MYTHS OF PRIVATE EQUITY

What is most surprising about PE industry performance data is that anyone relies on it in the first place. Returns are so easy to manipulate and misreport that it is impossible to prove their relative superiority or inferiority let alone their veracity. ILLUSTRATION: PIXABAY

Why analytical tools fail in assessing PE performance against other asset classes

The inconsistencies inherent in the analytical process render comparison exercises futile. **By Sebastien Canderle**

THREE myths about the reliability, predictability, and resilience of private equity (PE) performance play a salient role in drawing investors to the asset class.

To prove outperformance, however, PE returns are assessed relative to those of other asset classes. From this practice, the myth of performance comparability emerges.

Myth: Private equity performance can be benchmarked

Our fascination with league tables bears some of the blame for the competition around performance reporting. Asset managers' results are often benchmarked against those of their peers. PE managers typically report the quartile in which the investment returns of their vintage funds fall.

But it serves PE firms' interests to make their true performance cryptic. If prospective investors can't get a full grasp of a fund manager's relative results, they will be susceptible to marketing tricks and branding and more prone to such behavioural biases as fear of missing out (FOMO), anchoring, and homophily, or our tendency to associate with those with whom we bear a resemblance.

In addition to performance manipulation techniques, PE fund managers have devised various strategic tools that make it difficult to analyse and assess their returns.

By building giant one-stop shops, for instance, the Big Four PE firms – Apollo, Blackstone, Carlyle, and KKR – are configuring a unique business model. Prospective investors are unable to benchmark them against the rest of the pack. They are becoming peerless, even if Ares, Bain Capital, CVC, EQT, and TPG, to name a few key challengers, are trying to keep up.

This is a risky enterprise. TPG's field of expertise is supposedly mega buyouts, yet its track record does not always inspire confidence. My former employer Carlyle's notable failures in the hedge fund space are hardly commensurate with the firm's reputation. Meanwhile, EQT recently exited its credit activities business. All of which demonstrates that there are many false starts on the road to incomparability.

Individual fund managers are careful to conceal their money-making process. The investment pyrotechnics of leverage buyout (LBO) artists infuse the latter with an air of mystery derived as much from their financial innovation as from the ambiguity of their reported performance. But this theory of comparability has another side that has much broader ramifications.

Benchmarking against public markets

The accumulation of surplus capital from institutional investors is an almost infinite game. Blackstone reached US$500 billion in assets under management (AUM) in the first quarter of 2019. But by then, the firm had already set its sights on US$1 trillion. For this reason, the Big Four are not so much in competition with their PE brethren. Rather, they aim to poach market share from other asset management sectors and morph into fully diversified private capital groups.

To attract a broader asset base and, in the process, significant fee-extraction opportunities, the leading firms emphasise their economic value creation and growth-enhancing pedigree. There's a fatal logic to this. To appeal to this capital, PE firms have to market themselves as outperformers relative to the most visible and popular asset class: public equity.

Regrettably, PE has failed to outperform the public markets in recent years. Ample research backs this up. In a study of cash flow data from almost 300 institutional investors in more than 1,800 North American buyout and venture capital funds, Robert S Harris, Tim Jenkinson, and Steven N Kaplan determine that US private equity returns for post-2005 vintages were more or less equal to those of the public markets.

PE investors earned an average annual return of 15.3 per cent for the 10 years ending in June 2019, according to Bain & Company. Over the same period, the S&P 500 generated annualised returns of 15.5 per cent on average.

In a forthcoming study of US endowment fund performance, Richard M Ennis, CFA, finds that none of the 43 reviewed funds outperformed the public markets over the last 11 years, but one in four underperformed. "The problem," Mr Ennis writes, "is the combination of extreme diversification and high cost."

Late last year, consulting firm CEM Benchmarking added its own research into the mix to show that, net of fees, PE underperformed small-cap stock indexes in the past two decades. The researchers concluded that an in-house, lower-cost approach was the only viable investment strategy.

Flawed analytical tools

These findings are stark. But they don't tell the whole story. In my experience, the inconsistencies inherent in the analytical process render these comparison exercises futile. What is most surprising about PE industry performance data is that anyone relies on it in the first place. Returns are so easy to manipulate and misreport that it is impossible to prove their relative superiority or inferiority let alone their veracity.

The shortcomings of the internal rate of return (IRR) method are well documented. To address its deficits, Austin Long III, and Craig J Nickels, CFA, developed a tailor-made indicator – the public market equivalent (PME) or index comparison method (ICM). The PME reproduces private equity cash flows as if the same capital calls and distributions had occurred in the public markets. The yield is then compared to the fund's actual IRR. If the IRR outperforms the PME, then the fund outperformed the public index.

Don't think that, from then on, the PME became the new yardstick to measure performance and reach a definite conclusion to determine whether the illiquid asset class outperformed public equity.

Almost as soon as the PME was introduced, academics developed new metrics to supersede it. Why? Because as Warren Buffett once observed: "The data are there and academicians have worked hard to learn the mathematical skills needed to manipulate them. Once these skills are acquired, it seems sinful not to use them, even if the usage has no utility or negative utility."