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Evergreen Private Equity Funds

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Evergreen private equity (PE) funds, also known as open-end or semiliquid PE funds, offer investors access to private equity assets in an efficient and diversified manner. In contrast to drawdown PE funds, evergreen PE funds are SEC-registered under the Investment Company Act of 1940, which may provide a range of benefits for investors, such as lower investment minimums, immediate capital deployment and the potential to redeem capital with certain limitations. In addition, open-end PE funds allow investors more flexibility to initiate or augment their PE portfolios. Drawdown PE funds, on the other hand, typically require investors to commit capital upfront. The capital is then drawn down over a period of time as the fund secures investments. This drawdown process can span several years, during which investors may have limited liquidity options. While the open-end space is still maturing, the number of PE managers offering evergreen funds has rapidly proliferated, warranting a deeper examination.

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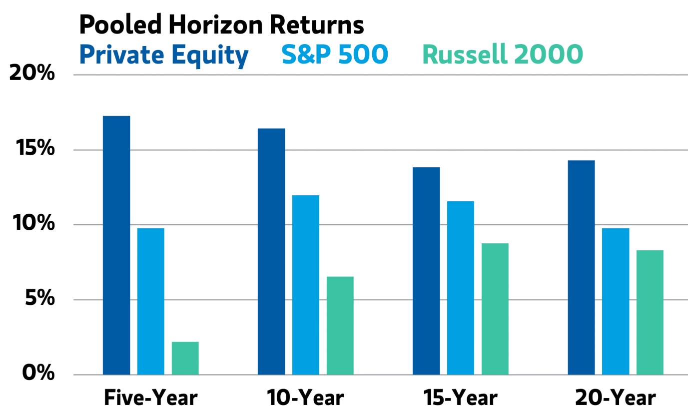
Why Private Equity?

Historically, private equity and the broader alternative investment universe were largely reserved for institutional investors, such as endowments, pension plans, foundations and other large allocators. The benefits of private investments as part of modern portfolio theory led to further adoption and increased allocations from institutions to the alternative asset class. Individuals needed wealth levels resembling those of small institutions to access the same kinds of opportunities.

The ability to generate strong long-term, uncorrelated returns and to access a larger investable universe continues to be PE's main attractions for investors. Though PE's historical return profile is attractive, these investments come with added risks in the form of leverage and illiquidity. In addition, PE has consistently outperformed public markets, namely, the S&P 500 Index and Russell 2000 Index, across many market cycles (see Exhibit 1).

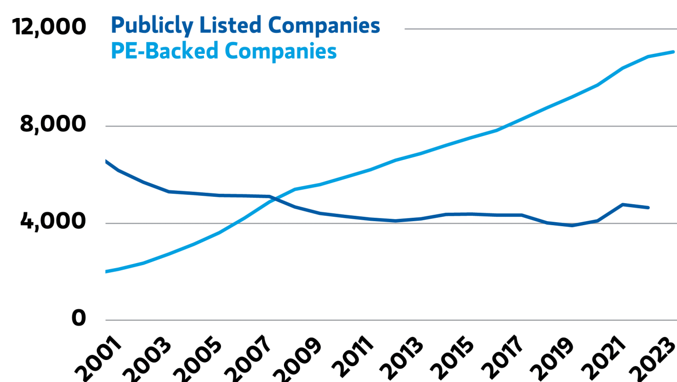
Exhibit 1: PE Has Generated an Attractive Return Profile on an Absolute and Relative Basis



Note: Private equity includes buyout, growth equity and venture capital. Net annualized internal rates of return from inception to Dec. 31, 2023. Russell 2000 is an mPME index (modified public market equivalent).
Source: Cambridge Associates as of Dec. 30, 2023

Private equity's performance is partially attributable to strong deal flow driven by a large and growing opportunity set. Notably, there are more than twice as many US PE-backed private companies (businesses that have received investment from a PE firm) than publicly listed US companies, the number of which has been steadily declining since peaking in 1996 (see Exhibit 2). Parts of the public equity universe are also highly concentrated, as exemplified by the fact that the seven largest stocks in the S&P 500 account for 24.2% of the index and contributed 60.9% of its 2023 total return. Alternatively, within the large investable universe of private companies, PE can offer a wide array of return profiles from different types of companies via substrategies, such as venture capital, growth equity, buyout and others. As a result of this diversification, the divergence of opportunities that can drive performance for private companies is much greater than it is for public equities, providing a rich environment for active management. In addition, PE's value-creation "playbook" has more pages than the public equity playbook. That is, PE managers are more likely to be in control situations—where they can drive improvement in their portfolio companies—than is the case with public equities, which tend to require greater investor reliance on existing management teams.

