ARES | Wealth Management Solutions

PRIVATE MARKETS
INSIGHTS

Why Do I Keep Hearing About Private Equity?

Today, a broad structural shift is underway with private markets becoming larger, more diverse, and more available to companies and investors than ever before.

Driven by lower costs, less regulation, increased availability of private capital and more flexibility to focus on longer-term growth, corporations are increasingly choosing to forgo public listings. Additionally, given the large consolidation of banks and investment managers, the minimum size of a viable/attractive public deal (which includes both equity and debt) has grown over the years.

As such, private markets increasingly have displaced public markets as the go-to means of financing and accessing the full US economy.

We believe there are three related takeaways our investors should recognize:

#1 Investors indexing their equity exposure are capturing only a tiny, increasingly top-heavy fraction of companies in the US economy.

#2 For investors seeking attractive and durable performance in all types of market conditions, private equity has historically demonstrated superior results.

#3 We believe that the strong incentives embedded in private companies create a powerful and sustainable alignment of interests for institutional and private investors alike.

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Takeaway #1

Investors indexing their equity exposure are capturing only a tiny, increasingly top-heavy fraction of companies in the US economy.

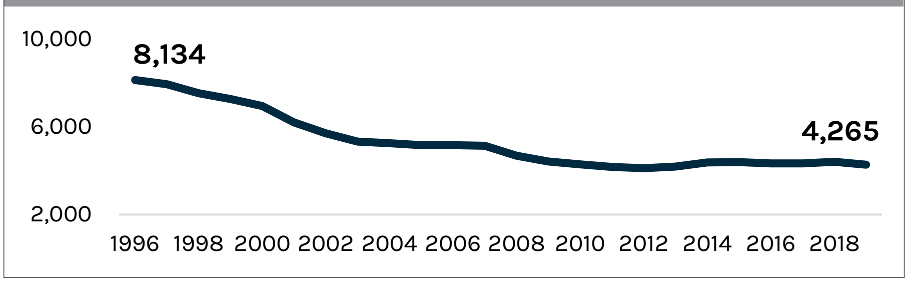
The opportunity-set within public markets is not what it used to be. The number of US publicly traded companies peaked at 8,134 in 1996 and has dropped by nearly half to 4,265 (including to OTC listings).[1]

The Wilshire 5000 index that used to be synonymous with the total US stock market, today has only ~3,600 holdings.[2]

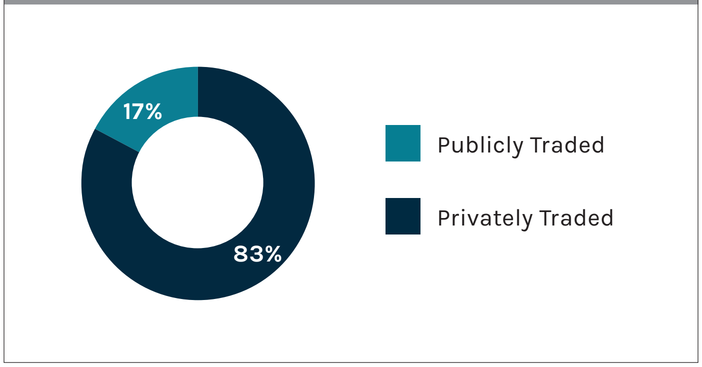
Meanwhile, public equity indices are becoming increasingly top-heavy. Today, the ten largest constituents in the S&P 500 account for approximately one-third of the entire index. And they're nearly all technology companies. So, the diversification benefit of "buying the index" has eroded significantly.

Now compare that to the more than 17,000 large private companies in the United States and approximately 197,000 midsize private companies in the US—companies that are accessed through private equity.[3]

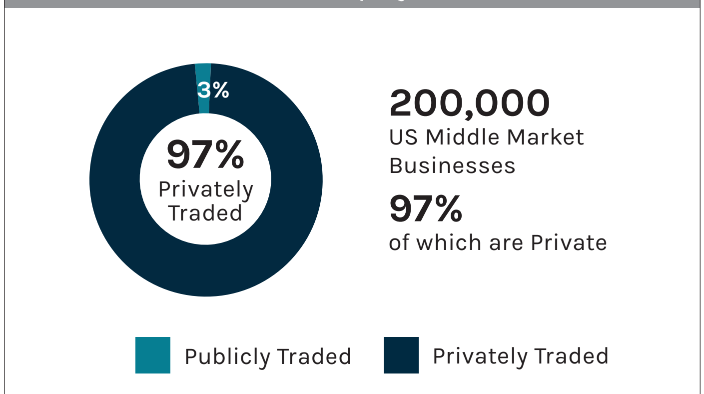
Number of US Publicly Traded Companies



# of US Large Companies (500+ employees)



# of US Moderate/Larger Companies (100+ employees)



Midsize businesses account for approximately **one-third of employment** and **one-third of output** of the US economy.

