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WHAT INVESTORS NEED TO KNOW ABOUT PRIVATE EQUITY INVESTING

Pantheon Research





Key takeaways

- 1 Private equity has historically outperformed public equities, with the Preqin Buyout Index achieving 20-year annualized returns of 14.8% versus those of 9.2% from MSCI World.¹
- 2 Private equity's long-term investment horizon, coupled with direct control through which managers can bring operational skill to bear, means that investment managers can be afforded the time to effectively execute value-add theses without being burdened by daily mark-to-market volatility.
- 3 Diversification of investments across strategy, vintage year, sector, stage, and geography is key to building a successful private equity program.
- 4 Manager selection is also important for investors to consider, due to the wide dispersion in private equity manager performance.

Why private equity?

The private equity industry has come a long way since the 1980s, when it began gaining popularity as an alternative asset class. At the beginning of that decade, there were fewer than 30 private equity firms across buyouts, growth equity, and venture capital. Fast forward to 2025 and there were more than 9,100 firms and 3,900 private equity funds in the US alone. Globally, private equity assets under management (AUM) have risen from \$581bn as recently as 2000 to \$6tn by the end of 2023, representing an estimated 35% of all private capital.² Preqin's latest forecast indicates that AUM could double reaching \$12tn by 2029.³

At their core, private equity investments involve the purchase of private companies (or the taking private of public companies) by professional investment managers, who are known as General Partners (GP). These investments are typically funded by institutional investors — and, increasingly, qualified individuals — who commit capital to GPs' funds and are known as Limited Partners (LP). Acquired companies are typically held for around five years before the GP executes an exit strategy, which could be in the form of selling to another GP or strategic buyer, or a public listing.

Investors are attracted to private equity primarily because of the return potential. Private equity-backed businesses often benefit from having access to operational expertise, ranging from management consultants to ex-CEOs acting as advisors. The long-term investment horizon, coupled with direct control through which managers can bring operational skill to bear, means that GPs can afford the time to effectively execute their value-add theses without being burdened by mark-to-market volatility, or the pressure to hit short-term profitability targets.

¹Preqin as of June 30, 2024

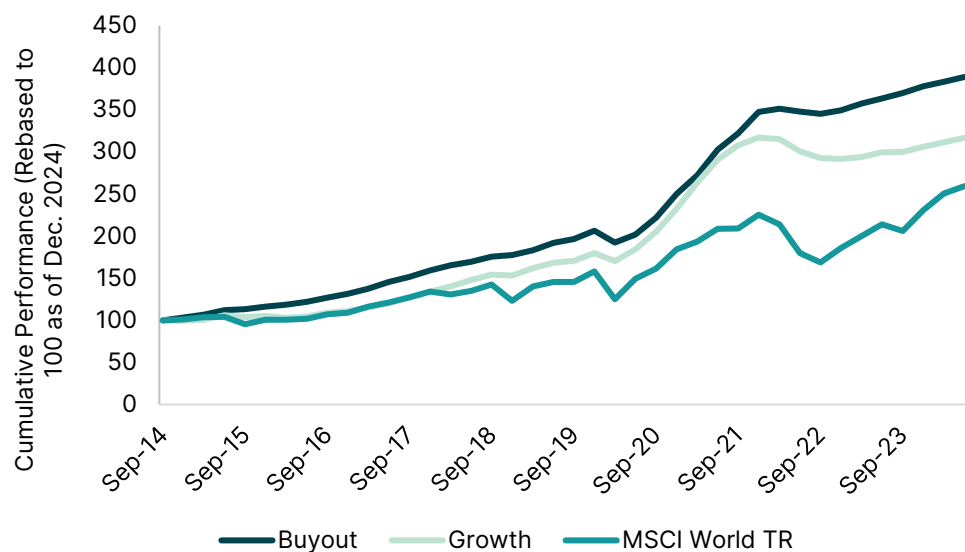
²Preqin, October 2024, "The Future of Alternatives in 2029."

³PitchBook, January 2025, "2024 Annual US PE Breakdown"



Private equity becomes even more compelling when considering the growing number of private equity-backed deals in the last 10 years, private equity-backed deals have grown on average 8% per year.⁴ Historical return figures also showcase the outperformance potential of private equity. The Preqin Buyout index generated 20-year annualized returns of +14.8% (as of Q3 2024) vs the MSCI World 20-year annualized return of 9.2%, as shown in Figure 1. In addition to the performance advantage of private equity, investors may have benefited from the potential reduction in volatility by adding private equity alongside traditional public equity and fixed income allocations.⁵

Figure 1:
Performance of Preqin Buyout and Growth indices vs MSCI World



Source: Preqin as of December 31, 2024. Private equity benchmark returns are net of fees. Past performance is no guarantee of future performance.

