Too hot to handle

Private equity investing has the potential to deliver outsized returns but carries enormous risk and requires large sums of capital. It’s not for the faint-hearted, as RUCHIKA TULSHYAN finds out.

PRIVATE: equities are serious business. With significant initial investment, risky and often slow returns as well as high management fees, young investors should think carefully before they choose to invest in a private equity fund.

Private equity refers to investing in securities of a company that is not listed on a public stock exchange. Almost equivalent to a stock, their investment returns often take a longer period of time than public stocks. Furthermore, with the absence of a traditional trade platform such as a stock exchange, investors must seek out private brokerage firms for trade in private equities.

Private companies use the sale of their securities to generate capital and private equity funds are organised as limited partnerships. According to an essay by Raymond Hood, managing director, Asia Direct Capital Management, in the first quarter of 2006 alone, US$4.5 billion was raised in the Asian private equity market.

But as lucrative as this pool of investment may sound, it is not for the faint-hearted. Private equities garner very high entry costs with most requiring minimum initial investment of US$100,000 plus a drawdown—further investment for the initial few years of the fund.

Unlike a mutual fund, private equity funds do not rely on thousands or even hundreds of investors to invest small amounts to create a large fund. In fact, private equity funds generally operate on the principle of as few investors as possible, investing as large a sum of money as possible.

LONG WAIT FOR RETURNS
Most importantly, however, is that private equities rarely provide an immediate form of return on investment. In most cases, these funds are long-term investments which can be illiquid for many years on end. In addition, there is the danger of not being able to find suitable investments, which in the best case scenario would result in a private equity fund returning some of your investment but in the worst case scenario would result in great losses. In venture capital funds, there is a risk of losing all investment as these companies are usually young and without market security.

“Private equity and venture capital are generally not appropriate for individual investors. These are high-risk, albeit potentially high-return investments. Investing in these asset classes requires specialised knowledge about emerging industry trends and economic cycles, as well as a good understanding of the business operations. Moreover, these investments are, by nature, long-term investments and an investor cannot liquidate or sell the investments to another investor easily,” warns Winston Koh, associate professor of economics, Singapore Management University. Industry watchers find that these lightly-regulated funds ironically have copious amounts of transfer restrictions while managers can charge exorbitant fees—often more than 20 per cent performance fees and over 2 per cent for management fees.

Private equity fund managers are known to charge the highest in the industry to three people can be managing billions of dollars of investments.

No, you didn’t read that figures wrong. Private equities are certainly risky and very expensive. So what makes it a billion-dollar industry globally? Consistent with the risks involved in private equity investments, their returns, though slow, can be exceedingly high. Compared to the public stock markets, many private equity funds significantly outperform the more traditional ways of trade and investment. To invest indirectly through a fund which has a better ability in getting access to information and in processing the information. In addition, you can also reduce risks through diversification in such a way.

The attractiveness of private equities cannot be contested—with potential high returns and skilled fund managers handling your finances, it’s no wonder that this billion-dollar industry is booming. However, for young investors it is often not the right choice. Most veterans of the industry say wait until you make the big bucks and gain the relevant experience before you venture into these investments.

Says Inmo Lee, associate professor of finance, NUS Business School: “You can expect higher returns from private equity investments because private equities are typically much riskier. Since private firms are not required to disclose much information, there are a lot more uncertainties involved in investing into private equities. Therefore, it is not distributable to invest into private equities by yourself unless you have access to credible information about the company. Rather, it would be more desirable to invest indirectly through a fund which has a better ability in getting access to information and in processing the information. In addition, you can also reduce risks through diversification in such a way.”

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