.85%

Source: PitchBook.

The Morningstar PitchBook Global Unicorn Index's track record is also worth considering. The index was launched in 2022 with performance backcast to late December 2014 based on a pricing methodology that estimates daily valuations—an inexact science for companies that aren't marked to market. Pricing factors in past deals data, comparable private-company deals, and changes in comparable public-company valuations. As displayed in Exhibit 4, the unicorn index has outperformed the listed private equity index. Annualized returns for the index approached 19%, with the biggest contribution coming in 2021 when the index rose 66%. An important caveat is that unicorns and listed private equity are apples and oranges. The former are the largest VC-backed companies, while the listed private equity index considers companies' investments in private equity and venture capital to select constituents.

Exhibit 4 Morningstar PitchBook Global Unicorn Index: Returns Have Exceeded the Listed Private Equity Index



Source: Morningstar Direct. Gross returns are in USD for Morningstar Indexes.

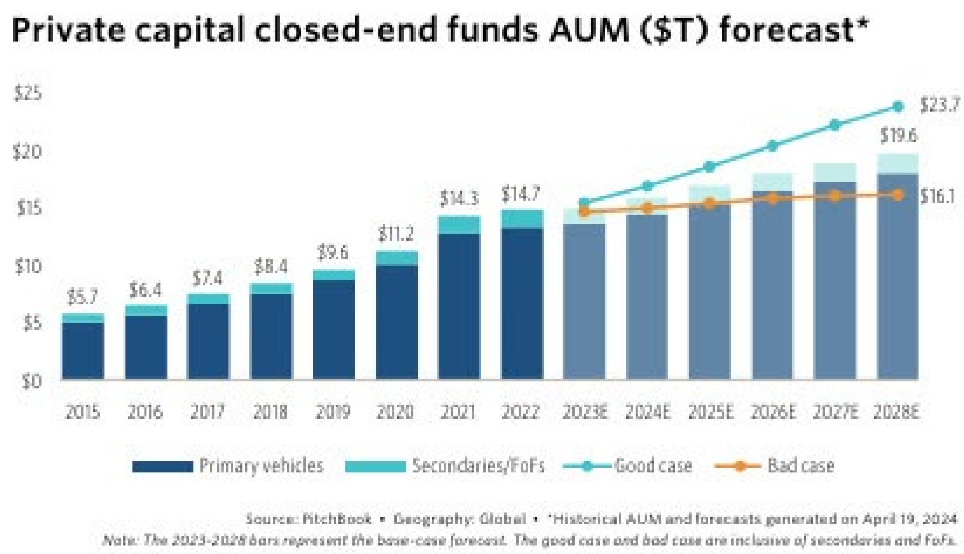
Another, far less encouraging measurement of private company investments was made by Morningstar senior manager research analyst Jack Shannon, who studied mutual funds' ownership stakes in private companies, calculating their returns from the end of 2013 through June 2024.[9] Shannon concluded that "mutual funds would have been better off allocating their private stakes to public markets over the last 10 years." In Shannon's analysis, removing funds' ownership in a single unicorn—SpaceX—would have left their private investments in net negative territory. Clearly, private-market returns are difficult to measure.

What Does the Future Hold?

"There is plenty of room for private fund AUM to expand further," concluded PitchBook in the aforementioned May 2024 report, which models the growth trajectory of private equity, venture capital, real estate, real assets, and private-debt-focused funds. The authors project private capital reaching nearly USD 20 trillion by 2028, with an upside scenario of nearly USD 24 trillion and a downside of USD 16 trillion. The good case and bad case growth trajectories are displayed in Exhibit 5.

9 Shannon, J. Oct 7, 2024. When Will Public and Private Equity Markets Finally Converge? Morningstar.

Exhibit 5 PitchBook Forecasts Global Private Capital Growing to Nearly USD 20 Trillion by 2028



Source: PitchBook.

