Private Market Insights

A NEWSLETTER BY FAST

The Evolving Role of Public and Private Equity

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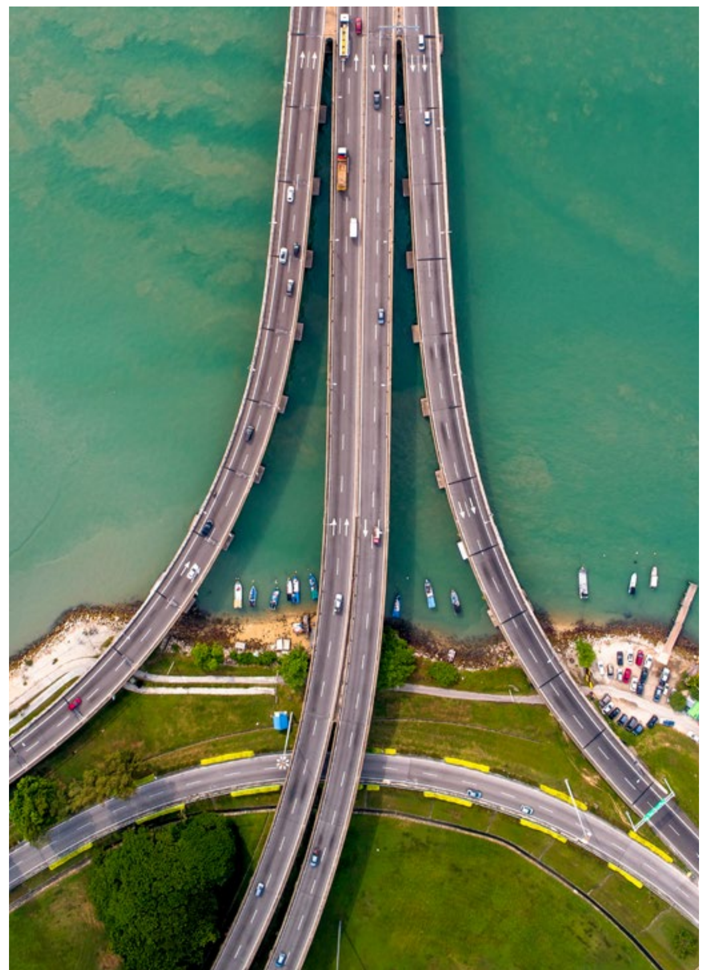
Why and how private equity markets represent the foundation of the future economy

For most, investing in public equity markets has been synonymous with investing in core economic growth, as the capital raised in these markets (via IPOs) has facilitated the financing of corporate growth plans. IPO activity was a bellwether for the growth potential of the wider economy, while private markets were the domain of financial engineering, truly deserving of the moniker "alternative."



Today, private equity markets have evolved to become the mainstream place for—and a significant means of investing into—the real economy (tangible goods and services). Companies are waiting longer to go public or avoiding it completely, and as a result, a significant amount of value creation is captured while they are still private. Meanwhile, public markets have increasingly become dominated by large companies geared more toward technological and digital innovation.

As these roles have evolved, so have the respective roles of public and private markets in the wider economic structure. **In this edition of *Private Market Insights*, we'll explain why private equity markets are the foundation of the future economy and how investors can access this large and growing investable universe.**

