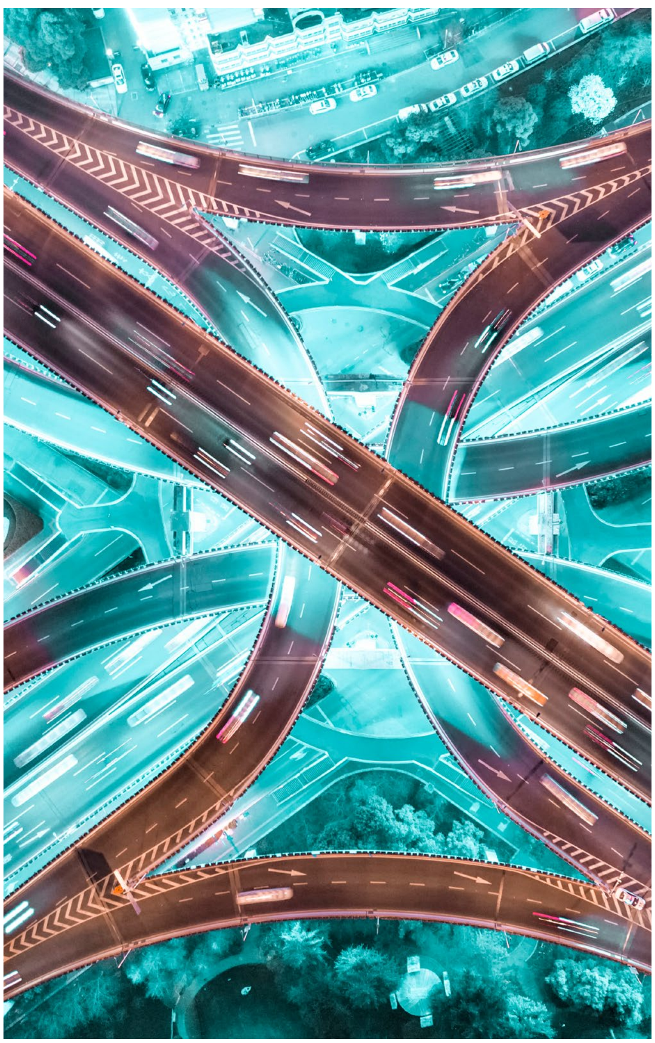
# Private Market Insights

A NEWSLETTER BY FAST

# Why Do I Keep Hearing About Private Equity?

**Co-authors:**
**Carlin Calcaterra,** Principal, Financial Advisor Solutions Team
**Brendan McCurdy,** Managing Director, Financial Advisor Solutions Team



**Today, a broad structural shift is underway, with the private equity market becoming larger, more diverse and more available to companies and investors than ever before.**

Driven by lower costs, less regulation, increased availability of private capital and more flexibility to focus on longer-term growth, corporations are increasingly choosing to forgo public listings. Additionally, given the large consolidation of banks and investment managers, the minimum size of a viable and attractive public deal (which includes both equity and debt) has grown over the years.

As such, the private equity market has increasingly displaced the stock market as the go-to means of financing and accessing the full U.S. economy.

# We believe there are three related takeaways investors should recognize:

### TAKEAWAY #1

Investors indexing their equity exposure are capturing only a tiny, increasingly top-heavy fraction of companies in the U.S. economy.

### TAKEAWAY #2

For investors seeking attractive and durable performance in all types of market conditions, private equity has historically demonstrated superior results.

### TAKEAWAY #3

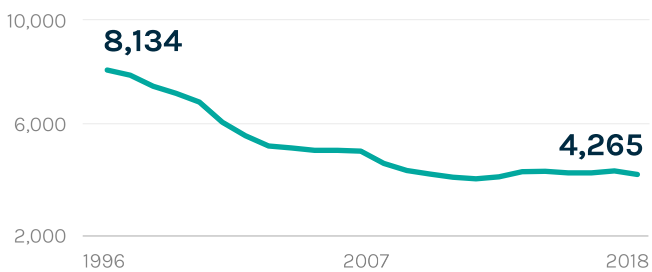
We believe that the strong incentives embedded in private companies create a powerful and sustainable alignment of interests for institutional and private investors alike.

