iCapital

European Private Equity's Outsized Edge Over Public Markets

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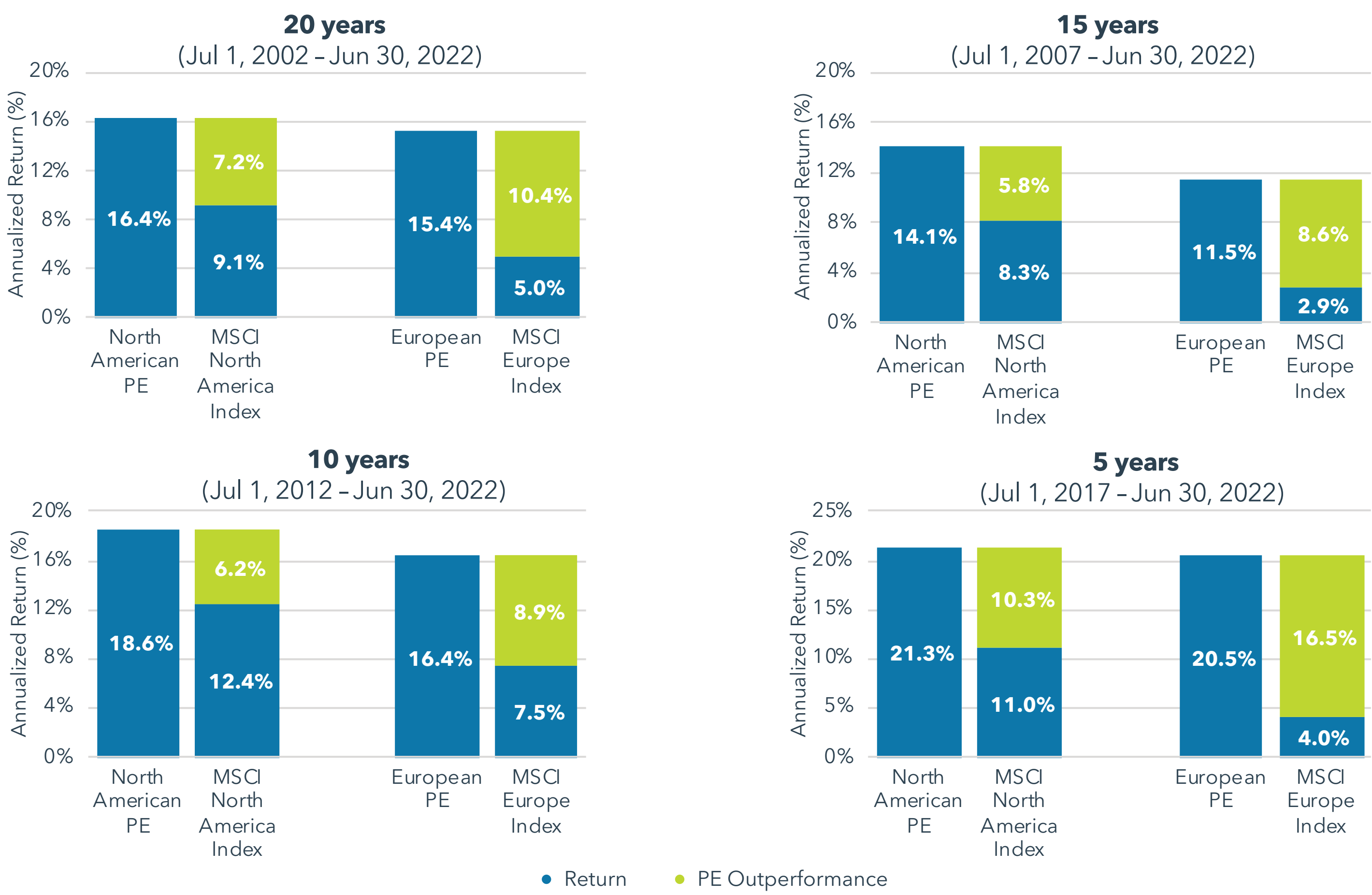
A lot has been written about the illiquidity premium and the additional return potential that can be achieved by allocating part of an investor's portfolio to private assets. But is private markets' outperformance over public indices comparable across different regions, or should investors proactively diversify their geographical exposure to further increase their return potential? Our analysis suggests that investors should consider an even more aggressive equity allocation to private markets over public markets in Europe than in North America.

