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Investing in private vs public equity – can you have the best of both worlds?

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Private equity investments are becoming an increasingly mainstream component of a balanced investment portfolio, providing valuable diversification benefits to "traditional" listed equities and bonds. However, the downsides to private equity include the lack of liquidity and the significant capital required to acquire control of a company.

Listed equity investments have long been used in client portfolios, providing daily pricing and liquidity for investors, however depending on the strategy employed (active or passive) returns are largely dependent on a manager picking the right stocks or the broader direction of the market rather than specific skill and involvement of the manager in its portfolio companies.

In this article we outline the key differences between investing in listed and private equities and consider opportunities to leverage the advantages of both investment strategies.

Private Equity Investing:

Private equity investing typically involves buying a significant stake in a company with the goal of improving its value through operational improvements, cost-cutting, or other measures. Private equity investors may acquire privately owned companies or seek to take-private publicly listed companies – requiring a control premium to be paid to selling shareholders.

Key attributes of private equity investing:

Portfolio concentration	Funds typically hold concentrated portfolios.
Control and investor involvement	Private equity managers typically have voting control of portfolio companies, allowing them to direct strategic planning decisions and drive value creation.
Risk and return	Typically exhibit a high degree of risk, due to illiquidity and use of leverage – as a result investors should expect higher returns over the long term.
Investment process	Long time frames for sourcing, evaluation and execution of appropriate investments due to less transparency in the opportunity set and a requirement to undertake due diligence on companies that may have less curated information available.
Investment horizon and liquidity	Dictated by fund term (generally 7 – 10 years) – which tends to drive a 'buy to sell' investment strategy. Companies that are owned need an event (listing) or to be sold to another interested buyer (often a larger PE fund) to realise the investment which can take time.
Manager capability	Manager capability in identifying attractive investment opportunities and skill in unlocking value portfolio companies is a key driver of returns for investors.

Traditional Listed Equity Investing

In contrast, traditional listed equity investing provides a different set of advantages and drawbacks:

Portfolio concentration	A traditional listed equities manager typically holds a diverse portfolio of small shareholdings in 30-50+ names.
Control and investor involvement	Generally limited to voting at shareholder meetings, with limited input on strategic decision making.
Risk and return	Although higher risk than bonds or cash, a diversified public equity fund is typically lower risk over the long term than private equity – however is exposed to potentially greater volatility over the short term due to the highly liquid nature of public equities, which may be impacted by market "noise" outside of the control of the investee companies. Expected returns over the long term are generally lower than private equity and are typically benchmarked to an index rather than focused on absolute returns.
Investment process	Investment decision making can occur quickly given good availability of information and liquid trading markets.
Investment horizon and liquidity	Depending on the manager's strategy, hold period of underlying equities can be as short as a number of days or as long as 5 years– and funds typically allow for daily redemptions.
Manager capability	Where an active strategy is pursued, manager capability in identifying attractive investment opportunities is a key driver of returns for investors – however this return is often driven by factors out of the control of the manager. Additionally the manager generally does not seek to apply their expertise to drive value within the investee companies themselves.

Proactive Management – the HMC Capital approach:

Proactive management is a form of "activism" and involves buying a significant stake in a company with the goal of influencing the company's management and strategic decisions. Proactive management may seek to improve the company's financial performance, governance practices, and overall value through the expertise and efforts of the investment team. Over the long term, this approach seeks to generate strong, positive risk adjusted returns – that are uncorrelated to the broader equity market.

The HMC Capital Partners strategy seeks to take the best of both private equity investing and traditional listed equity investing – resulting in a high conviction, proactive management approach.

For further explanation on how our approach differs from traditional stock picking, see our article Stockpicking vs Proactive Management – What's the difference?

In conclusion, HMC Capital's proactive management approach and private equity investing share similarities in their focus on creating value, long-term investment horizons, absolute returns and active involvement in companies. However, given the underlying investments in listed equities rather than private companies, each style of investment is exposed to different risks and hence have unique roles to play in an investment portfolio.

Refer to the relevant PDS, TMD or Information Memorandum available at www.hmccapital.com.au for further information.

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