## TAKEAWAY #1

**Investors indexing their equity exposure are capturing only a tiny, increasingly top-heavy fraction of companies in the U.S. economy.**

The opportunity set within public markets is not what it used to be. The number of U.S. publicly traded companies peaked at 8,134 in 1996 and has dropped by nearly half to 4,265 (including to OTC listings).[1]

**Number of U.S. publicly traded companies**



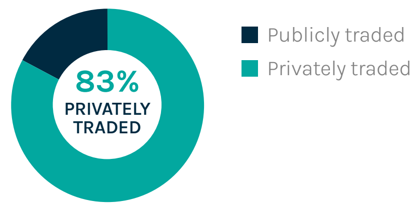

The Wilshire 5000 index, which used to be synonymous with the total U.S. stock market, today has only about 3,600 holdings.[2]

Meanwhile, public equity indices are becoming increasingly top-heavy. Today, the ten largest constituents in the S&P 500 account for approximately one-third of the entire index. And they're nearly all technology companies. So, the diversification benefit of "buying the index" has eroded significantly.

Now compare that to the more than 17,000 large private companies in the United States and approximately 197,000 midsize private companies in the U.S.—companies that are accessed through private equity.[3]

**Number of U.S. large companies**

(500+ employees)




**Number of U.S. moderate/larger companies**

(100+ employees)


**200,000**
U.S. middle-market businesses

**97%**
of which are private

Midsize businesses account for approximately one-third of employment and one-third of output of the U.S. economy. If these companies were their own country, they would be roughly the size of Germany or Japan.[4]

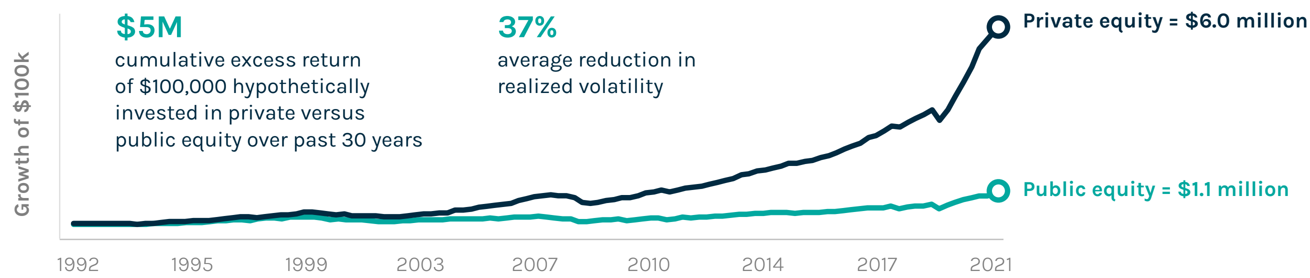
1. Fred St. Louis Fed, US Census Bureau, S&P.
2. Wilshire. As of July 2022. The difference between the Fred St. Louis count and Wilshire count is driven by OTC listings.
3. US Census Bureau. US company count to December 2019, as of July 2022. "Large companies" defined as 500+ employees.
4. National Center for the Middle Market, as of Q2 2022. "Middle market" includes companies with $10 million to $1 billion in revenues.

## TAKEAWAY #2

**For investors seeking attractive and durable equity performance in all types of market conditions, private equity has historically demonstrated superior results.**

As investors, it always comes back to return and risk. Here, we believe private equity has demonstrated its superiority over its public market peers. While there are several types of private equity, we focus here on Buyout, which is the largest and most mature segment.

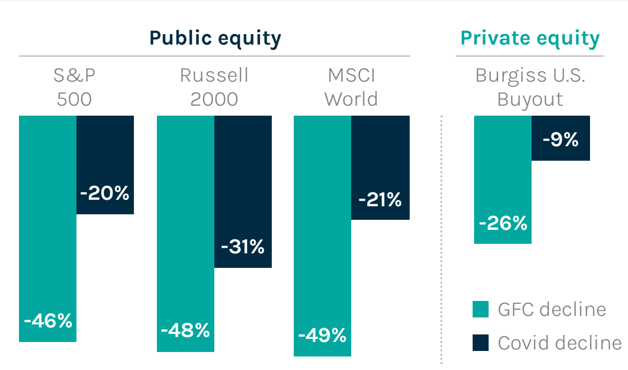
### Historically superior risk-adjusted returns, with higher net returns and less realized volatility