Exhibit 2: Amid a Diverging Number of Private and Public Companies, the Overall Opportunity Set Has Grown



Note: Publicly listed companies are all US companies listed on stock exchanges. PE-backed deal sizes typically range from $25 million to $1 billion. However, they can vary widely, with some deals involving smaller companies and others involving much larger companies.
Source: PitchBook as of Sept. 30, 2023; World Bank as of Dec. 31, 2022

Given PE's expanding opportunity set and historical outperformance of public markets, large wealth management firms and registered investment advisors (RIAs) have been motivated to bring PE and alternative investment opportunities to high net worth individuals. Furthermore, as penetration of the institutional investor community proceeds, large alternative investment managers are focusing their fundraising efforts on the underpenetrated wealth management market, which is estimated to hold approximately $44.8 trillion of assets, according to McKinsey & Co.[1] Potential growth for alternative asset managers from this area, coupled with increased demand from individuals, has spurred further democratization of PE, mainly in the form of evergreen funds. These semiliquid products are now gaining more recognition, as bigger firms that were early movers in the space have reached scalable points where they can make these offerings available to a larger investor set. PE firms have also narrowed the gap in quality and cost relative to institutional products and funds. Consequently, these products can add value to both individuals and institutional portfolios.

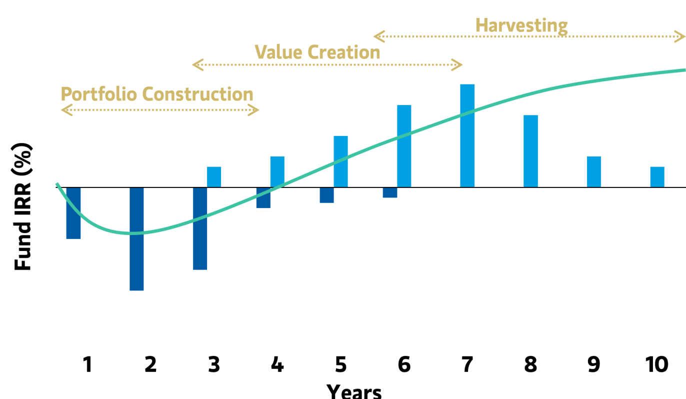
Please refer to important information, disclosures and qualifications at the end of this material.

Benefits of Investing in Evergreen Private Equity

For individual and institutional investors alike, there are a number of advantages to investing in evergreen private equity funds versus traditional drawdown funds, including the following.

Immediate capital deployment and diversified exposure. Evergreen PE affords investors the ability to immediately scale their exposure to the asset class. Rather than invest in drawdown vehicles that may take years to fully deploy and distribute capital, evergreen PE allows investors to build their PE exposure quickly, with the potential to experience only a minimal "J-curve" compared to that of the typical drawdown vehicle (see Exhibit 3). Additionally, investors in evergreen PE funds will typically be allocating capital to a portfolio comprising a diversified pool of companies or funds to which allocations have been directed over multiple vintage years.

Exhibit 3: J-Curve: Hypothetical Cash Flows of a PE Fund Over Time



Note: Exhibit is a hypothetical illustration of a J-curve. J-curve refers to a J-shaped section of a time-series graph in which the curve falls into negative territory and then gradually rises to a higher level than before the decline.
Source: Morgan Stanley Wealth Management Global Investment Manager Analysis (GIMA)

Potential for favorable relative returns versus public equities. Fully scaled evergreen PE equity funds are designed to capitalize on the expanding PE opportunity set, including the ability to potentially outperform public markets while also capturing a portion of the upside that drawdown PE funds offer. Additional incremental returns may be achieved through higher risk/reward substrategies, such as growth equity and venture capital. Overall, these products will still seek to offer competitive returns while factoring in potential performance drags that come with offering limited liquidity.

Ease of administration. Managing the administration of a PE portfolio's capital calls and distributions may be resource-intensive for both individual and institutional investors. An evergreen PE fund will make the administrative aspects of a PE portfolio more efficient for investors who do not maintain the administrative support to manage capital calls and distributions.

Lower minimum investments. The minimum investment size for evergreen PE funds can be in a range as low as tens of thousands of dollars, compared with up to millions of dollars for a traditional drawdown vehicle.

Manager/fund diligence. Evergreen PE funds enable investors to streamline their PE portfolio into a single fund or a select few instead of having to continually reinvest capital into multiple drawdown funds. This alleviates the need to constantly perform due diligence on multiple drawdown funds across multiple vintages. As a result, investors can remain fully invested, seamlessly maintain their PE exposure and compound returns over many years through one vehicle.

