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Private equity

A rising star in the multi-asset universe

For many asset owners, private equity is an integral part of their portfolio's asset allocation. With global interest rates at historic lows since 2010, government bonds no longer provided adequate yields to meet asset owners' return targets.

This forced them to diversify from domestic bonds and allocate more to riskier and less liquid but higher yielding alternative assets.

As super funds gain in size and scale, much greater investment opportunities are opening up to them in the form of direct investment and access to assets that fall outside traditional public markets, such as private equity which requires more robust analytics and reporting than traditional assets.

Asset owners need a multi-asset class platform that equips them with the information and insights they need to track performance for both public and private assets.

A full and accurate picture

As institutional investors continue to diversify into multi-assets, measuring and reporting for these portfolios becomes more complex. However, before we discuss specifics of reporting for a multi-asset class portfolio, it is vital to recognise what we are trying to measure. It is important to understand that returns being calculated need to be fit-for-purpose across the fund structure and its component parts.

If an asset owner wants to measure its private equity manager's performance, internal rate of return (IRR) should be used. However, if they are looking at the performance of the whole portfolio, we would typically use a time-weighted rate of return to measure the asset allocation decisions of the fund.

Most investors apply a time weighted return across every portfolio to provide a consistent methodology rolling up to the total portfolio return.

However, most software products only provide private equity performance updates monthly, and some of the illiquid investments that must be incorporated alongside all others only price quarterly or even annually.

This is simply not suitable for many asset owners as they need to analyse their portfolio and report to outside stakeholders in a timely fashion.

This means published monthly returns will be based on stale private equity valuations that could be materially different from the actual valuations (when they become available), which is particularly the case when markets are more volatile as they have been at times during the COVID-19 pandemic.

One solution to this is to run two separate books. The monthly reported book will tie to the accounting book of record, only reflecting hard close valuations which will be stale for some private equity assets.

The 'live book', meanwhile, would always be updated with the best available information. So, if a manager valuation comes in two months after the valuation date, it will update the historical record.

Stale valuations can also be replaced with estimates, proxies or PMEs (public market equivalents) that better reflect the likely value of the asset based on the movement of a correlated index or similar instruments with more readily available valuations.

Returns from a monthly closing process or true lagged returns are useful because many asset owners need to analyse their portfolio and report to outside stakeholders in a timely fashion. However, running your returns on the live book, which has the best available information, including final values from the manager regardless of when they are reported, is also critical, especially when you move from assessing your total portfolio to assessing individual private equity managers and funds.

The quote

Institutional investors need to deliver returns in a world where the illiquid premium is shrinking.

Fair benchmarking for a multi-asset investor performance

Asset owners need to consider their overall investment objectives and make an asset allocation decision at the total portfolio level. A broad private equity industry benchmark that reflects the true risk and return profile of private equity as an asset class makes sense.

However, when it comes to manager selection and benchmarking each individual investment, investors need an industry-accepted benchmark to measure a specific PE manager's track record.

Most institutional investors adopt two common approaches.

The first is a relative performance benchmark based on public market indices plus a premium, for example S&P 500 + 300 basis points.

The second approach is to choose a peer group benchmark.

Both of them have their drawbacks. The former creates large tracking error since public and private market returns are not closely correlated and it is difficult to evaluate PE portfolio performance over a shorter time period. The latter is challenged by the lack of transparency and industry consensus in terms of fund classification.

Given the challenges, it is important to have a platform with the flexibility to employ different benchmarks at different times depending upon which has the greatest level of comparability over a particular evaluation period.

Increasingly, investors will also use PMEs to provide a fairer indication of how comparable assets would have performed with the same cash flows as the private equity investment.

It is essential for asset owners to use multiple metrics to analyse a private portfolio. They need to revisit performance and analytical tools, whether they are internal rate of returns (IRRs), investment multiples, PMEs, risk-adjusted returns or benchmarks, and find ways to both refine and fully utilise them.

The medium term outlook for multi-asset strategies

We believe the strong demand for alternative assets will be maintained as the low yield environment is likely to continue for a long while yet.

There'll also be a further increase in the internationalisation of asset allocation by super funds, as well as growth in the size and scale of super funds.

Alongside those factors, US equities are unlikely to perform as well as they did last decade. Institutional investors need to deliver returns in a world where the illiquid premium is shrinking. They also need to allocate to real assets to diversify their long equity book. FS