Diversification is key to building a sound investment strategy

When it comes to building a private equity portfolio, there are several considerations. Chief among them is diversification, which Nobel Prize laureate Harry Markowitz said was the only “free lunch” in investing.⁶ This refers to the idea that different financial assets exhibit different traits and, therefore, behave differently over time. Understanding this, you could invest in a combination of assets and, through diversification, achieve the same return as holding a single asset with less fluctuation in the value of the assets over time. In other words, Markowitz argues that investors can potentially achieve the same return with less risk through diversification.

In the context of building a private equity portfolio, and as we will show below, LPs should consider diversification across a variety of private equity investment attributes, such as strategies, vintages, stages, geography, and managers.

⁴PitchBook, January 2025, “2024 Annual US PE Breakdown”

⁵JP Morgan Asset Management, November 2024, “Guide to Alternatives 4Q 2024”

⁶The Times, July 2022, “How to diversify your investment portfolio when all prices are in freefall”



Diversification by strategy

The three main private equity strategies for LPs are: (1) primaries, (2) secondaries, and (3) co-investments. Each has its own unique characteristics, and the three strategies can complement each other to provide a more balanced portfolio.

Primaries

This is the strategy most investors associate with private equity, as it accounts for more than 90% of all private equity AUM.⁷ It refers to LPs committing capital to a GP's fund, which in turn invests in a portfolio of companies over time. The typical deployment period is two to five years, with the overall lifespan of a fund running to around 10 years, so capital is invested over a long-term time horizon.

In the early years of the investment, as capital is put to work, investors experience a negative cash flow as commitments are being called, or invested, into the companies and the GP takes their management fee. Over time, as the GP successfully executes its value-add strategies across the fund's portfolio assets, investors should receive returns in the form of cash distributions. As the distributions increase and capital calls recede, investors should expect to see an overall positive cash flow. This period typically lasts for a couple of years, after which, as investments mature, returns start to rise and distribution activity picks up – gathering pace through the fund's life. This creates a hockey stick-like return profile, or the “J-Curve”.

Secondaries

A growing part of private equity is the secondaries market, where GPs can buy and sell pre-existing investor commitments in a portfolio of assets, or even a single company. There is often the potential to purchase stakes at a discount, if, for example, the transaction is driven by a seller's desire for liquidity.

Secondaries play an important role in diversifying a private equity portfolio. Traditional secondary transactions involve purchasing stakes in mature funds that are typically four to six years into their lives. Because most of the capital has already been put to work, investors usually have good visibility on the underlying assets and their performance track record. Crucially, investors can expect net cash flow to turn positive much sooner than in the case of primaries or co-investments.