As seen in the slowdown that started in 2022, private capital growth is nonlinear. Higher borrowing costs have a massive impact on funds employing leverage, as private equity does. It's also important to acknowledge that private and public markets are deeply intertwined. When public equities fall, valuations for private companies sink in tandem. Morningstar’s pricing model for unicorns considers public-market comparables for a reason. IPOs flourished in 2021, a year in which Roblox, Coinbase, and Rivian listed their shares. After the down year of 2022, venture capital activity slowed considerably, with 2023 being the worst year for unicorn creation since 2017. IPO "exits" have yet to rebound.

Cyclical bumps aside, the long-term secular growth story for private markets is strong. "Private-market allocations have become a cornerstone of institutional investors’ portfolios," write the authors of the May 2024 PitchBook report. The "Yale Model"—pioneered by Yale University Endowment manager David Swensen and heavily reliant on private-market investment vehicles—has been widely adopted. "Asset owners" like pensions, endowments, foundations, and sovereign wealth funds don’t mind long lockup periods and lack of daily pricing on their assets.

Meanwhile, efforts are underway to bring private markets to the masses. "Access class" is how private equity and venture capital have been labeled, available only to "qualified" or "accredited" investors. In addition to the mutual funds that Morningstar's Shannon studied, interval funds, exchange-traded funds holding private credit, and “secondaries” platforms aim to democratize private markets. For investors, accessibility to private assets without high fees, illiquidity, and opacity is a plus. For the asset manager, it's a huge opportunity to tap into new assets.

There are risks though. Morningstar's Warren and his equity research colleagues see the publicly traded alternative asset managers as benefiting from narrow moats around their businesses (wide being the most durable competitive advantage), noting that they face risks of competition and continued pressure on fees. Firms like BlackRock, which have traditionally focused on public securities, are upping their involvement in private assets. Mass market accessibility may lead to margin compression. After all, ETFs and interval funds will not be charging fees of 1.75% to 2.00%, which PitchBook says is typical for private equity. Whether higher volumes compensate for lower management fee revenue, only time will tell.

What Does All This Mean for Investors?

The rise of private markets has shrunken the opportunity set for public equities investors. The number of US stocks has fallen from roughly 8,000 in the late 1990s to closer to 4,000 today. Companies are choosing to stay private or go private, with no shortage of capital funding. The median age of a private company has extended from 6.9 years in 2014 to 10.7 years today.

Small-cap equities are where the changes are most evident. The asset class has massively underperformed over the past decade in the US. As displayed in Exhibit 6, the Morningstar US Small Cap Extended Index has posted a cumulative return of 130% since 2014, whereas the broad US equity market is up more than 235%.

Exhibit 6 Small-Cap Equities Have Underperformed. Has Private-Market Growth Come at Their Expense?

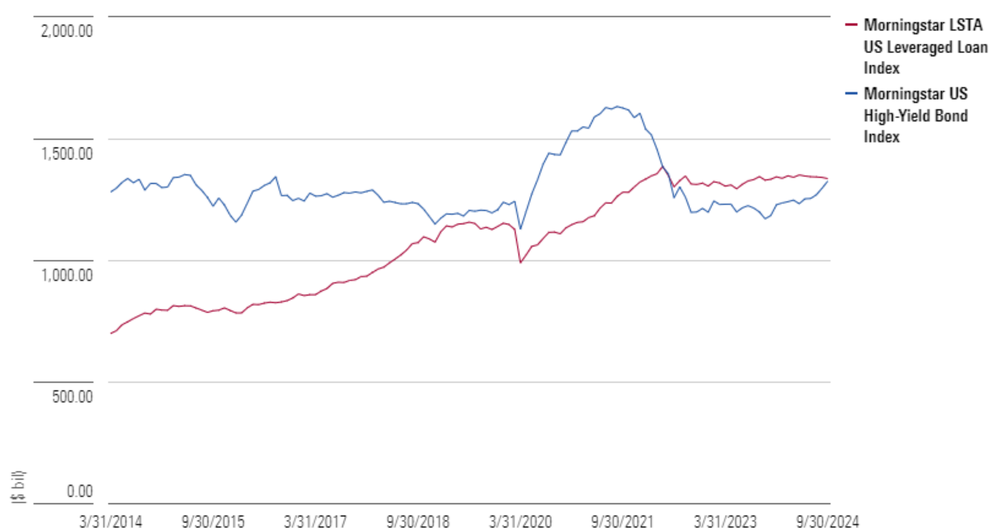
Source: Morningstar Direct. Gross returns are in USD for Morningstar Indexes. Data as of Sept 30, 2024.