If these companies were their own country, they would be roughly the size of Germany or Japan.[4]

1 Fred St. Louis Fed, US Census Bureau, S&P.
2 Wilshire. As of July 2022. The difference between the Fred St. Louis Count and Wilshire count driven by OTC listings.
3 US Census Bureau. US company count to December 2019, as of July 2022. "Large companies" defined as 500+ employees.
4 National Center for the Middle Market, as of Q2 2022. "Middle market" includes companies with $10 million to $1 billion in revenues.

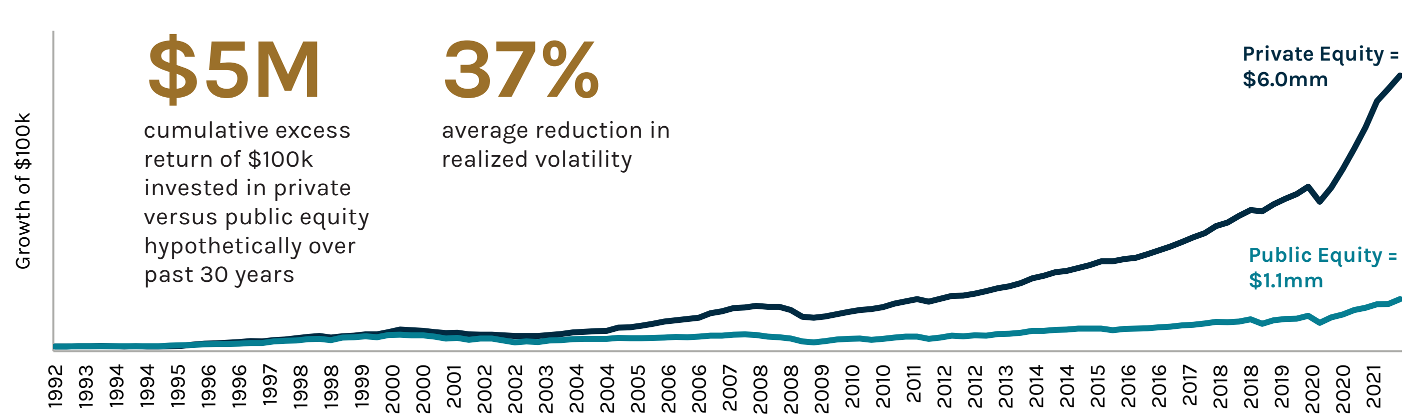
Takeaway #2

For investors seeking attractive and durable equity performance in all types of market conditions, private equity has historically demonstrated superior results.

As investors, it always comes back to return and risk. Here, we believe private equity has demonstrated its superiority over its public market peer(s).

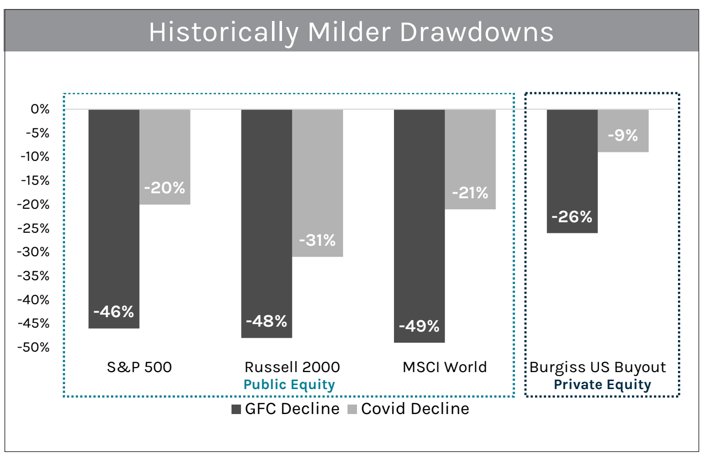
While there are several types of private equity, we focus here on Buyout, which is the largest and most mature segment.

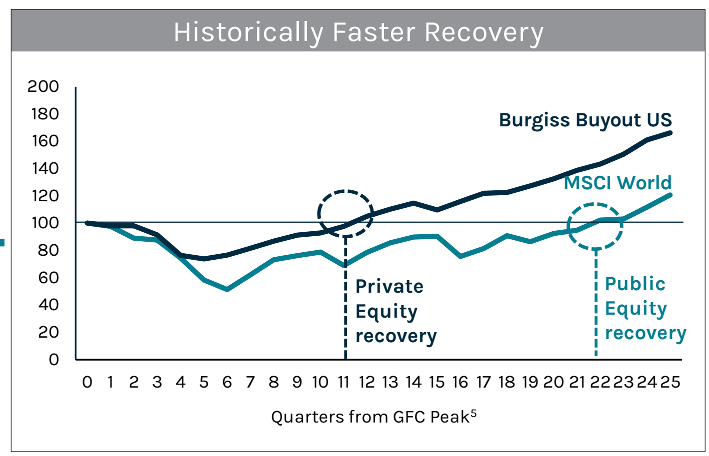
Historically superior risk-adjusted returns, with higher net returns and less realized volatility



Past performance is not a guarantee of future results.