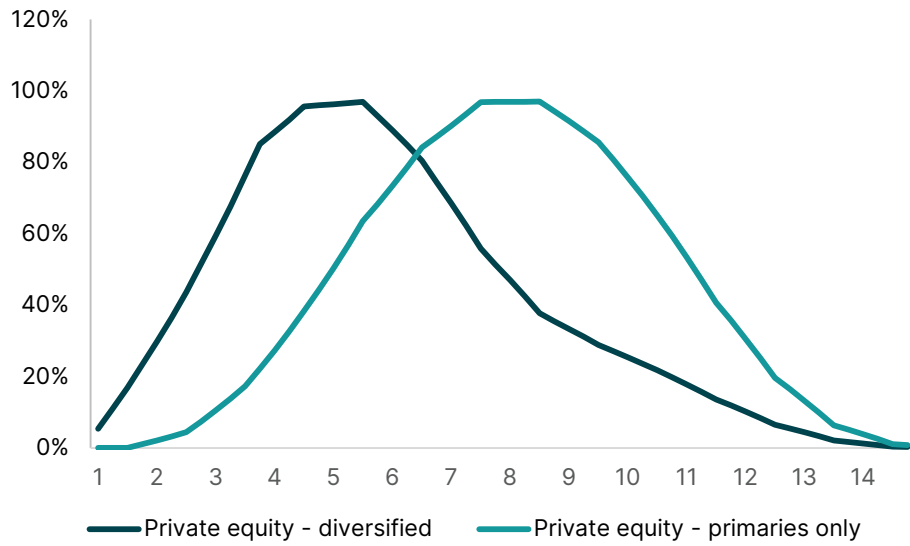
Co-investments

As the name suggests, this strategy involves investing directly in a company alongside a GP. These investments have the potential to enhance returns in a portfolio due to the defining feature of a typical co-investment deal: low, and often, no management fee or performance-related fees. Over time, this can be accretive from a net return perspective. Figure 2 illustrates the net asset value (NAV) impact of a hypothetical diversified private equity portfolio with commitment split equally across primaries, secondaries, and co-investments, compared to a primary-only portfolio. The diversified portfolio has the potential to harness the benefit of early positive cash flow from secondaries and the lower fees from co-investments, to allow distributions to be re-invested more quickly and so potentially to enhance overall return.

⁷ Pantheon calculation based on Preqin data as of June 30, 2024. (Includes: Venture (General), Growth, Early Stage, Buyout, Fund of Funds, Early Stage: Seed, Early Stage: Start-up, Expansion / Late Stage, Balanced, Turnaround, Hybrid, Hybrid Fund Of Funds “).”



Figure 2:
NAV profile of two
hypothetical private equity
portfolios with different
strategies



Source: Pantheon. Private equity Diversified strategy assumes an equal allocation to primaries, secondaries, and co-investment. This is for illustration purposes only and is not representative of all Pantheon client portfolios.

Diversification across vintage

Within each strategy, it is also important to diversify across vintage, which refers to the year in which an investment is made, or when a fund began investing. Given the longer-term time horizons it can be almost impossible to time private equity investments with optimal market conditions. For instance, few GPs would have foreseen the Global Financial Crisis of 2007-2009, and, if they had deployed all capital in the years prior to the crisis when markets and valuations were reaching a peak, it is likely that performance would be subpar due to exits taking place in the years that followed the significant market correction.

This is illustrated in Figure 3, which shows the internal rate of returns (IRRs) from vintages between 2000 and 2022 and highlights that the years with the lowest median IRRs were 2005 and 2006, while those for the years after climbed steadily. GPs tend to deploy capital consistently across all vintage years in their investment phase to mitigate the risk of adverse macro conditions.



Figure 3:
Median net fund IRR



Source: Preqin as of June 30, 2024. Past performance is not a guide to future results.

Diversification across sectors, stages, and geographies

The same arguments can be extended to support diversifying across sectors, stages, and geographies. Stage refers to the type of private companies being considered. Broadly speaking, the main types are: (1) buyout, (2) growth equity, and (3) venture. Like strategy, each stage has its own unique characteristics and together they should complement each other to achieve a more balanced risk-return profile.

| Buyouts | Growth equity | Venture capital |
|--|--|---|
| In the life cycle of a company, buyouts generally involve purchasing mature businesses with well-established revenue, operating costs, and profitability. The value-add comes in the form of improvements to the operational efficiency and/or merger and acquisition opportunities. | Growth equity companies sit in between buyout and venture capital from a risk-return perspective. These are fast-growing companies with established business models, but that are yet to reach their full potential, or sometimes to return a profit. Here, GPs can work with management to build a roadmap to achieve and maintain profitability. | Venture sits at the highest end of the risk/return spectrum. These businesses tend to be start-ups with a limited operational track record, let alone any profits. GPs often back an idea, an individual, or a team. Risk of business failure is high, but when investments do succeed, the return potential can be large compared to other stages. |

With respect to geography, although there may be a strong tendency to only invest in LPs' home country (in economic terms, this is known as "home-bias"), doing so could result in sub-optimal portfolio construction and performance. This is because economies experience fluctuating fortunes in the same way as sectors and markets do, so LPs could



be missing out on better investment opportunities in other parts of the world at any given time. As an example, a well-balanced portfolio could have its core exposure in North America, Europe, and Asia, while supplementing the portfolio with opportunities from the rest of the world (ROW).

Figure 4 provides a good illustration of the risk of not diversifying across both stage and geography, as no single combination of these diversifying characteristics has consistently topped the performance ranks over nearly two decades. Being invested in only one set of characteristics could have performed well in one year but not consistently over the whole reference period, and so returns would be likely to be either sub-optimal, or at least volatile.