Morningstar analyst Zachary Evens wonders whether underperformance can be pinned on companies staying private longer, challenging the notion that today's small caps are tomorrow's large caps.

"For small-cap investors, the worry is that tomorrow's Microsoft may never be a public small-cap company. Many of the most promising young companies now choose to stay private for longer, seeking growth capital from private shareholders instead of entering public markets. As a result, much of their growth accrues as a private firm before they're subject to the scrutiny and regulation that comes with being publicly traded. Uber Technologies went public in 2019 with a valuation of USD 82 billion after 10 years as a private company. Today, its market cap measures around USD 140 billion. Solid growth, but not the sky-high returns many public investors had hoped for." [10]

On the credit side, the line between public and private is blurrier than with equities. That said, private-market growth is impacting fixed income as well. Leveraged loans are one example. Companies backed by private equity represent a large share of the borrowers of syndicated bank loans, just as they do private credit. Loans finance buyouts, acquisitions, recapitalizations, and other transactions. For example, September 2024 saw the largest dividend recapitalization of all time, by Belron, a UK-based provider of auto glass repair.[11] As displayed in Exhibit 7, the Morningstar LSTA US Leveraged Loan Index surpassed its US high-yield bond equivalent in market value.

Exhibit 7 The Leveraged-Loan Asset Class Has Grown, Exceeding the High-Yield Bond Market in the US



Source: Morningstar Direct. US sector indexes' total return is in USD. Data as of Sept. 20, 2024.

As an asset class, leveraged loans have gone from niche to mainstream. Because their coupons are floating-rate in nature, the loans benefit from rising interest rates. Yields surpassed double digits in 2023, though the Federal Reserve rate cut in September 2024 brought them down.

10 Evens, Z. Sept. 17, 2024. Why Bother With Small-Cap ETFs? Morningstar.

11 Lutasky, M. Oct. 3, 2024. Q3 US Leveraged Loan Market Wrap: M&A, Dividend Deals Rise as Fed Pivots. PitchBook.

How Will an Altered Opportunity Set Affect Private-Market Managers?

The opportunity set for investors has shifted. These days, "capital formation" occurs in both public and private markets. The conclusions of a 2018 CFA Institute study[12] still hold true:

"There are benefits to both public and private capital markets, and so the ability to allocate to both is important ... Having increasingly large sections of capital markets being out-of-bounds for pension savers is unlikely to be politically viable or even desirable in the long term ... It is not credible to allow an entire generation of retail investors to be left with only diversified public market exposure to generate retirement returns, while institutional investors crowd into innovative business models that offer potentially higher returns."

A combination of policy and market forces will broaden access to private markets. Whether that expands the asset base and helps private-market managers, or whether it brings fee compression and competition that erodes their margins remains to be seen. What it means for investors is also an open question.

12 Rosov, S. Nov. 26, 2018. Capital Formation: The Evolving Role of Public and Private Markets. CFA Institute.

About Morningstar Indexes

Morningstar Indexes was built to keep up with the evolving needs of investors—and to be a leading-edge advocate for them. Our rich heritage as a transparent, investor-focused leader in data and research uniquely equips us to support individuals, institutions, wealth managers and advisors in navigating investment opportunities across major asset classes, styles, and strategies. From traditional benchmarks and unique IP-driven indexes, to index design, calculation and distribution services, our solutions span an investment landscape as diverse as investors themselves.

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