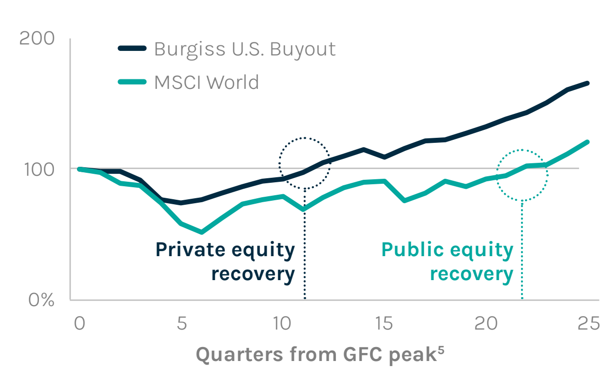



Sources: Bloomberg, Burgiss, Ares. Private equity represented by Burgiss US Buyout and Public Equity represented by MSCI World Index.

### A history of better downside protection, with smaller declines and faster recoveries

Historically milder drawdowns + Historically faster recovery




We believe much of this was driven by fundamentals. For example, during COVID-19, the predominantly private middle-market segment saw revenues decline only one percent versus six percent for the S&P 500. Similarly, employment was down only two percent for these companies versus eight percent for the S&P 500.[6]

History has shown us the superior risk-adjusted return profile of private equity relative to public equity. But can we trust that these dynamics will last? We believe yes.

5. X-axis is measured from the individual peak of each given asset class in order to compare drawdowns and recoveries without delayed timing effects.

6. National Center for the Middle Market, as of Q2 2022. “Middle market” includes companies with $10 million to $1 billion in revenues.

## TAKEAWAY #3

### We believe that the strong incentives embedded in private companies create a powerful and sustainable alignment of interests for institutional and private investors alike.

The three-decade shift toward the private markets has been driven by real, structural benefits to companies in remaining private. Many of these benefits have to do with incentives and alignment of interests that are likely to continue driving these trends. These benefits are typically grouped under four categories:

| Incentives and alignment of interests | | Private companies | Public companies |
|---|---|---|---|
| | **Executive compensation** | • Typically aligned with successful exit of private equity sponsor<br>• Tied to growth in revenue and better operational efficiency **over the next 5-7 years** | • Aligned with market cap (e.g., public market CEO pay is highly correlated to the size of the company)<br>• Tied to growth in company size and share price **over the next 12 months** |
| | **Board membership** | • Typically have significant personal investment<br>• Typically sit on fewer boards<br>• Limited personal liability for regulatory compliance | • Often flat $ compensation<br>• Typically sit on many boards at a time<br>• Personally liable for regulatory compliance |
| | **Board structure** | • Frequent meetings (~12x/year)<br>• Prioritize previous industry and company experience and contribution to value creation | • Infrequent meetings (~4x/year)<br>• Prioritize independence, leading to lack of industry expertise and inability to drive value creation |
| | **Regulation & oversight** | • Lower cost of compliance due to fewer regulations<br>• Long-term value often prioritized over short-term accounting profits | • Executive board structure influenced by industry regulation<br>• Short-term accounting profits often prioritized over long-term value |

Source: Partners Group (https://www.partnersgroup.com/fileadmin/user_upload/Files/sec-download/Research_PDF/2018_Partners_Group_White_Paper_The_Rise_of_Governance_Correctness.pdf) and Ares data

The structure of private companies allows them to focus on longer timeframes and innovative growth, with aligned boards answering to owners (the investors) rather than "The Street." These longer timeframes also tend to align with the longer timeframes of most institutional and individual investors.

Taken together, we believe these reasons create an equal if not stronger long-term value proposition for private equity relative to public equity. This has historically manifested itself in superior risk-adjusted returns that we believe will continue to persist and grow.

# Conclusion

**We expect that private equity will play an increasingly large and important role for both business owners and investors.**

Today, investors have much greater means of investing in private markets than ever before. While institutional investors have invested in the private markets extensively for decades, more and more investment firms are now providing the same access for individuals.

Financial advisors can now incorporate private equity and other private market asset classes into client portfolios—providing fuller access to the broad American economy while tapping into their structural resilience and potential growth.

Individual investors are likely to continue hearing about private markets for a long time to come.