Figure 4:

Median net IRR by stage/geography for each vintage year

| Ranked in order of median net IRR highest to lowest | | | | | | | | |
|---|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|--------------------------------|---------------------------------------|---------------------------------------|------------------------------------|
| 2001 | Buyout - Small - Asia & Rest of World | Buyout - Small - Europe | Buyout - Mid - Europe | Buyout - Mid - North America | Buyout - Large - Europe | Buyout - Large - North America | Growth - North America | Buyout - Small - North America |
| 2002 | Buyout - Mid - North America | Buyout - Small - Europe | Buyout - Large - North America | Venture - Asia & Rest of World | Venture - Europe | Buyout - Small - North America | Venture - North America | Early Stage - North America |
| 2003 | Buyout - Small - Europe | Buyout - Mid - Europe | Buyout - Mega - Europe | Buyout - Large - North America | Buyout - Mid - North America | Buyout - Small - North America | Venture - North America | Early Stage - North America |
| 2004 | Buyout - Mid - Europe | Buyout - Mid - Asia & Rest of World | Buyout - Small - Asia & Rest of World | Early Stage - Asia & Rest of World | Buyout - Small - North America | Buyout - Large - North America | Buyout - Large - Europe | Growth - North America |
| 2005 | Growth - Asia & Rest of World | Growth - North America | Buyout - Small - Asia & Rest of World | Buyout - Small - Europe | Buyout - Small - North America | Buyout - Large - Europe | Venture - Europe | Buyout - Large - North America |
| 2006 | Growth - Asia & Rest of World | Buyout - Small - Europe | Buyout - Mid - Europe | Growth - North America | Venture - Asia & Rest of World | Buyout - Small - North America | Buyout - Large - North America | Buyout - Mega - North America |
| 2007 | Buyout - Small - North America | Buyout - Large - North America | Growth - North America | Buyout - Small - Asia & Rest of World | Buyout - Mid - North America | Buyout - Mid - Europe | Buyout - Mega - North America | Buyout - Small - Europe |
| 2008 | Early Stage - North America | Buyout - Small - Asia & Rest of World | Buyout - Mega - Europe | Buyout - Mid - North America | Buyout - Large - North America | Buyout - Small - North America | Buyout - Small - Europe | Buyout - Large - Europe |
| 2009 | Growth - Europe | Buyout - Mid - North America | Buyout - Small - Europe | Buyout - Small - North America | Buyout - Mid - Europe | Venture - North America | Growth - Asia & Rest of World | Growth - North America |
| 2010 | Venture - Asia & Rest of World | Buyout - Small - North America | Growth - North America | Buyout - Small - Europe | Buyout - Mid - North America | Growth - Asia & Rest of World | Buyout - Mid - Europe | Early Stage - North America |
| 2011 | Early Stage - Asia & Rest of World | Buyout - Small - Europe | Venture - Asia & Rest of World | Buyout - Large - North America | Venture - North America | Buyout - Mid - Europe | Growth - North America | Buyout - Mega - North America |
| 2012 | Growth - Asia & Rest of World | Buyout - Mid - North America | Buyout - Small - Europe | Buyout - Small - North America | Early Stage - North America | Buyout - Small - Asia & Rest of World | Venture - North America | Venture - Asia & Rest of World |
| 2013 | Buyout - Mega - North America | Buyout - Large - North America | Early Stage - North America | Buyout - Small - North America | Venture - North America | Buyout - Small - Europe | Buyout - Mid - North America | Venture - Asia & Rest of World |
| 2014 | Venture - Asia & Rest of World | Growth - North America | Buyout - Small - Europe | Buyout - Small - North America | Early Stage - North America | Buyout - Mid - Europe | Buyout - Large - North America | Venture - North America |
| 2015 | Growth - North America | Buyout - Mid - North America | Early Stage - Asia & Rest of World | Buyout - Small - North America | Venture - Europe | Buyout - Large - North America | Buyout - Large - Europe | Venture - Asia & Rest of World |
| 2016 | Buyout - Mid - North America | Buyout - Small - Europe | Early Stage - North America | Buyout - Large - North America | Buyout - Small - North America | Growth - North America | Venture - North America | Buyout - Mega - North America |
| 2017 | Early Stage - Asia & Rest of World | Buyout - Small - Europe | Buyout - Mid - Europe | Buyout - Small - North America | Buyout - Large - North America | Venture - Asia & Rest of World | Buyout - Mega - North America | Growth - North America |
| 2018 | Buyout - Small - North America | Buyout - Mid - Europe | Growth - North America | Buyout - Small - Europe | Venture - Asia & Rest of World | Buyout - Large - Europe | Buyout - Mega - Europe | Early Stage - Asia & Rest of World |
| 2019 | Buyout - Small - North America | Buyout - Mid - Europe | Early Stage - Asia & Rest of World | Buyout - Small - Asia & Rest of World | Growth - Europe | Venture - Europe | Buyout - Mid - North America | Buyout - Mega - North America |
| 2020 | Buyout - Large - North America | Buyout - Small - North America | Growth - Europe | Buyout - Small - Europe | Buyout - Mid - Europe | Early Stage - Asia & Rest of World | Buyout - Mega - North America | Buyout - Mid - North America |
| 2021 | Buyout - Small - Europe | Growth - Europe | Buyout - Small - North America | Venture - Europe | Buyout - Mid - North America | Buyout - Large - North America | Buyout - Mid - Europe | Early Stage - Asia & Rest of World |
| 2022 | Buyout - Small - North America | Venture - Asia & Rest of World | Buyout - Mega - North America | Buyout - Mid - Europe | Buyout - Mid - North America | Buyout - Mega - Europe | Buyout - Large - Asia & Rest of World | Early Stage - Asia & Rest of World |