When building exposure to private assets, investors globally have traditionally allocated the majority of their portfolios to the North American region, which continues to account for approximately 60% of total capital commitments by high-net-worth individuals (HNWI), compared to lower double-digit percentage exposure to Europe.[1]

Investing in Europe is often pervaded by the somewhat negative narrative about slower growth leading to lower expected returns, which, in public markets may be true. For the 20-year period ended June 30, 2022, North American public equity indices have substantially outperformed their European peers. The MSCI North America Index has returned an annualized 9.1%, almost double the 5.0% posted by the MSCI Europe Index[2] (see Exhibit 1). In the last five years, which saw mostly uninterrupted market growth to year-end 2021, followed by six months of market correction in the first half of 2022, the outperformance of North American public markets over Europe has been even larger, with the MSCI North America Index generating an annualized 11% return, compared to 4% for the MSCI Europe Index.

However, the data reflects a completely different narrative in the private markets. Private equity funds in North America and in Europe have generated somewhat comparable annualized returns, 16.4% and 15.4%, respectively, per annum over the last 20 years.[3]

Exhibit 1: Public and Private Equity (PE) Returns in North America and Europe



Source: PitchBook, MSCI, as of June 30, 2022. PitchBook Benchmark Private Equity North America is used for North American PE returns; PitchBook Benchmark Private Equity Europe is used for European PE returns. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

These figures suggest that over the last 20 years, European private equity funds have outperformed the region's public indices by an annualized 10.4%, while North American PE has generated a premium over public equity markets of 7.2% per annum. Investors would have benefitted from private equity's illiquidity premium over public markets in both regions, with Europe generating a consistently greater return premium than North America over five, 10, 15, and 20 years.[4]

While it is valuable to compare the performance of public and private equity markets in North America and Europe across various time horizons, we also can use portfolio modeling to understand how the premium from European private equity could have improved portfolio outcomes. To do so, we created and analyzed the performance of three model portfolios representative of three different hypothetical equity allocations (Exhibit 2).[5]

PORTFOLIO A:
PUBLIC EQUITY (NORTH AMERICA AND EUROPE)

- Public equity-only portfolio with a pro rata allocation based on relative market capitalizations to MSCI North America Index (79%) and the MSCI Europe Index (21%).[6]

PORTFOLIO B:
PUBLIC EQUITY (NORTH AMERICA AND EUROPE) WITH NORTH AMERICAN PE

- One-third equity allocation to North American PE, funded pro rata from the public equity allocations in Portfolio A, resulting in a Portfolio B comprised of 53% MSCI North America Index, 33% North American PE, and 14% MSCI Europe Index.

