Soundbite Investing

The prospect for lower future returns has many institutional investors scrambling for a savior. During the previous cycle, it was hedge funds. That shift in allocations hasn't worked out so well. So the latest push has seen money pour into private equity in hopes of juicing returns through the use of leverage in the private markets.

My guess is many of these investors will be sorry because so much money has now gone into a space that should be reserved only for those investors who have the bandwidth to assess these types of investments. The reason private equity has worked for the early adopters is that the illiquidity of the investment structure has lent itself to more mispricings and opportunities.

Now that enormous pensions and sovereign wealth funds have become large investors in private equity it's estimated that there's almost $1.5 trillion in dry powder still waiting to be invested in the form of future commitments. That's roughly half the size of the entire ETF industry. The opportunities that were afforded in the past are likely gone save for the very top private equity firms. More competition means lower returns.

I bring this up after reading the following headline recently:

The Wall Street Journal reported the following:

Apollo Global Management LLC, the private-equity firm co-founded by billionaire investor Leon Black, has raised $23.5 billion for the world's largest-ever buyout fund.

The record-breaking fundraising is the latest demonstration of a surge in investor appetite for leveraged buyout funds, extending a run of records in recent months.

Now compare that story with a headline from the spring of 2013:

Here's what Black had to say at the time:

"It's almost biblical. There is a time to reap and there's a time to sow," Leon Black, chairman and chief executive of Apollo Global Management (ticker: APO) declared to the Milken Institute's global conference in Los Angeles, alluding to that same Scriptural passage. "We are harvesting," he added pointedly.

That is, the private-equity giant is a net seller because things simply can't get much better. "We think it's a fabulous environment to be selling," he says, noting Apollo has sold about $13 billion in assets in the past 15 months. "We're selling everything that's not nailed down. And if we're not selling, we're refinancing."

I recall reading stories about this at the time. The institutional investment community -- who are heavy investors in private equity -- was quite concerned at the time. I remember multiple conference calls to discuss the state of the markets based on Apollo's assessment of the markets (full disclosure: my former fund was an investor in some Apollo funds).

The S&P 500 is up almost 70% since Black made his "selling everything that's not nailed down" comment.

So it's obvious that he was wrong when he made these statements, right?

Not exactly. Black isn't as well known outside of finance circles as other great investors but he has an enviable track record in this business.

The problem with investing based on headlines from well-known investors is that they require context. Most people don't understand how the private equity industry works. Consider the following:

Private equity firms are constantly marketing new funds. Most put out a new vintage year fund every 2-3 years. It's nearly impossible to assess their performance in such a short period of time because most PE funds have an investment period that can last up to 10 years while investors could have their money tied up for even longer than that.

This can be a problem with pensions, endowments, foundations and sovereign wealth funds who are increasingly looking for short-term outperformance. Therefore, many private equity firms will sell big chunks of their portfolio companies to show results to current and prospective investors. "Locking in" gains quickly can also juice your IRRs to make the institutional investors feel better about their short-term performance targets.

My guess is Black and Apollo were making what sounded like an intelligent market call that was really masquerading as a marketing ploy. They wanted to show their investors that they were doing something on their behalf.

While many investors read Black's comments as a take on how expensive the markets were, it was really just a way for Apollo to return capital to their investors and subsequently raise more money for future funds. Not only did Apollo just raise the largest buyout fund in history, but they also raised an $18.4 billion fund in early 2014. So it obviously worked because they've raised $40+ billion in commitments since "selling everything."

It can be difficult to ignore headlines and soundbites from uber-successful investors because you want to believe that they're giving you advice when they speak in public settings. My general rule of thumb is to ignore making decisions based on investing soundbites from legendary investors.

There are a few reasons for this.

First of all, there's a good chance they have way more money than you, so the circumstances are completely different. Billionaires are playing a different ballgame than you and I.

Then there's the fact that you have no idea what their time horizon, risk tolerence or overall strategy are in regards to their quip about the markets.

And finally, most really great investors are also really great marketers as well, so there's no way of telling whether they're really serious or just trying to earn some publicity or raise more money.

Investing based on soundbites is tempting but it's more trouble than it's worth.

Further Reading:
Are Private Equity Returns Overstated?

Now here's what I've been reading this week:

- People have emotions, markets don't (Abnormal Returns)
- Worrying is a serious offense (Above the Markets)
- Financial nutrition labels (Irrelevant Investors)
- Good decisions can have bad outcomes (Oblivious Investor)
- Lessons from a faux-retirement (Morningstar)
- Nice review of one of my favorite investing books (Reformed Broker)
- FIRE and financial freedom (Monevator) and see my thoughts on this as well (AWOCS)
- Two nice recaps of our EBI West Conference from last week (The EBI) and (Alpha Architect)