To earn a premium, illiquidity must have a cost

Advocates of large allocations to private equity often discuss the concept of an illiquidity premium. Investors willing to lock up their capital for long periods of time, the logic goes, should earn a premium return for their patience.

But that illiquidity comes at a cost. An investor wishing to exit their illiquid private investments has to sell at an illiquidity discount in the secondary market.

The size of these discounts varies over time and across assets. Yale recently sold a cherry-picked portion of its private equity portfolio at a reported ~10% discount, and Jefferies reports average discounts of around that amount. In London, however, listed private equity investments trade at a 30% discount.
Today, allocators tend to value their private equity portfolios at NAV, ignoring these illiquidity discounts. The true mark-to-market of an asset is what you could sell it for today, so incorporating some discount into private markets valuations—and thus private market performance calculations—seems a no-brainer.

What's striking, however, is the extent to which incorporating such a discount would change our views of private equity performance. Figure 1 compares the Cambridge Associates private equity index to what the figures would look like incorporating a 10% illiquidity discount.

Figure 1: Cambridge Associates Private Equity Returns vs. 10% NAV Discount

	@ NAV			**@ 10% Discount**		
	CA PE Index	Russell 3000	ACWI	CA PE Index	Russell 3000	ACWI
3-year	5.7%	11.3%	9.8%	2.0%	11.3%	9.8%
5-year	16.5%	15.6%	13.2%	14.0%	15.6%	13.2%
10-year	15.3%	13.1%	10.5%	14.0%	13.1%	10.5%
15-year	16.4%	14.2%	10.5%	15.6%	14.2%	10.5%
20-year	14.5%	10.8%	8.9%	13.9%	10.8%	8.9%

Source: Cambridge Associates, Verdad

Here we see private equity has underperformed the Russell 3000 over the trailing three years on a NAV basis but outperformed at every other horizon. But incorporating a 10% discount, private equity has underperformed at a three- and five-year horizon.

The figures look even worse at a 20% or 30% discount, where the London-listed funds trade.

Figure 2: Private Equity Returns at 20% and 30% NAV Discount

	@ 20% Discount			@ 30% Discount		
	CA PE Index	Russell 3000	ACWI	CA PE Index	Russell 3000	ACWI
3-year	-1.9%	11.3%	9.8%	-6.2%	11.3%	9.8%
5-year	11.4%	15.6%	13.2%	8.4%	15.6%	13.2%
10-year	12.7%	13.1%	10.5%	11.2%	13.1%	10.5%
15-year	14.7%	14.2%	10.5%	13.7%	14.2%	10.5%
20-year	13.3%	10.8%	8.9%	12.5%	10.8%	8.9%

Source: Cambridge Associates, Verdad

At a 20% discount, private equity has underperformed through a 10-year horizon, and at a 30% discount through a 15-year horizon.

At a 15-year horizon, private equity has outperformed public equities somewhere between 0.5% underperformance and 2.2% outperformance. At a 20-year horizon, private equity has outperformed public equities somewhere between 1.7% per year and 3.8% per year.

Beauty in private markets is in the eye of the beholder, specifically in the extent to which LPs incorporate a mark-to-market discount that reflects pricing in the secondary markets or on the London exchange.

Most allocators with substantial private equity allocations likely underwrote greater outperformance than these trailing numbers would suggest, particularly when incorporating an illiquidity discount.