

# Harvesting illiquidity premia

Private equity outperforms public equity – not least thanks to its illiquidity premium. But, as **Cyril Demaria** writes, using public equity as a benchmark for valuation can make it difficult to harvest this benefit

## Commentary Illiquidity and Benchmarking

The adoption of the European Alternative Investment Fund Directive in 2011, and its upcoming transposition by European member states in national legislation, will put private equity fund valuations and performance under scrutiny.

This legislation states that third parties will have to review and deliver an opinion on the interim valuation provided every quarter by private equity funds managers. Other regulations governing solvency ratio calculations for banks, pension plans and insurance groups, which are major sources of capital for private equity funds, have transformed the question of performance and valuation of these funds.

Modern private equity activity started in the 1970s in the US with leveraged buy-outs (LBO) and venture capital, during 1990s for the rest of the developed world, and essentially after 2000 for everyone else. For that reason, the performance history is relatively limited and skewed towards US figures, which still represent 60% of documented activity worldwide.

Still, while there is much academic debate about private equity returns, the consensus is that private equity's realised returns outperform stock exchange indexes (notably the S&P 500 index) by 500-800 bps.

The real problem is that this performance is particularly difficult to capture as a benchmark for investors. Listed private equity indices (such as the LPX 50) do not help because dispersion of returns around the mean were and remain very high (and numerous studies have shown that top quartile managers tend to stay in this quartile): they merely serve as early indicators of upcoming venture capital or leveraged buy-out bubbles.

Moreover, as the table below illustrates, it seems clear that the timeframes considered, the timing of investments and the weighting of venture capital, leveraged buy-outs and other private equity strategies, can significantly affect the overall performance of private equity investors.

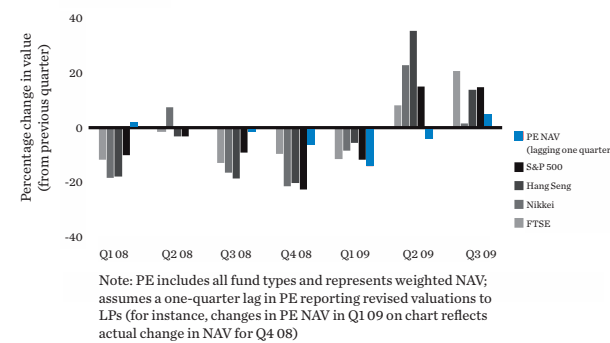
### Illiquidity management

But even if median and average returns from private equity could be assessed and predicted, the core difficulty remains harvesting that performance – that is to say, dealing with its illiquidity.

Theoretically, given the long investment horizon of pension funds, private equity funds' reported unrealised returns have proven to be less volatile than the returns of private equity indices – indeed, one of the lessons of the 2007-09 crisis is that the volatility of stock exchanges is higher than those of private equity.

Pension fund managers do not have the same liquidity constraint that other investors in a crisis have – so for them, illiquidity need not be consid-

### Market indices versus private equity NAVs



Source: Bain, 2010, based on Preqin and Bloomberg

ered merely as a risk, but rather as an additional dimension to the usual risk-return framework through which asset classes are evaluated. However, stock exchange and private equity volatility still translates into portfolio valuations through accounting and reporting under pension funds' solvency and risk-management regimes. The illiquidity of private equity translates into a certain inertia in its valuations (reflecting potential future returns), which affects pension funds during their yearly reporting exercise.

One illustration of this additional risk was the 'denominator effect' faced by long-term investors in 2008 and 2009. Long-term investors usually formulate their asset allocation as a percentage of their total assets under management. If the total of assets under management varies downwards (notably due to heavy discounts on the stock exchange), and private equity does not (due to its lower volatility, as shown in the graph above), then there is a superficial 'over-commitment' to private equity.

Due to the denominator effect, investors had to divest to match their target allocation or temporarily increase their private equity allocation – as certain US pension funds did. Divesting into the secondary market for private equity funds is tricky: it is not liquid, transaction costs and delays are high, and the stakes are usually negotiated at a discount due to lack of transparency.

How might pension funds deal with the potential of being hit by the denominator effect? Recently, The Carlyle Group decided to include an early liquidity clause for its investors – after six years of fund activity, limited partners are entitled to exit from the fund at a valuation established by three independent secondary investors. But this, too, will embed a discount, as well as severing the relationship with the fund manager and forcing the investor to forgo any future profit.

Instead, pension fund managers could decide to re-think the way their asset allocation is designed. Some investors, such as endowments or innovative pension funds, have shown the way by allocating their assets to 'equity', 'bonds', 'real estate', and so on, without differentiating between public and private markets. This blends stock exchange and private-market valuation volatilities and solves part of the accounting and reporting problem.

Other investors, such as sovereign wealth funds and private equity fund managers, have pre-planned liquidity solutions. Before the financial crisis, the Singaporean sovereign wealth fund, Temasek, decided that, in the event of difficulty, instead of selling its private equity assets, it would securitise them. This product has proven successful as it guaranteed that Temasek would get liquidity (notably to fund further private equity capital calls) without giving away the potential profit that still lay in its portfolio.

This kind of arrangement could show the way for pension funds that are similarly willing to organize their mid to long-term liquidity, notably when their private equity programmes have reached a certain maturity, without giving up their unrealised profits. Though expensive, securitisation also guarantees that the investor does not lose its relationship with private equity fund managers.

Innovative approaches like these might better enable institutional investors to benefit from the true performance of private assets – while honouring reporting obligations that are defined by public markets.

*Cyril Demaria is CIO of Tiaré Investment Management, a professor at HEIG-VD, EDHEC and EADA and author of Introduction to Private Equity (Wiley 2010)*

### Mean net private equity fund return by limited partner type, as a percentage

LP Type	Entire sample	Time Periods		By region (1991-2003)		
		1991-1998	1999-2003	US	Europe	Rest of the world
Funds of funds	14.62	20.39	13.00	13.64	14.77	22.39
Public pension	14.55	19.26	10.94	14.27	18.29	17.48
Corporate pension	15.05	16.40	14.47	13.29	18.83	13.44
Banks	16.85	14.38	17.91	10.70	21.97	18.21
Insurances	18.26	23.77	15.85	16.38	20.79	17.64
Endowments	16.00	24.42	12.26	16.01	18.62	8.05
Family Offices	14.60	19.50	12.49	14.33	20.18	-3.60
Govt. Agencies	11.80	8.09	14.66	-2.19	4.80	19.36
Total	14.88	19.44	12.46	14.28	16.52	16.68

Source: Daniel Hobohm, Investors in Private Equity, Gabler Research, 2010.