

Private Equity Returns: Is there really a Benefit of low Co-movement with Public Equity Markets? *

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Abstract

In this paper we show how cross-sectional correlations between Private Equity (PE) and Public Market Equity (PM) returns can be approximated, resolving the lack of time series PE data. Based on a sample comprising 2,380 realized PE projects, we observe low cross-sectional correlations between PE and stock index returns (e.g. 0.18 for Nasdaq Composite Index). Despite overall low correlations, we find that investor can not benefit from a diversification effect when they really need it - during times of low PM returns. We point out differences between early and later stage PE investments regarding hedging capabilities against bearish stock market conditions, triggered by distinct valuation approaches and exit channels. In contrast to early stage investors, later stage investors price projects based on fundamental information and are less dependent on IPOs as exit channel. We find significant statistical evidence for the negative correlation between early stage investments and excess returns over PM in bearish stock market conditions. Later stage investments exhibit a significant positive relation with excess returns over low PM returns. The conflict of objectives for Venture funds between active market timing and smoothing of PM returns is resolved in favor of active market timing. Buyout funds' returns are less dependent on PM developments and are thus the better complement for PM portfolios if investors seek diversification.

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