Potential for limited liquidity. The flexibility to access limited liquidity in an evergreen PE fund is not afforded to investors in drawdown vehicles, which have defined terms (often 10-plus years) and do not allow for capital redemption. While this construct may entail risks (see below), the option for limited liquidity can enhance client experience.

Given these advantages, the larger evergreen fund space, which includes open-end PE, has grown significantly in recent years. According to Preqin, evergreen assets are estimated at $320 billion across 520 funds. Many PE firms consider high net worth and "instividual" investors key to growing their assets under management. We expect increasing numbers of institutional-quality PE managers to enter the open-end PE space to tap into this growing client type.

How GIMA Evaluates Managers

Evergreen private equity funds can take many forms, investing across different PE substrategies (e.g., buyout, growth equity, venture capital) and investment types (e.g., direct investments, co-investments, secondaries). Likewise, the fund managers can be either generalists or specialists. As such, understanding the key differences between products and how they can be additive to a broader portfolio is critical to manager selection. Below are some of the main attributes and areas of focus when selecting or comparing evergreen funds.

Scalable firm. The manager of an evergreen PE fund will often build a product based on the manager's existing core competencies. Thus, the evergreen fund frequently resembles what the manager has historically done in a drawdown fund structure. An evergreen PE fund should be managed by a firm

that has enough scale and resources to support a new product, with a proper investment and operational process that is repeatable and synergistic for a semiliquid vehicle.

Historical track record of executing on strategies in the evergreen vehicle. To the extent that the evergreen fund's investable universe is similar to that of an adjacent drawdown fund strategy, the performance of the drawdown fund should be evaluated to show a demonstrated and repeatable investment process with a track record of strong returns for investors.

Experienced team. An experienced team with a history of working together is preferable to instill confidence in the success of executing on a newer product. A dedicated team that manages the evergreen strategy daily and that can tap into a broader organization's resources is beneficial for proper diligence, speed of execution and sourcing.

Strong sourcing capabilities. A manager must be able to match significant and often sporadic capital inflows with deal flow. Therefore, the ability to continually and efficiently source quality deal flow is crucial to the success of evergreen funds. A team with a history of doing so with drawdown vehicles over various market environments should have an advantage in identifying future deals.

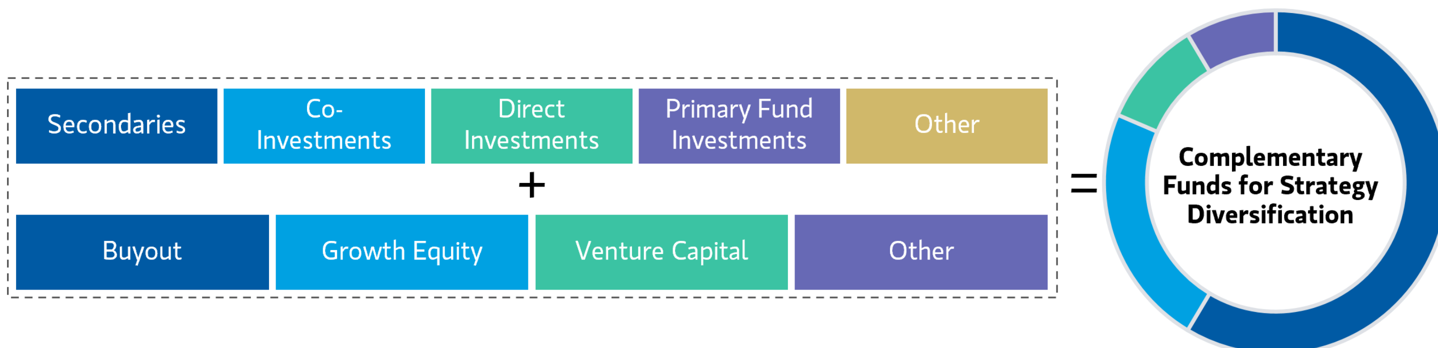
Thoughtful approach to portfolio construction. Evergreen products seek to differentiate themselves via portfolio construction, resources and returns. Many funds are also still developing; therefore, evaluating a fund's current exposure and its approach to either maintaining that exposure amid more capital inflows or ramping up the portfolio toward a particular target allocation mix is critical.