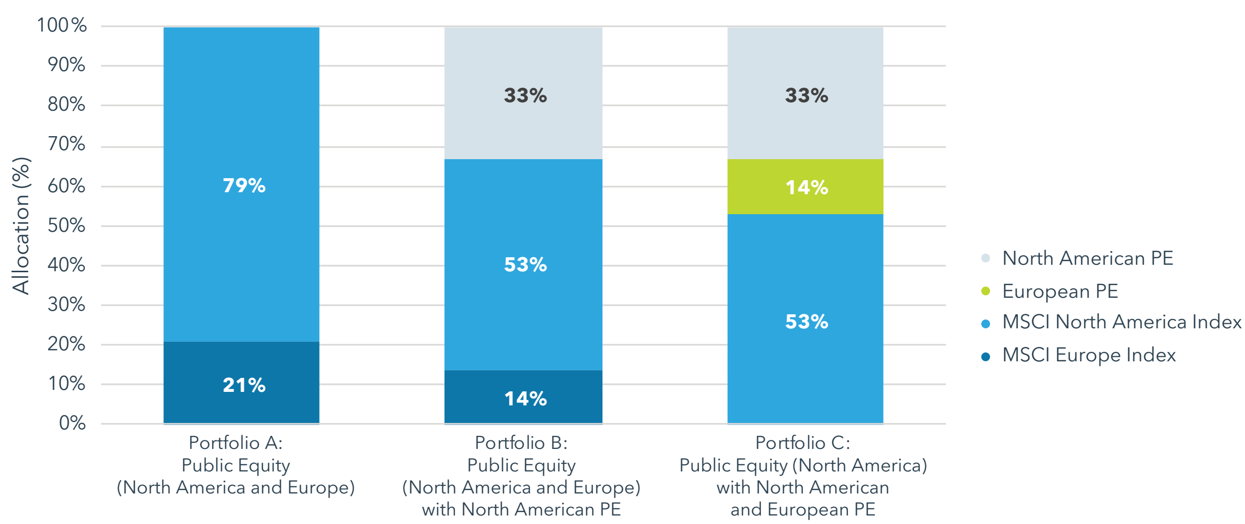
PORTFOLIO C:
PUBLIC EQUITY (NORTH AMERICA) WITH NORTH AMERICAN AND EUROPEAN PE

- The European public equity allocation is fully utilized to reallocate to the European PE allocation. Portfolio C consists of 53% MSCI North America Index, 33% North American PE, and 14% European PE.

Portfolio A serves as the benchmark portfolio, while Portfolios B and C demonstrate the impact on returns of adding both North American and European private equity to a portfolio.

As Exhibit 3 shows, an investment of $1 million at the end of 2001 would have generated over $9.9 million in Portfolio C over the 20-year period. This is over $5 million

Exhibit 2: Model Portfolios with Hypothetical Equity Allocations



Source: iCapital, as of January 2023. PitchBook Benchmark Private Equity North America is used for North American PE; PitchBook Benchmark Private Equity Europe is used for European PE returns. For illustrative purposes only.

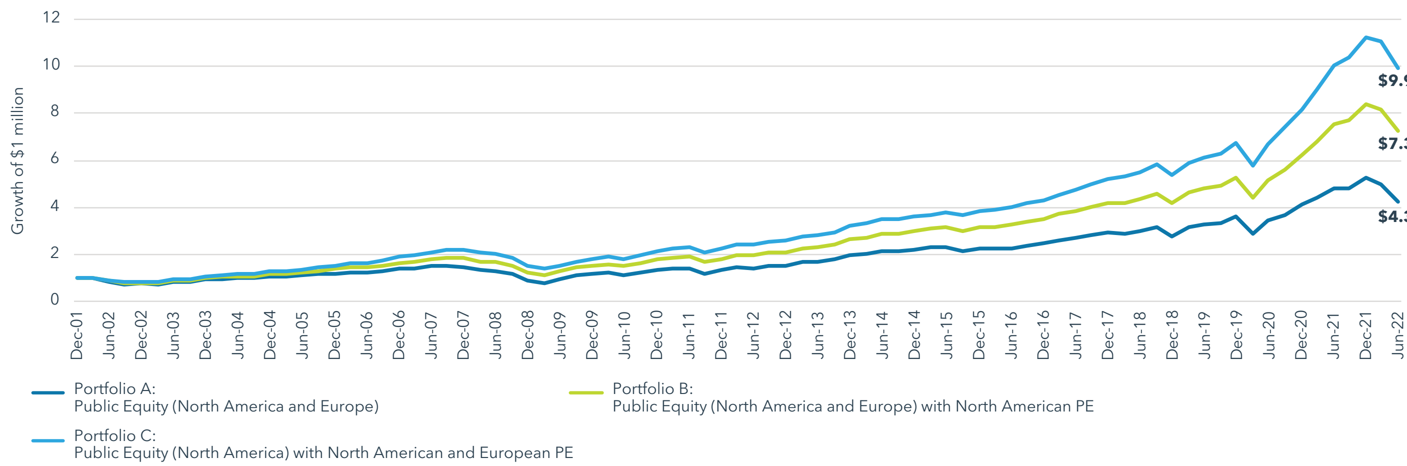
more than the public equity-only Portfolio A generated, demonstrating the advantage of adding an allocation to European PE and reducing exposure to the continent's public markets. Furthermore, the shift to European PE (demonstrated in Portfolio C) would have resulted in 36.8% cumulative higher growth than Portfolio B, which has a one-third allocation to North American PE but none to Europe.