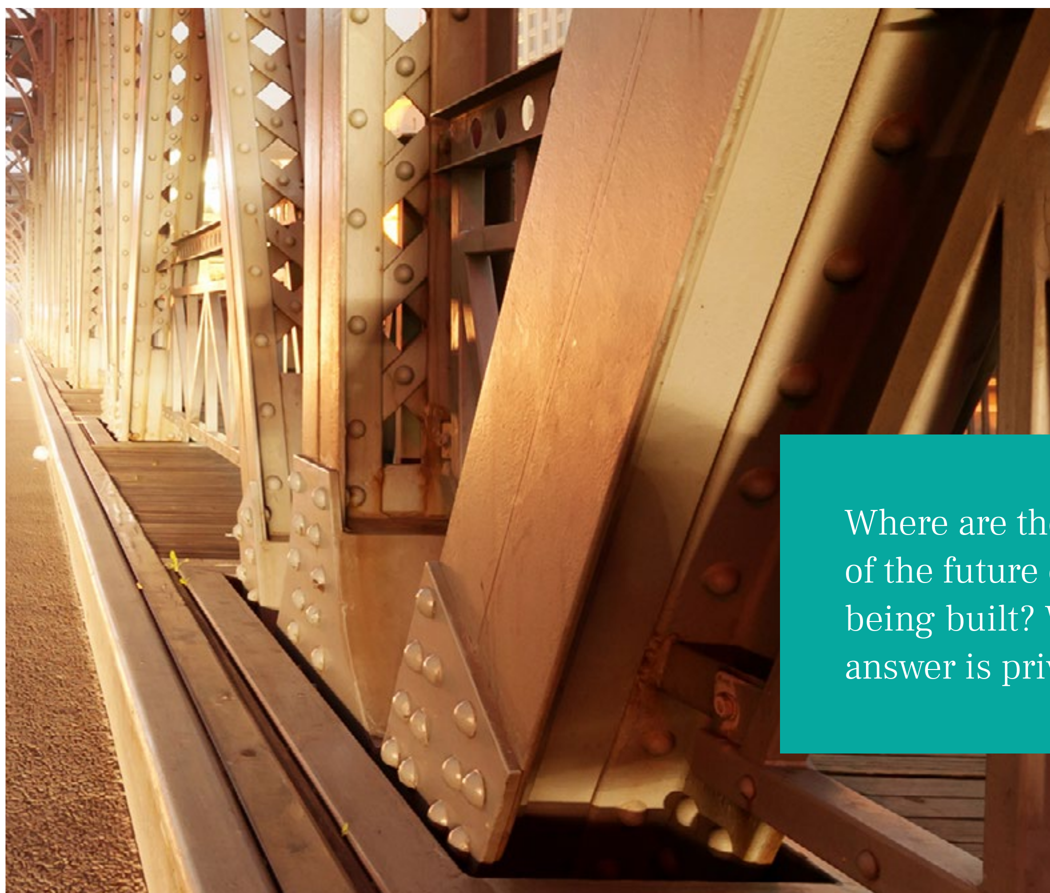
A brief history of the roles of public and private equity

For much of modern history, public markets have been a cornerstone of capitalism. Financing equity via the public markets has led to the formation and growth of companies that form the bedrock of the economy: Ford Motor Company, General Electric, Microsoft, and Amazon, to name a few. Through the 1990s, public markets were a place for proven enterprises—profitable, asset-rich businesses that were creating tangible products or core services.

Private markets, on the other hand, were quite different up until the 1990s. Private buyouts, the largest segment, were often focused on financial engineering and sophisticated deal structures, making this segment relatively niche. Venture capital (VC), a smaller segment, provided financing to startup companies that were in the early stages of their development and had little ability in those days to raise capital in the public markets. As a result, private equity was generally typified by smaller companies (relative to public companies) whose value creation was more about creating value through leverage and M&A than investing in their fundamental growth.

Fast forward to today. The role of capital markets—to facilitate the raising of new capital for businesses building their future success—hasn't changed. And public equity markets are indeed still home to large and profitable corporations (e.g., Nestle, Unilever). However, these names, having gone public many years ago, represent an era of public markets past, where value was unlocked through the IPO process.

Where are the foundations of the future economy being built? Where is the new engine room for creating value? We believe the answer is private markets. Here's why.



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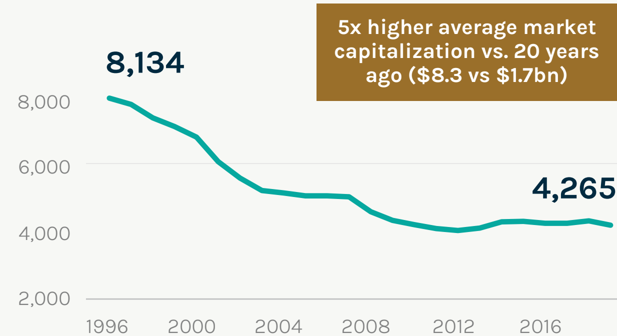
The large and growing investable universe of private equity