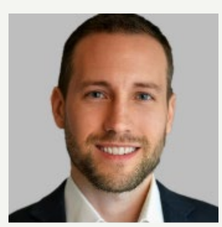
# About the Financial Advisor Solutions Team (FAST)

FAST offers resources and one-on-one support to help navigate the complexities of private markets investing. The team's goal is to empower investors to confidently incorporate private markets investments into portfolios. The educational content, research and analytics that FAST delivers are designed to enhance the understanding of the benefits of private markets investments. FAST is a skilled and knowledgeable team of professionals who can answer questions and foster more informed decisions.

## AWMS Financial Advisor Solutions Team

**Carlin Calcaterra**

PRINCIPAL
Financial Advisor Solutions Team



**Brendan McCurdy**

MANAGING DIRECTOR
Financial Advisor Solutions Team

IMPORTANT INFORMATION:

AccessAres is the thought-leadership and educational division of Ares Wealth Management Solutions. The materials distributed by AccessAres are for informational purposes only and do not constitute investment advice or a recommendation to buy, sell or hold any security, investment strategy or market sector. Ares Wealth Management Solutions is a global brand of Ares Management Corporation.

Investing in private markets investments involves a high degree of risk including, but not limited to:

- Risk of substantial loss of principal. Direct Investments in private companies and investments, involve a high degree of business and financial risk that can result in substantial losses
- Illiquidity risk. Secondaries investments are not listed on any securities exchange and may not be readily liquidated, therefore it may be impossible to get your money back
- Valuation risks. Securities may be valued at prices the seller is unable to obtain upon sale due to factors such as incomplete data, market instability, human error, or no readily available market quotations, and other factors
- Risk related to private companies. Private companies are generally not subject to SEC reporting requirements, are not required to maintain accounting records in accordance with generally accepted accounting principles and are not required to maintain effective internal controls over financial reporting. As a result, there is the risk that investors may invest based on incomplete or inaccurate information, which can adversely affect performance. Private companies may also have limited financial resources, shorter operating histories, more asset concentration risk, narrower product lines and smaller market shares that can make such private companies more vulnerable to competitors' actions and market conditions

Financial advisors must carefully consider the risks and other suitability details in determining appropriate investments for their individual clients' portfolios.

DISCLAIMER

These materials may contain "forward-looking" information that is not purely historical in nature, and such information may include, among other things, projections, forecasts or estimates of cash flows, yields or returns, scenario analyses and proposed or expected portfolio composition. The forward-looking information contained herein is based upon certain assumptions about future events or conditions and is intended only to illustrate hypothetical results under those assumptions (not all of which will be specified herein). Not all relevant events or conditions may have been considered in developing such assumptions. The success or achievement of various results and objectives is dependent upon a multitude of factors, many of which are beyond the control of Ares. No representations are made as to the accuracy of such estimates or projections or that such projections will be realized. Actual events or conditions are unlikely to be consistent with, and may differ materially from, those assumed. Prospective investors should not view the past performance of Ares as indicative of future results. Ares does not undertake any obligation to publicly update or review any forward-looking information, whether as a result of new information, future developments or otherwise.

This may contain information obtained from third parties, including ratings from credit ratings agencies such as Standard & Poor's. Reproduction and distribution of third party content in any form is prohibited except with the prior written permission of the related third party. Third party content providers do not guarantee the accuracy, completeness, timeliness or availability of any information, including ratings, and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such content. THIRD PARTY CONTENT PROVIDERS GIVE NO EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. THIRD PARTY CONTENT PROVIDERS SHALL NOT BE LIABLE FOR ANY DIRECT, INDIRECT, INCIDENTAL, EXEMPLARY, COMPENSATORY, PUNITIVE, SPECIAL OR CONSEQUENTIAL DAMAGES, COSTS, EXPENSES, LEGAL FEES, OR LOSSES (INCLUDING LOST INCOME OR PROFITS AND OPPORTUNITY COSTS OR LOSSES CAUSED BY NEGLIGENCE) IN CONNECTION WITH ANY USE OF THEIR CONTENT, INCLUDING RATINGS. Credit ratings are statements of opinions and are not statements of fact or recommendations to purchase, hold or sell securities. They do not address the suitability of securities or the suitability of securities for investment purposes, and should not be relied on as investment advice.

REF: AM-02351