Moreover, looking across five, 10, 15, and 20 year time horizons, Portfolio C, lifted by its European PE exposure, would have consistently generated higher returns than Portfolios A and B (see Exhibits 3 and 4).

Just as importantly, the shift from European public equity to European PE simultaneously reduced volatility across

Exhibit 3: Growth of $1M: Model Portfolio Allocations

(Q4 2001 – Q2 2022)



Source: iCapital, based on quarterly index data from PitchBook and MSCI, as of June 30, 2022. PitchBook Benchmark Private Equity North America is used for North American PE returns; PitchBook Benchmark Private Equity Europe is used for European PE returns. Performance includes quarterly rebalancing. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

Exhibit 4: Performance Metrics across Model Portfolios

	Time Horizon			
	20 years	15 years	10 years	5 years
Return (Annualized Average Compound Return)				
Portfolio A Public Equity (North America and Europe)	8.3	7.2	11.5	9.6
Portfolio B Public Equity (North America and Europe) with North American PE	11.1	9.6	14.0	13.6
Portfolio C Public Equity (North America) with North American and European PE	12.6	10.9	15.2	16.0
Volatility (Annualized Standard Deviation)				
Portfolio A Public Equity (North America and Europe)	16.7	17.6	14.9	19.9
Portfolio B Public Equity (North America and Europe) with North American PE	13.5	14.1	12.0	16.2
Portfolio C Public Equity (North America) with North American and European PE	12.6	13.2	11.2	15.3

*Source: iCapital, based on quarterly index data from PitchBook and MSCI, as of June 30, 2022. PitchBook Benchmark Private Equity North America is used for North American PE returns; PitchBook Benchmark Private Equity Europe is used for European PE returns. Performance includes quarterly rebalancing. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed. *The Sharpe Ratio is a measure of the risk-adjusted return (or return per unit of excess risk assumed) of a security or portfolio. It is calculated by looking at the standard deviation of returns relative to the performance of a risk-free asset.*

these time horizons (Exhibit 4). While volatility and risk are not necessarily the same thing – the former is simply a measure of the magnitude of movements in both directions over time – lower volatility often contributes to a reduction in measures of risk, such as drawdowns or maximum loss.

Our analysis suggests that investors could further increase their return potential by diversifying private equity exposure across geographical regions. Specifically, the historical data indicates that the return premium generated by European private equity over the MSCI Europe Index is greater than the return premium generated by North American private equity over the MSCI North America Index. As such, there is value to be gained by investing in European private equity, especially if such a commitment is funded out of an investor's allocation to the region's public markets.

END NOTES

1. Source: "The Future is Private. Unlocking the Art of Private Equity in Wealth Management." A collaboration between BCG and iCapital, March 2022.
2. Source: PitchBook, MSCI, as of June 30, 2022. PitchBook Benchmark Private Equity North America is used for North American PE returns; PitchBook Benchmark Private Equity Europe is used for European PE returns. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.
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4. Source: PitchBook, MSCI, as of June 30, 2022. PitchBook Benchmark Private Equity North America is used for North American PE returns; PitchBook Benchmark Private Equity Europe is used for European PE returns. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.
5. Please note, the model portfolios are used to demonstrate differences between portfolios and are for illustrative purposes only.
6. Pro rata allocation based on relative market capitalizations in USD of the two indices as of Jan. 31, 2023.

INDEX DEFINITIONS

PitchBook Benchmark Private Equity North America: Consists of those funds within PitchBook's database that are categorized as North American and fall within one of the following private equity categories: buyout, growth/expansion, mezzanine, restructuring/turnaround, and diversified PE.

PitchBook Benchmark Private Equity Europe: Consists of those funds within PitchBook's database that are categorized as European and fall within one of the following private equity categories: buyout, growth/expansion, mezzanine, restructuring/turnaround, and diversified PE.

MSCI North America Index: Measures the performance of the large and mid-cap segments of the U.S. and Canada markets. With 713 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.S. and Canada.

MSCI Europe Index: Captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe. With 425 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

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