Insights on...

PRIVATE EQUITY BENCHMARKING

PRIVATE EQUITY INDEXES – INSIGHT OR SELF-DECEPTION?

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Every prudent investment program manager needs a way to measure progress. However, benchmarking a private equity program is a difficult proposition, defying the traditional notions of benchmarking. So-called private equity benchmarks lack the classic attributes of a good benchmark: investability, known constituency, appropriateness, etc. Yet, managers and investors demand some barometer of success, with the performance industry eagerly responding with a plethora of composites, indexes and universes. However, investors and managers both need to be aware of the benefits and limitations of so-called private equity indexes – these increasingly popular metrics – because they either can be insightful or deceptive depending on their ultimate use.

GOT DATA?

Conceptually, the creation of indexes and universes seems fairly straightforward: gather a set of transactions, valuations and performance data for a large sample of partnerships and go. The challenge is very much in the completeness, availability and timeliness of the raw data, not necessarily the mathematics.

Categorization seems clear enough, but to evaluate an index, you need to understand where the various types of private equity are classified. For example:

- Are secondary interests included in the larger group?
- Are the funds of funds their own group?
- Are mezzanine and debt lumped together?
- Is there an "other" category and what does it include?

These definitional differences, the partnership names represented in the sample and grouping criteria all help explain the differences between vendors. A clear understanding of classification can help the investor understand "appropriateness" of the comparison.

IT'S JUST MATH!

Typically indexes are capitalization weighted or, in the case of private equity indexes, partnership-size weighted. However, private equity indexes and composites can use a variety of weighting schemes, including pooled composites (with partnership size influencing weighting, similar to market capitalization or float in the public market) and equal weighting composites (average or mean of partnerships). Once the weighting is established, the data can be summed into a single stream of dated cash flows and valuations over time to create a time-weighted rate of return series, much like the ones used for measuring a portfolio of marketable assets.

You can easily see from comparing a simple average (mean) to a pooled average that weighting has considerable effect. This effect is arguably more pronounced in the world of private equity

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given the recent phenomenon of mega partnerships. Comparing the average to the median of the partnerships in the sample is an indicator of private equity's skew of performance characteristics. Viewing the top and bottom deciles of the data provides a picture of the dispersion of results in this world, but the "pooled average" is the de facto standard in creating time-weighted composite index series.

Typically, various time-weighted series are created for any cut of the data, including partnership type (buyout, venture), venture stage (seed, expansion) and buyout partnership size (mega, large). Placing the data into a time-weighted format makes it convenient to understand the broad behavior of private equity sliced various ways. The next temptation is to use it to gauge the success of an investor's portfolio since such a nice time series easily lends itself to creating point to point periods (quarter, year, five years, etc) as well as blending these series for "custom comparisons" to ostensibly reflect the investor's portfolio composition. After all, it's just math once the data sample is labeled and assembled.

OR IS IT JUST MATH?

Mathematics aside, at least three characteristics of private equity confound the creation of a true private equity index: lack of a true market price, J-curve effect and tiered markets. Throw in incomplete and uncontrolled constituency, late-arriving pricing, inconsistent pricing standards, and partnership categorization issues, and the private equity index results become increasingly nebulous.

The foremost challenge is that no market pricing mechanism exists for private equity; the manager is the source of the price. Despite the push for "fair value," managers can produce different prices for the same company holding. A lack of a true market pricing mechanism plus lack of standards can produce somewhat mysterious results. If your manager was diligent about write-downs, your partnership could compare very unfavorably in the vintage herd.

The second issue is the age of the partnership. Unlike marketable assets, the classic J-curve phenomenon (losses due to startup costs plus fees and gains later) of individual partnerships means any comparisons made during the investment period and shortly thereafter are usually nonsensical. This is also true for portfolios with a bias toward newer or older partnerships, or concentrations that look much different than the so-called index. You could compare individual partnerships to the universe of vintage year and type, but you would still encounter our next issue.

The third issue is that private equity investing is widely accepted as a tiered market; not every investor has the same access to the same partnerships. If winners truly repeat in private equity, the best performing managers will also select the investors with whom they have established relationships. Private equity is a relationship business, and if you have just gotten into the game, your performance may be less than what investors with the stellar established managers will realize. These "quality" differences can make your portfolio and the index incompatible.

The constituency of the index or composite is also problematic. To help understand the impacts of the second and third issues, investors would need to see the partnerships in the index to understand how representative it is of their portfolio. Private equity universe and index providers do not publish the constituency or show individual partnership performance. Even an index representing a complete census of every partnership created still is problematic if it does not look like your portfolio.

All of these factors result in private equity indicators that may be interesting but not terribly dependable benchmarks in the traditional sense. Just try to compare medians, averages or composites (indexes) from one vendor to the next and observe the dispersion of results in a very finite, but very hard to access, universe of partnerships. For example, one popular set of indexes is often

criticized that its manager-volunteered data results in an upward bias, yet one of the much-touted "well-managed constituency" providers has higher index results. In the opaque world of private equity indexes, separating marketing from fact is difficult, as is understanding the reasons for the differences.

One thing is clear, using this data for developing investment policy expectations, portfolio benchmarking and traditional performance attribution is inherently problematic and leads to what some term "deceptions of science."

THE DECEPTIONS OF SCIENCE

Despite these difficulties in creating a true private equity benchmark, some consultants, investors and managers use this data in mean-variance planning exercises such as optimization, asset liability modeling and so on. The infrequency of pricing events and even quarterly market values can result in indefensible estimations of standard deviation and correlation, leading to overly optimistic expectations of diversification benefits. Not to mention, from an asset expectation modeling perspective, private equity does not have a very long history of return data.

Very often, consultants quote total composites that include all private equity types as evidence of private equity's ability to outperform the S&P 500 over long periods. Although the drawbacks are now fairly well understood by consultants and academics alike, self-deluding efficient frontier charts touting the efficiency benefits of adding private markets assets to the asset mix continue to surface.

For performance analysis, investors also want to know how their private equity contributed to total portfolio return. But since private equity indexes fail the test of true benchmark, they will cloud total portfolio performance attribution. Some have suggested using the time-weighted performance of the private equity portion of the portfolio in total plan attribution. This helps, but arguably results in a faux attribution effect caused by the difference in the target and actual allocation, for which most sponsors do not have any control. Anywhere a traditional index is used, the investor needs to understand the undesired effects of using so-called private equity indexes.

BETTER APPROACHES COMING

Private equity indexes, comparisons and universes can provide some insights into the aggregate behavior of these illiquid assets, but they fall short of being true benchmarks in a traditional sense. These indexes may allow generalizations to be made about how private equity types have performed or the influences of vintage years on the total asset class, so the index data itself should not be dismissed wholesale. But the investor, consultant, manager or other consumer needs to be aware of the shortcomings of the information, and understand the wide dispersion of private equity performance. So-called private equity index results are simply not dependable for investment decision-making, including program manager compensation.

Better approaches are on the horizon, but for now, there are no "perfect" benchmarking solutions with private equity.

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