A history of better downside protection, with smaller declines and faster recoveries





We believe much of this was driven by fundamentals. For example, during COVID-19 [predominantly private] middle market companies saw revenues decline only one percent versus six percent for the S&P 500. Similarly, employment was down only two percent versus eight percent for the S&P 500.[6]

History has shown us the superior risk-adjusted return profile of private equity relative to public equity. But can we trust that these dynamics will last? We believe yes.

5 X-axis =measured from the individual peak of each given asst class in order to compare drawdowns and recoveries without delayed timing effects.
6 National Center for the Middle Market, as of Q2 2022. “Middle market” includes companies with $10 million to $1 billion in revenues.

Takeaway #3

We believe that the strong incentives embedded in private companies create a powerful and sustainable alignment of interests for institutional and private investors alike.

The three-decade shift toward private markets has been driven by real, structural benefits to companies in remaining private. Many of these benefits have to do with incentives and alignment of interests that are likely to continue driving these trends. These benefits are typically grouped under four categories:

Incentives and Alignment of Interests		Private Companies	Public Companies
	Executive Compensation	• Typically aligned with successful exit of private equity sponsor • Tied to growth in revenue and better operational efficiency **<u>over the next 5-7 years</u>**	• Aligned with market cap (e.g. public market CEO pay is highly correlated to the size of the company) • Tied to growth in company size and share price **<u>over the next 12 months</u>**
	Board Membership	• Typically have significant personal investment • Typically sit on fewer boards • Limited personal liabilty for regulatory compliance	• Often flat $ compensation • Typically sit on many boards at a time • Personally liable for regulatory compliance
	Board Structure	• Frequent meetings (~12x / year) • Prioritize previous industry and company experience and contribution to value creation	• Infrequent meetings (~4x / year) • Prioritize independence, leading to lack of industry expertise and inability to drive value creation
	Regulation & Oversight	• Lower cost of compliance due to fewer regulations • Long-term value often prioritized over short-term accounting profits	• Executive Board structure influenced by industry regulation • Short-term accounting profits often prioritized over long-term value

Source: Partners Group (https://www.partnersgroup.com/fileadmin/user_upload/Files/sec-download/Research_PDF/2018_Partners_Group_White_Paper_The_Rise_of_Governance_Correctness.pdf) and Ares data

The structure of private companies allows them to focus on longer timeframes and innovative growth with aligned boards answering to owners (the investors) rather than "The Street." **These longer timeframes also tend to align with the longer timeframes of most institutional and individual investors.**

Taken together, we believe these reasons create an equal if not stronger long-term value proposition for private equity relative to public equity. This has historically manifested itself in superior risk-adjusted returns that we believe will continue to persist and grow.

Conclusion

We expect private equity will play an increasingly large and important role for both business owners and investors.

Today, investors have much greater means of investing in private markets than ever before. While institutional investors have used them extensively for decades, private market investment firms are now providing the same access for individuals.

Financial advisors can now incorporate these arguably core asset classes into portfolios—providing fuller access to the broad American economy while tapping into their structural resilience and potential growth.

Investors are likely to continue hearing about private markets for a long time to come.

About Ares Wealth Management Solutions (AWMS)

Ares Wealth Management Solutions' mission is to provide advisors and their clients access to innovative, solutions-oriented investment opportunities, across the Ares platform of industry-leading credit, private equity, real estate and secondaries strategies. Through our range of institutional and retail structures, coupled with excellent client service and educational resources, we help investors diversify their portfolios with private market solutions that seek to deliver consistent, long-term growth.

See the next page for important additional information.

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- Valuation risks - the risk that the securities are valued at prices the seller is unable to obtain upon sale due to factors such as incomplete data, market instability, human error, or no readily available market quotations, and other factors
- Risk related to private companies – these companies are generally not subject to SEC reporting requirements, are not required to maintain accounting records in accordance with generally accepted accounting principles and are not required to maintain effective internal controls over financial reporting. As a result, there is the risk that investors may invest based on incomplete or inaccurate information, which can adversely affect performance. Private companies may also have limited financial resources, shorter operating histories, more asset concentration risk, narrower product lines and smaller market shares that can make such private companies more vulnerable to competitors' actions and market conditions

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

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