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'Alpha-flation': A private market syndrome

By Massimiliano Saccone

IN PRIVATE equity (PE), there are more ways to calculate the alpha of a portfolio or fund than any other asset class. And in no sector other than private markets does investing in the average fund seem to go so poorly.

Should it be this way? Is the average private market fund a bad fund and the mean private market return a bad return? And if so, why?

In every other asset class, the average fund is one that hits its minimum threshold. The average fund, then, is not "exceptional".

To be sure, beating a relevant index or beta reference on a rolling basis, on the key investment horizons, is hardly an easy task.

Quite some time ago, I wrote about private capital beta and internal rate of return (IRR)-alpha but the alpha narrative has still not changed. What accounts for PE beta's poor reputation? The undeniable influence of David Swensen and the Yale Endowment Model is a critical factor.

A 2013 Yale financial report contains the blueprint statement for the private equity alpha run:

"Yale has never viewed the mean return for alternative assets as particularly compelling. The attraction of alternatives lies in the ability to generate top quartile or top decile returns. As long as individual managers exhibit substantial dispersion of returns and high-quality investment funds dramatically outperform their less skilled peers, Yale enjoys the opportunity to produce attractive returns for the Endowment and to demonstrate that manager alpha (excess return) is alive and well."

The Alpha Narrative, then, is about picking winners, possibly those in the highest deciles, assuming wide dispersion of returns. Too bad that PE quartiles are meaningless and that dispersion is exacerbated by the IRR's implicit reinvestment assumption on which these concepts are based.

The private market's alpha syndrome

Marketing will always emphasise superior returns and the alpha generated by general partners. This is widely understood and easily discounted. But what about the alpha take of allocators, limited partners and their advisers?

Here, human nature bears much of the blame as does a combination of emotional biases and cognitive errors, which can affect the behaviours and decisions of financial market participants.

There may be the need to address the investors' and stakeholders' pre- and post-investment requirements – and their behavioural biases, such as anchoring, regret aversion, and illusion of control – behind the development of several measures of alpha for private market investments by allocators and advisers.

Stakeholders demand assurance and reassurance, particularly with respect to often expensive and hardly reversible investment decisions in long-term, illiquid assets. Alpha, as the ultimate outperformance seal, should meet that need.

Absence of private market beta leads to alpha-flation

The fact is the various measures of private market alpha fail to reflect the only definition of alpha that should apply to financial investments: The excess return of the specific investment relative to the relevant representative benchmark. In the case of PE, that means an accurate private market beta.

Since accurate and representative benchmarks for private market investments have not been traditionally available, allocators, advisers, and academics have devised different alpha-like metrics. Most of these reference the public market beta, or in some cases, completely unrelated market metrics.

The direct alpha method is the principal "financial alpha" outperformance metric in the private market. Often associated with the Kaplan–Schoar PME (KS-PME), it has been recently supplemented by the excess value method.

The direct alpha method delivers a rate of outperformance versus a listed benchmark, while the KS-PME generates a ratio and the excess value method the related monetary amounts. The KS-PME was indeed introduced to fill in some of the gaps left by its predecessors. Nevertheless, all these metrics have the same inherent limitation: They are deal-specific, so their results cannot be properly generalised. Without checking that box, they cannot be considered proper benchmarks, or their definition of alpha seen as accurate.

Academics and data providers have proposed other metrics to gauge PE alpha. But these haven't overcome the generalisation limitations or achieved the necessary one-to-one correspondence between actual monetary amounts and the compounded rates generated by the algorithms.

More recently, practitioners have shifted the alpha focus to the probability of outperforming the required investment returns. This is an interesting and coherent approach given PE's absolute return nature. Still, it resembles an escape hatch more than a solution to the alpha puzzle.

All told, the risk of these definition drifts for stakeholders is that allocators will create self-referential benchmarking tools that fail to bring the necessary objectivity to the investment and reporting process.

What PE alpha should be in private equity and what it takes

As in other asset classes, PE alpha should measure outperformance the way Burton G. Malkiel did in A Random Walk Down Wall Street. Malkiel declared: "A blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts."

That is, positive alpha is produced when a discretionary allocation in the private markets beats a rules-based diversified allocation in a coherent cluster, over a coherent time frame, on a fully diluted basis and under no-arbitrage conditions.

This calculation is possible with robust and properly representative private market benchmark indices that are built in time-weighted terms.

These should be capable, through compounding, of producing a one-to-one correspondence to the actual cash and NAV balances of the underlying constituent fund portfolio.

This is one of the core purposes of the Duration-adjusted Return on Capital (DaRC) methodology, which is a critical building block for proper PE benchmarks. The DaRC and related indices give users the ability to determine a proper alpha and to leverage the characteristics of private market beta and of the market risk profile in private market investments.

The mean PE fund is not a bad fund, according to our analysis, and the mean return has not been bad for the 25 years we observed. Indeed, we found that even fund underperformance can be explained by the relevant private market vintage index (that is, the mean fund). Investing in blind pools is hard, and the robust statistics that indexed diversification provides can help.

The alpha-flation of private market narratives creates significant distortion. It generates outperformance expectations that misrepresent the total return management style of private market investments. This could create unintended "boomerang" consequences for the industry, especially now that less-sophisticated retail investors are gaining greater access to the asset class.

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