Use of liquidity sleeve. Evergreen PE funds can offer investors limited liquidity by repurchasing shares from investors—typically up to the equivalent of 5% of a fund's net asset value on a quarterly basis. To offer this capability, evergreen PE funds must maintain more liquid assets in the portfolio. This allocation, or "liquidity sleeve," usually contains cash, cash equivalents or other fixed income investments to meet potential redemption needs while generating an incremental return. It is important to understand how a manager expects to manage liquidity, and investors should be aware that no assurances to meet redemption requests pertaining to any particular time period can be given.

Approaches to Portfolio Construction

When seeking to build an allocation to evergreen private equity, we suggest allocating to multiple funds that have complementary strategy types to achieve manager and strategy diversification (see Exhibit 4). In building this allocation, investors should be mindful that strategy types have distinct risk/return profiles and may fall in and out of favor in certain market cycles. As such, during a time when a given strategy type may be out of favor, a complementary strategy may help augment performance. Additionally, allocating to multiple funds may mitigate the potential liquidity risk of a single fund.

Exhibit 4: Approach to Alternatives Portfolio Construction



Note: Exhibit is for illustrative purposes only and is not a recommendation.
Source: Morgan Stanley Wealth Management GIMA

Risks and Considerations in Evergreen Private Equity

As the number of evergreen PE funds increases, there are many points to consider, including liquidity management, fees, performance dispersion, impact of cash or liquidity sleeves held by funds, strategy capacity and portfolio construction philosophy. Given the recent emergence of evergreen funds, many are early in their investment life and therefore have not been tested across multiple market cycles or prolonged downturns. As the marketplace continues to develop, we expect performance among evergreen PE funds to diverge. Manager selection will continue to be paramount. In addition, investors should be mindful that management fees, incentive fees and performance hurdles can vary across products.

Evergreen PE fund investors should also be cognizant of return drivers and overall portfolio construction. Depending on the opportunity set, ideal allocations may evolve. Certain investments, such as discounted secondaries invested during an evergreen PE fund's early stages, may drive initial returns that are outsized relative to long-run expected returns. While secondaries may be useful in contributing to strong early returns, particularly when the manager is still building a diversified portfolio, return anomalies from discounts may be harder to achieve once the fund is fully scaled. Investors in evergreen PE funds should properly calibrate return expectations to account for such potential early performance anomalies.

In times of stress, style drift and the ability of managers to meet investor redemption requests should be critical dynamics to monitor. The marketing of these products to investors should be clear. These are not fully liquid funds, and they should be positioned as long-term investments with the potential for liquidity under normal market conditions (emphasis on normal).

Conclusion

Evergreen private equity fund managers seek to provide a diversified portfolio of PE assets that produce competitive returns. However, evergreen PE funds have certain structural elements, such as cash holdings and liquidity sleeves, that may moderate performance relative to a mature PE portfolio of traditional drawdown funds. To a certain extent, a trade-off exists between liquidity and returns; however, individual investors are still able to leverage evergreen PE funds to achieve their desired PE exposure at lower minimums, with fewer resource and administrative burdens, while delivering compelling returns that can compound over multiple years.

Ultimately, while there may be cycles within PE strategies, we view these funds as long-term holdings. As with all long-term PE holdings, manager selection matters, and picking the right managers can result in compounding returns and quality long-term outcomes for clients.

Endnote

[1]Euart, John, Jonathan Godsall, Vlad Golyk, and Jill Zucker. "US wealth management: Amid market turbulence, an industry converges." McKinsey & Company. https://www.mckinsey.com/industries/financial-services/our-insights/us-wealth-management-amid-market-turbulence-an-industry-converges.

Disclosure Section

IMPORTANT DISCLOSURES

For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

Drawdown refers to the largest cumulative percentage decline in net asset value or the percentage decline from the highest value or net asset value (peak) to the lowest value net asset value (trough) after the peak.

Illiquidity premium is the extra yield investors expect to earn for giving up control to liquidate their capital for a certain period of time.

Internal rate of return (IRR) is the interest rate at which the net present value of all the cash flows (both positive and negative) from a project or investment equal zero. Internal rate of return is used to evaluate the attractiveness of a project or investment.

J-curve effect refers to a "J" shaped section of a time-series graph in which the curve falls into negative territory and then gradually rises to a higher level than before the decline.

mPME (Modified Public Market Equivalent) Cambridge Associates mPME is a proprietary private-to-public comparison that evaluates what returns would have been achieved had the dollars invested in private investments been invested in public markets instead. mPME attempts to answer the fundamental question investors ask themselves about their private investments: are the returns from private investments worth the illiquidity and administrative burden incurred?

Vintage Year: Typically refers to the year or period in which a fund initiated investments and typically used as reference period for performance review.

Risk Considerations

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk, or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

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