

Liquid Alternative to Private Equity

Stockholm (HedgeNordic) – One of the trends seen in the past decade has been investors falling in love with private markets. Whereas private equity returns have outperformed public markets over the long term, the private equity asset class does not offer investors the ability to buy and, more importantly for some, sell at a moment's notice.

OPM Listed Private Equity, managed by Tom Berggren – who acted as managing director of the Swedish private equity association for ten years, offers investors the opportunity to earn the juicy returns associated with private equity and access the much-needed liquidity. “By launching our fund ten years ago, we sought to offer liquidity for those investors who wanted to invest in private equity but needed more liquidity,” explains Berggren. “Bringing the returns of private equity to investors in a daily format, that is what we do in a nutshell.” OPM Listed Private Equity brings the private equity returns to investors by investing in publicly-listed private equity firms rather than investing in private businesses themselves.

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OPM's Approach Versus Traditional Private Equity Approach

OPM Listed Private Equity operates as a long-only equity fund that invests in listed private equity firms around the globe. Large institutional investors such as pension funds could and do invest in private equity directly, but this traditional approach of investing in private equity might not outclass OPM Listed Private Equity, according to Berggren. The traditional approach comes with the so-called J-Curve, which represents the tendency of private equity funds to post negative returns in the initial years and then delivering increasing returns later on as underlying investments mature.

“Large investors could invest in big successful private equity managers of the sort we like, but then you face the J-Curve,” says Berggren. “You commit the capital, and you have the money waiting until private equity managers find something interesting to invest in,” explains the portfolio manager. With OPM Listed Private Equity investing in public equities and being almost fully invested at all times, “investors can skip the J-curve.” Interestingly enough, OPM Listed Private Equity managed to outperform the traditional private equity portfolios managed by some of the largest Swedish pension funds in the recent past.

Berggren finds two reasons for the outperformance, one of which involves the spot-on selection of private equity managers. “We have been good at choosing the right companies and private equity managers,” emphasizes Berggren. In addition, by investing in public markets, OPM Listed Private Equity gets a piece of each public private equity firm the fund is invested in. This enables OPM to earn money from the management and performance fees those private equity managers collect on the assets they oversee. “As an owner of public private equity firms, we benefit extra,” explains Berggren. “With the underlying funds managed by private equity players getting bigger and bigger, management companies become an attractive investment as well.”

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The fondness for private equity among institutional investors comes down to steady and strong returns, as well as low volatility. Investors in OPM Listed Private Equity, however, should stomach some volatility in order to achieve private equity-like returns over the long term. “In the long term, our fund’s returns should be similar to the returns generated by traditional private equity players,” says Berggren. “Shorter term, however,” notes the portfolio manager, “we have more volatility due to market exposure.” For long-term investors, the higher volatility makes no big difference, argues Berggren. In fact, volatility is welcome and very convenient to investors, he explains, because “private equity managers tend to make very good investments when stock prices go down across the board.”

Portfolio Composition

From a universe of around 300 listed private equity firms, OPM Listed Private Equity builds and maintains a portfolio of between 30 and 40 names. As Berggren explains, “the universe contains companies that have the majority of their investments in unlisted companies and employ an active ownership approach.” Some companies in the universe include American private equity firms such as Blackstone and Apollo Global Management, Swedish investment company Investor AB, and even Warren Buffet’s Berkshire Hathaway, which owns a fair share of private companies.

OPM Listed Private Equity’s portfolio can be broken down into three smaller pieces: direct private equity funds; funds of private equity funds; and, thirdly, investment companies. Using an approach of buying and developing value assets, Aurelius Group, often referred to as the German Berkshire Hathaway, represents an example of a direct private equity fund. Berkshire Hathaway, meanwhile, fits in the “investment company” bucket. “We include Berkshire Hathaway in our universe because they are active owners in a way, as they own quite a bit of unlisted companies,” explains Berggren. “The reason behind allocating to investment companies is to keep costs down and Berkshire is the number one example of a low-cost investment company.” HarbourVest Global Private Equity and others, meanwhile, use a fund of funds structure to invest in external private equity funds.

Despite the three categories exhibiting subtle differences, all holdings owned by OPM Listed Private Equity seek to create value by allocating capital to private companies. To build their portfolio of public private equity firms, Berggren and the team “look for very experienced fund managers with long track records.” The evaluation process relies on both qualitative and quantitative analysis, which help OPM’s private equity team to understand the quality of the capital allocators at each firm. “We try to assess if the managers add any real contribution as active owners,” emphasizes Berggren, “which many of them do nowadays.” The portfolio manager, however, tries to avoid financial engineers.

“When analyzing a huge private equity player, we cannot look into every single underlying investment that had been made,” says Berggren. Instead, “we look at the big picture and try to get a good understanding of how managers are doing.” OPM Listed Private Equity’s allocation process depends on two main factors. “Firstly, the allocation depends on our view of how good the managers are at allocating capital, and secondly, on the valuation of the company relative to other global companies.” All in all, “really good managers and attractive valuations is what we look for,” emphasizes Berggren.

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Large U.S. listed private equity firms are often considered “perpetually undervalued,” as investors and analysts arguably misunderstand the variable cash flows innate to private equity. “In the United States, the cash flows from fixed management fees are assigned a price-to-earnings of around 18, for instance, and then the carried interest or the potential performance fees get a PE of one, two or three,” says Berggren. “Private equity managers may be very upset that their valuations are so low, but we have no problem with that as long as managers keep delivering and beating expectations.”

10-Year Anniversary

Launched in October of 2009, OPM Listed Private Equity reached its ten-year anniversary this October. The fund’s institutional share class delivered an annualized return of 16 percent, whereas the more common share class returned around 15 percent per year over the same period. OPM Listed Private Equity is up 40.9 percent year-to-date through the end of September, having beaten broader equity markets with a handy margin. “Lower interest rates and some American companies changing from being a limited partnership to being a corporation helped us a little bit extra this year,” smiles Berggren. The corporation structure is expected to attract more capital from exchange-traded funds, other vehicles and investors.

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“We enjoy the power of compounding,” comments Berggren on the fund’s anniversary. “We made four times the money in ten years and we hope this compounding machine will continue to work,” he adds. “We hope to keep delivering high returns, which should not be that difficult because private equity has done that since the 1970s,” notes the portfolio manager. Berggren hopes that one Swedish krona invested in early October of 2009 will become 8 kroner five years from now and 16 kroner ten years from now. The beauty of compounding at its best.

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