PE Replication webcast

Event summary

This week's Mackenzie PM Event series webcast examined the unique and differentiated Mackenzie Private Equity Replication Fund. The fund aims to provide investors with performance characteristics similar to those delivered by the average US buyout private equity firm but using fully liquid securities. By doing so, the strategy is expected to outperform its public equity market benchmark with meaningfully lower volatility — thus aiming to deliver the performance and risk characteristics that investors have come to expect when investing directly in private equity.

From its launch in December 2020 through February 2022, the fund has generated an annualized return of 18.2% (Series F), 10.4% ahead of its benchmark (Russell 2500) with only 63% of the benchmark's volatility[1] — well in line with the fund's objectives.

Webcast host Mike Evans, Vice President, National Sales Initiatives with Mackenzie, was joined by the three architects of the Mackenzie Private Equity Replication Fund:

- Harvard Business School Professor Randy Cohen, whose two decades of research into the concept of replication led to the genesis of the strategy
- Arup Datta, Head of Mackenzie's Global Quantitative Equity team
- Nelson Arruda, Co-Lead of Mackenzie's Multi-Asset Strategies team

Together they discussed Mackenzie's innovative approach to accessing the appealing attributes of private equity investing, with public market assets.

The primary appeal of private equity is that it's performance has historically beaten public markets by two to three percentage points per year; a tremendous performance advantage when compounded over several decades. Because the investments held by PE firms are not publicly traded, these returns came with significantly lower volatility than public markets.

Unfortunately, direct investment in private equity is difficult for individual investors to access. Prof. Cohen outlined the many hurdles facing individual investors, including:

- Large up-front investment amounts.
- Long lockups of invested capital.
- Difficulties maintaining readily available funds to meet PE capital call schedules.
- Building and maintaining a diversified exposure to direct private equity.

However, there is a way to capture PE's attractive return characteristics without investing directly. Prof. Cohen's research identified six ways PE firms profit from their investments, and how four of these can be replicated using publicly traded stocks.

1) PE firms have been very good at picking industries which end up delivering strong returns. Today, databases exist that track every PE deal as it is announced. Mackenzie's Global Quantitative Equity Team has created a process to compile these announcements in real time and replicate the industry exposures in public markets.
2) When buying out companies, PE firms tend to favour certain company-level characteristics. They have tended to prefer small to medium-sized companies that:

    - exhibit higher quality characteristics;
    - throw off a lot of free cash; and
    - can be bought at attractive prices.
    - Mackenzie has built a proprietary process that identifies publicly traded companies that are very similar.

3) PE returns benefit from the application of leverage, which Mackenzie's PE replication strategy can measure and match.
4) Finally, PE investments exhibit lower volatility than public markets. The Mackenzie Private Equity Replication Fund incorporates a simple but effective hedging strategy designed to dampen the volatility of the fund's equity investments.

Both the leverage and hedging are managed by Mackenzie's Multi-Asset Strategies Team, which applies its deep experience running similar hedging strategies across several other Mackenzie funds.

Individually, each element of the strategy is in use across Mackenzie's fund lineup. What is new is the way that they have been combined to bring Prof. Cohen's research to life in a mutual fund that is accessible to virtually any investor.

What can't be replicated?

There remain two ways that PE firms make money that cannot be replicated when buying publicly traded stocks.

1) The ability to access proprietary inside information at the company level before making an investment
2) The ability to implement operational improvements at the company level after acquiring full control.

As it turns out, both research and live data show that both of these are expensive. Control premiums tend to run at an average of over 30%, and investing directly in private equity firms can come with hefty fees for investors. Private equity replication avoids these costs and fees. So on a net basis, after all the costs and fees have been paid, the returns that the average US buyout private equity firm delivers to its investors have been very similar to the returns that have historically been generated by a well-designed private equity replication strategy.

While it's still somewhat early days, the past 15 months the Mackenzie Private Equity Replication Fund has produced very encouraging results that suggest the performance characteristics of the average US PE buyout firm can be replicated on a net-of-costs basis using fully public securities, thus avoiding the difficulties that can accompany direct private equity investing.

[1]Composite Inception Date: 2021/1/1
Past performance does not guarantee or indicate future results. The performance shown is that of a representative account which is a Canadian mutual fund.
Source: Morningstar