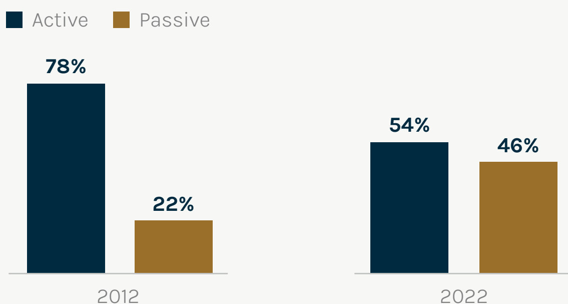
By now, it's a well-known fact that the number of public companies is shrinking. There were more than eight thousand public companies in 1995, and there are only around four thousand today.[1]

Number of U.S. publicly traded companies is shrinking[1]



Those that are public are moving to scale; the average market capitalization of a company is five times as large as it was 20 years ago.

Investment mix in active vs. passive funds—U.S. equity funds[2]

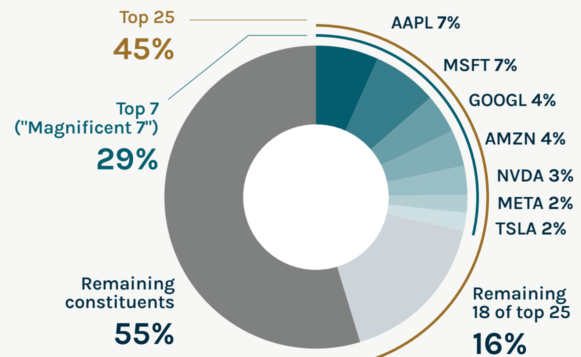


There has also been a shift to liquidity. This is evidenced by a meaningful move toward indexing in lieu of owning individual stocks whose trading volume could dry up in a broader market selloff. Active managers are finding it increasingly difficult to compete against passive managers, and while 80% of U.S. equity funds were once actively managed, that percentage is only about 50% today.

As the market moved into indexing, there has been increasing focus on the impact of the "Magnificent 7." These are the seven largest companies in the S&P 500 that represent close to 30% of its market cap and an even more disproportionate part of the market's overall returns.

In 2023, the return of the Magnificent 7 was 112%, versus 26% for the remainder of the S&P 500.[3] Another version of a similar statistic: If the remaining 493 companies of the S&P were equal weighted (instead of market cap), it would have returned only 12%. Further highlighting the impact of a concentrated group of companies, the top 25 companies in the S&P 500 represent close to 50% of the market cap of the entire index.

S&P 500 constituents by market cap[1,2]



Seven companies represent 29% of the S&P 500 market cap. In 2023, the Magnificent 7 had an average total return of 112% vs. 26% for the broader S&P 500 and 12% for the S&P 500 Equal Weight.

We believe this overrepresentation of the largest companies is problematic on a number of levels but also indicates the importance of size, scale, and liquidity—and the impact of that liquidity on the structure of public markets.

1. Sources: FRED, St. Louis Fed, Wilshire, US Census Bureau, Ares. FRED data current through 2019. All other data as of July 2022.
2. Source: Investment Company Institute 2023 Investment Company Factbook.
3. Source: S&P Capital IQ. Constituents as of 1/8/2024.
4. Source: NADSAQIR. Total returns are full year 2023.

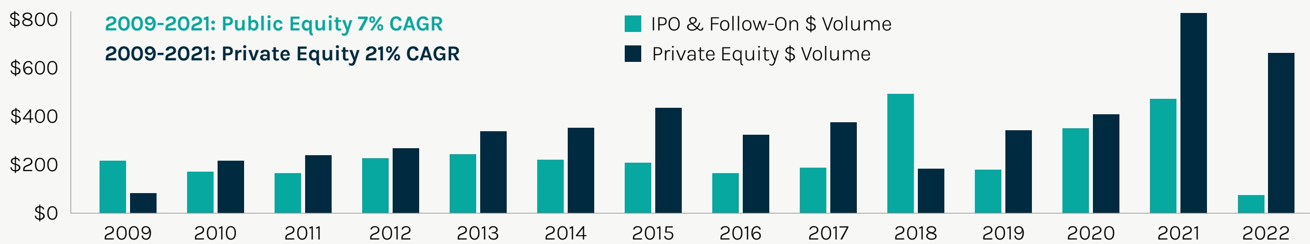
Given these dynamics, it is not surprising that fewer companies are going public and more companies are turning to the private markets for financing. Capital formation in the private markets has been outpacing capital formation in the public markets for almost a decade.