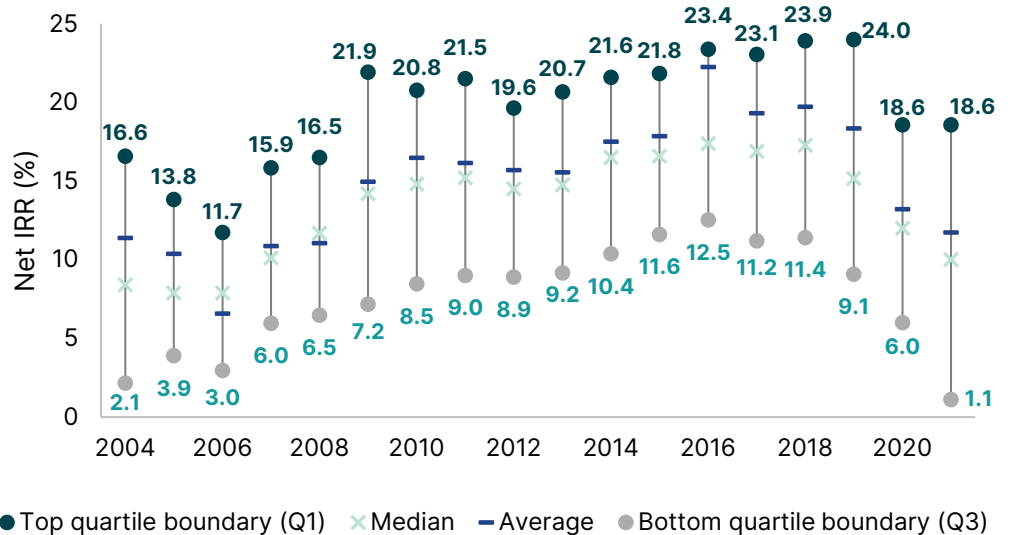
Source: Preqin as of June 30, 2024. Past performance is not a guide to future results.



Manager selection is key

In addition to the different aspects of diversification explained above, manager selection is key due to large variations in GP performance. As Figure 5 shows, there has historically been a wide gap between the top and bottom quartile performing GPs in any given vintage year, making it especially important to choose the right manager or managers.

Figure 5:
Dispersion of private equity fund performance by vintage year



Source: Preqin as of December 31, 2024 using most up-to-date fund returns data

Conclusion

Private equity focuses on investing in businesses over the long-term. Through this, GPs can in theory work more effectively with experts and management to improve operational efficiency of investee companies and generate value-creation for underlying investors. This is reflected in the long-term outperformance of private equity over public equities. To build a strong private equity program, LPs should place emphasis on diversification, specifically across strategy, vintage year, sector, stage, and geography. This could not only reduce risk and volatility, but in some cases also improve performance.

Finally, manager selection is also critical. This is as, if not more, important to building a successful private equity program due to the wide dispersion in private equity manager performance.



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