The short, the index, and the private markets

By Massimiliano Saccone

The GameStop story recently returned short-sellers to the front pages of the global financial press. The Reddit crowd's "Main Street takes revenge on Wall Street" narrative cast these short-sellers as the villains of the financial markets. It also created enough consensus buying pressure to squeeze their positions into margin calls and realised losses.

But my focus here is not the GameStop story. Rather, it is the necessity of both short positions and representative, investable benchmarks for private market investments.

Cash is king

I admit, early in my career I viewed naked short positions as a noisy and disturbing component of the market. But I was confident that the market would discover the fair value and that that fair value would become the transactional price.

Trained as a long investor, I had fixed-income quant notions, equilibrium economics, and efficient pricing models in mind, and when I was thrown headfirst into equity fundamental analysis in corporate finance and investing in public markets, I was fascinated by equity stories and entrepreneurial narratives. At that time, I naively believed that pure speculative short positions, those that sought to profit from a company's misfortunes, had some – yes, let's say it – unethical components.

Later, equity markets taught me about real-life investing and I soon realised the important and courageous role shorts play. Value is a target, an expectation, the result of the best possible judgment process. But the price you pay or receive in actual transactions is the only objective element that matters. The cash of settled transaction is king. The rest is opinion.

Short-sellers are a serious breed of investor. They borrow shares and sell them out of conviction. In a reasonable time horizon, they believe the price that they must pay to close their position will cover the costs and produce the targeted profit. Conviction is key. The ability to stand the passing of time, to wait, is the critical execution variable. You do not think something is a good investment per se, or in relative terms a good hedge against another investment – the long-short case – and can finance the trade, then you sell it. Full stop.

Talk is cheap

What does short-selling have to do with indices? If indices are investable, investors have the option to both buy and short an asset class. This implies that indices are representative of the asset class or the sub-allocation within it. That means taking a long or short position in an index creates a natural hedge to complement or create a well-diversified portfolio.

This, of course, applies not only to up-or-down, macro long-short situations, but also to any tactical adjustment of existing asset allocations.

What makes an index investable and representative? According to the accepted theory, a representative benchmark must satisfy seven requirements. It has to be:

- Specified in advance, prior to the evaluation period's onset.
- Appropriate, consistent with the investment style of the investors.
- Measurable and readily calculable on a reasonably frequent basis.
- Unambiguous, so that the identities and weights of its constituents are clearly defined.

> The industry's development trend (towards democratisation) implies the concept of product suitability. It is in the interest of both general partners and investors to anchor private equity return expectations to parameters that any category of investor can understand and verify.

- Reflective of current investment opinions.
- Owned, so as to offer adequate accountability.
- Investable: in other words, it is possible to indifferently hold the benchmark or its constituents.

The practice of the financial markets and the regulation of the European Union (Benchmark Regulation, EU 2016/1011) further indicate that the concept of financial benchmarks requires a specific regulatory regime for indices that are used to determine the amount payable, or the value of a financial instrument, or to define an asset allocation or to measure performance fees.

Outside these boundaries, the notion of benchmarking loses gravity. All other products that are simplistically defined benchmarks should be recategorised to metrics for peer-group comparisons since they lack the required formal elements of a valid benchmark definition. If an investor cannot regularly use the relative value indications of a benchmark index, that index does not meet the utility requirements and is a mere post-mortem exercise. Talk is cheap.

Money talks

Private equity (PE) is the perfect example of an asset class for which all currently used benchmark definitions should be reclassified. They are metrics for peer-group comparisons and relative value analysis ratios. There is no valid benchmark for the unlisted PE industry, none that yields an unambiguous performance valuation or that offers adequate market risk management of the investment portfolios.

For these reasons, discussions of PE returns are more like arguments among football fans than accurate performance evaluation exercises.

And I am not just referring to future return expectations, which are, by construction, subjective and based on hypothesis. I mean past and current returns, which should be ex-post notions that leave no room for ambiguity or subjectivity. And yet, they do.

Why is a performance assessment of an industry with trillions in assets under management (AUM) still so elusive? The industry metrics report sizeable absolute return and outperformance margins while academic studies produce divergent evidence. None of the metrics currently in use accurately calculate the industry's average performance.

I propose an objective solution. Anyone who discusses the outperformance or underperformance of the unlisted private equity asset class, or sub-sectors thereof, should align their financial interest with their judgment and eat their own cookies. Would they buy or sell their "benchmark" determinations forward? Would their benchmarks be tradable? Money talks, after all.

I advocate building benchmark indices that truly represent the physical allocation to unlisted private funds and that comply with the underlying theory and conform to the regulatory requirements.

The only objective criteria that should guide any such exercise is the short trade challenge that I am proposing. If an investor is long the physical constituents of the index – the unlisted PE funds – and short the index, the resulting net position should be zero, or reasonably close to it, depending on the match accuracy of the hedging position and costs associated with holding individual index constituents.

I do not see any such instrument available in the market today. This is a gap that needs to be filled.

In whose interest?

The industry's development trend is clear. It points towards democratisation. That implies the concept of product suitability. It is in the interest of both general partners and investors to anchor PE return expectations to parameters that any category of investor can understand and verify.

Benchmarks should provide that reference price in the market. Such benchmarks have historically contributed to significant market growth of the asset class they are constructed to represent. They could do the same for private equity. That is why it is in everyone's interest that they be created.

Massimiliano Saccone, CFA, is the founder and CEO of XTAL Strategies, a fintech SME developing a platform of innovative private market indices and risk-transfer solutions.