At one time, IPOs were the pinnacle of corporate development—a signal that a business had proven its value and coming of age. Today, companies that come to public markets tend to be less diversified, less mature, and not cycle-tested.

Meanwhile, private markets increasingly finance mature enterprises, building businesses and creating value through organic growth and operational excellence. In doing so, they have become the custodians of companies that support the "real economy" and drive fundamental economic growth.

Private equity fundraising has grown 21% over the last 10 years compared to ~7% in the public equity markets. We believe this is a permanent structural shift and that investors need to be thinking about the large and growing investable opportunity in private markets and how to access them.

Capital raised in the U.S. public markets vs. private markets[5]



Accessing true growth via the middle market

To understand the opportunity set in private markets, one must understand the structure of the U.S. economy, particularly the strength of a segment referred to as the "middle market."

While definitions vary, revenue is the most common metric used to identify these companies. The National Center for the Middle Market defines them as generating annual revenue between $10 million and $1 billion. There are about 200,000 such companies in the United States, employing about 48 million people and representing one-third of economic output.

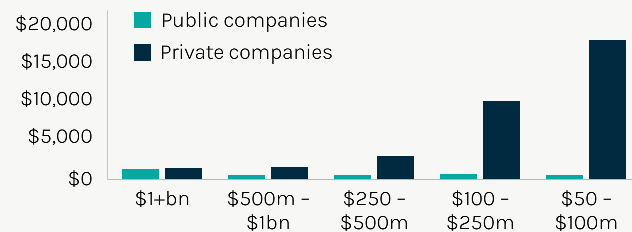
Buyout private equity, the largest segment of the private equity market, tends to focus on the middle to higher end of this range, bringing the bottom end of the range up from $10mm to $50mm annual revenue. Of these companies, 94% are private.[6]

This is not a trivial point. We believe private markets now represent what public markets used to: a set of diversified, durable, and cycle-tested businesses that are fueling a significant portion of the U.S. economy.

For investors looking to stay true to first principles of why equity is an important component in portfolio construction, this opportunity set cannot be ignored.

We believe the private middle market today is home to more high-quality, sizeable companies than the public market. These companies, both historically but increasingly going forward, represent the future of economic growth. Buyout private equity and direct lending (private credit) are the ways to access these companies.

Number of U.S. public and private companies by annual revenue



5. Public equity / IPO & follow-on data from Bloomberg. Private equity volume represented by aggregate buyout deal volume from Preqin Pro.
6. Source: World Economic Forum.

An alternative no more

The evolution of public equity markets also means that the driver and nature of returns from these markets have changed. The success (or failure) of IPOs tends to depend on unique effects and binary outcomes that may or may not be closely aligned, if at all, with the economy as a whole. More broadly, as consolidation continues, public markets tend to rise and fall with the whims of consumer sentiment and not on the basis of true fundamental growth.

Investors have a tendency to view the past as prologue. That, in part, is why many investors still see public markets as the main engine for the real economy and private markets as an "alternative" asset class. We believe this is no longer true and that the so-called alternatives are becoming mainstream. The question for investors, then, becomes how to access businesses that can offer differentiated returns in alignment with the foundations of the real economy. If investors seek access to what is potentially the best and most robust investment opportunities, they need to consider how to access and allocate capital into the private markets.

About the Financial Advisor Solutions Team (FAST)

FAST offers resources and one-on-one support to help navigate the complexities of private markets investing. The team's goal is to empower investors to confidently incorporate private markets investments into portfolios. The educational content, research and analytics that FAST delivers are designed to enhance the understanding of the benefits of private markets investments. FAST is a skilled and knowledgeable team of professionals who can answer questions and foster more informed decisions.

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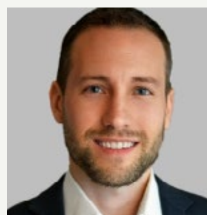

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Investing in private markets involves risk including the loss of principal. Other risks include, but are not limited to: illiquidity risk, valuation risks, and a number of other risks related to private companies in general.

Financial advisors must carefully consider the risks and other suitability details in determining appropriate investments for their individual clients' portfolios.

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