Assessing Risk of Private Equity: What's the Proxy?

Art and Science, Choosing the Right Proxy for Private Equity

In our recent issue of AIAR (Q3 2016), CAIA member Alexandra Coup from PAAMCO explores the common issues facing CIOS in identifying the right private equity proxy. She evaluates alternative methods in constructing a proxy and draws on PAAMCO's experience in managing hedge fund portfolios.

The full article may be accessed here.

Summary:

Asset allocation is perhaps the most important decision facing CIOs. It involves evaluating the risk/return profile of various asset classes and is usually based on a combination of forward-looking expected returns and risk measures derived from historical data. In this context, the traditional modeling of private equity is subject to significant drawbacks. Available index data for private equity is lagged, smoothed, and understated with respect to the beta, volatility, and correlation with public equities. These drawbacks can have a significant impact on portfolio allocation decisions when a large share of a portfolio is allocated to private equity. This article attempts to evaluate alternative methods to proxy private equity investments in the context of an overall portfolio allocation. Although her focus is on buyout funds, her methods can be applied across structure to hopefully construct a useful approximation to risk measurement within the private equity landscape.