THE BUSINESS TIMES

BT

businesstimes.com.sg

Wednesday, August 10, 2022

INSIGHTS FROM CFA SOCIETY SINGAPORE

# Not all net-asset-value valuations are created equal

Private-market valuations are still opaque and methodologies by which valuations are derived are often a mystery

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THE debate about private-market fund valuations and volatility has returned to centrestage. To quote Mohamed El-Erian, some private equity managers believe "their asset class would avoid the reckoning that stocks and bonds have been exposed to this year because they were structurally immunised against disruptive changes in the investment landscape". El-Erian says that this "may prove to be misplaced self-confidence", while Cliff Asness describes it as "volatility laundering". From a capital-market perspective, how can investors price net asset value (NAV) valuations and efficiently transfer their eventual risk?

We have developed an actionable framework. The best way to offer investment commentary is to walk the talk and take a side in a trade. If you think that a NAV's valuation is low, you should buy at that price. If you think it's high, you should sell. There should be a proper mechanism in place to reward such forward-looking, relative value trades. As a consequence, an investor could monetise a higher or lower return – a positive or negative risk premium – versus other allocations over a given time horizon.

Private-market valuations are still opaque, which makes it difficult for investors to determine the value of private assets. Unlike in listed markets, private-market prices are not publicly available and the methodologies by which valuations are derived are often a mystery.

Still, private-market investments can't ultimately conceal their true results. Their self-liquidating structures are intrinsically objective. Volatility can't be laundered indefinitely. In the end, the total value produced over time will be converted to cash.

Before liquidation, even when private-market returns are measured with an accurate methodology, they are heavily influenced by the on-paper gains and losses of the estimated interim NAVs.

General partners have different philosophies about what is a fair NAV valuation. Some have a mark-to-market outlook, while others take a less-sensitive stance on market risk. Not all private-market fund valuations are born equal.

Indeed, the International Private Equity and Venture Capital Valuation (IPEV) Guidelines dictate several valuation methodologies for deriving the fair value of private funds. These run the gamut from comparable transaction multiples to discounted cash flow methodologies to quoted investment benchmarks. Nevertheless, the Financial Accounting Standards Board (FAS 157 – ASC 820) places the focus on fair value, with an emphasis on the exit value, or the expected proceeds from the sale of the given asset.

While private market investments tend to be held for the long term, their fund's liquidation mechanism gives their mark-to-market value the final say. Only when portfolio assets are sold does the seller discover what the market is willing to pay. If the paper valuations of those assets do not reflect their corresponding secondary market price, the buyer may seek to negotiate a discounted price and thereby increase their probability of a positive risk premium.

Our research has sought to explain and maximise the value of time-weighted metrics in private-market investments. Why? Because private-market assets should be comparable to all other asset classes and easier to comprehend. This will make the asset class more usable, improve portfolio and risk management, and reduce the idiosyncratic inefficiencies of the undrawn cash or overallocation. Our investigations have yielded many first-of-their-kind private-market solutions.

Through our duration-based calculation methodology, we measure the time-weighted performance of private-market investments and establish a real-time valuation link with the public markets that makes volatility explicit and eliminates delays or lack of estimates.

This rules-based probabilistic framework is grounded on a robust benchmarking approach. Investors can nowcast and objectively assess the mark-to-market quality of the NAV of their private-market investments.


Private-market assets such as those managed by Blackstone offer diversification benefits, but valuation methodologies may be opaque. PHOTO: BLOOMBERG

With real-time, time-weighted indexing techniques, the duration-adjusted return on capital (DARC) methodology constructs a curve of forward returns for private market funds that ties ex-post performance to forward-looking expectations. Only time-weighted returns can be traded over time, and the DARC makes private funds tradable over future maturities.

With our Private Fund Forward Exchange (PRIFFE), investors can test the potential of current NAVs to deliver equivalent cash in the future, anticipate the expected forward returns over the targeted time horizon, and manage the volatility of the mark-to-market. The premise behind our approach is that money on the table can take advantage of the staleness of misplaced private-market NAVs — hence the PRIFFE acronym, which plays off of "priffe", or money in the 19th-century Roman dialect, and priffe, a traditional Swedish card game with bids and contracts.

A conventional rationale for private-market investments is that their "stale" valuation profile reduces the volatility of a typical multi-asset portfolio and provides return stability. But this is only true for short-term declines in valuations. Private-market fund reporting has a lag of several months and may benefit from hindsight. Since the global financial crisis, we have yet to see a prolonged period of asset repricing. Hopefully, we won't see one again, though that may be wishful thinking given the current economic framework. If such repricing occurs, private-market investments have no way out.

Market conditions will always influence the exit values and returns of private investment portfolios. Even assuming stable valuations, the liquidation process may take time, reducing returns. In up-trend cycles, like that of the last decade, duration and market risks are often neglected, but they track private-market investments through the ups and downs. Mark-to-market just makes them more visible.

Going forward we need to anticipate and manage the mark-to-market adjustments to increase transparency around private fund investments. Private-market funds that adopt a mark-to-market approach may exhibit more volatility and seemingly even underperform in certain market conditions. But they offer investors 3 important advantages:

- Despite the usual reporting lag, investors can calculate more robust now-casted NAV estimates. The more consistent the starting point, the lower and more random the estimation error.
- Such NAV data makes investors' balance sheets more resilient and eliminates the negative performance spiral that results from the artificial denominator effect, which locks in losses.
- At any time, any asset allocation that includes private-market funds would offer a balanced perspective of the forward-looking risk premia that the various asset classes are expected to earn.

A mark-to-market context creates positive anticyclical investment dynamics. This means the possibility of increasing risk at decreasing valuation and vice versa, rather than crystallising losses or adding risk at increasing valuations. This will naturally reinforce the smoothing benefits of diversification.

Not all NAVs are created equal, hence not all forward-looking returns will be equally attractive. Some of them may be worth selling, others may be worth buying, if you can tell them apart and execute.

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