

Better Benchmarks for Your Private Equity Portfolio

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Central Issue

In the paper titled, "Synthetic Peer Benchmarking for Diversified Private Equity Programs," Jeroen Cornel of BlackRock, wants to help institutional investors who hold diversified portfolios of private equity funds to have a better understanding of their portfolios' relative performance. As pension plans, insurers and endowments are making private equity a larger part of their portfolios, it is becoming more important to meet the challenge of monitoring and evaluating of such allocations.

Various methods exist to value and benchmark the performance of a single private equity fund:

- **Public Market Equivalent:** In this approach, the performance of the fund is compared to the performance of the hypothetical fund that generates the same positive or negative cash flows as the fund, but those cash flows are used to participate in public markets. The terminal values of the two funds are then compared.
- **Peer Group Benchmarking:** In this approach, the performance of the fund is compared to the performance of a portfolio of private equity funds that represents the performance of the broad private equity industry.

Most institutional investors, however, have a collection of private equity investments, and techniques that analyze and compare the performance of a diversified program have not been readily available – hence investors in diversified programs are in the dark about their performance relative to the broader industry.

Approach Employed by Paper

The present paper develops a simulation technique to peer benchmark diversified private equity programs, using a large universe of underlying funds. The method takes into account a program's exact composition and number of holdings. In particular, the approach developed in this paper provides a representative benchmark for a specific diversified private equity program in two key performance dimensions: a) internal rate of return and b) multiple of invested capital.

The author is able to create a benchmark that represents the portfolio whose performance is being evaluated. The approach allows portfolio managers to a) reconstruct underlying cash flows of the portfolio,

b) subsequently aggregate these to a program level and c) estimate the internal rate of return. The resulting aggregate internal rate of return can be compared to the portfolio's internal rate of return.

In the process of describing the simulation methodology, the author highlights an important fact about the impact of diversification on various metrics typically used to measure the performance of private equity investments. Similar to public equities, the impact of diversification is to reduce the potential range of Total Value to Paid-in (TVPI) that a portfolio may experience. Extremely high and low TVPI figures are eliminated as a portfolio becomes more diversified. However, the same predictable pattern is not observed when performance is measured by the internal rate of return (IRR). The point is that a similarly diversified benchmark must be used to measure the performance of a portfolio.

Findings of the Paper

This paper's approach to peer benchmarking a diversified program is highlighted by these three features:

- It calculates a program IRR after aggregating or pooling detailed historical cash flows of underlying investments to a program level and therefore overcomes the common problem that IRR of a portfolio cannot be obtained by aggregating the individual IRR's.
- It allows you to measure the performance of the portfolio across various dimensions.
- Unlike other approaches, it attributes the relative performance of the portfolio to various factors such as vintage, strategy and geography. Over-performance of the portfolio not explained by these factors, may be interpreted as the portfolio's alpha.

The methodology develop in this paper focuses on private equity investments, but it should be emphasized that this methodology works as well for other illiquid alternative asset classes such as real estate and infrastructure given a sufficient universe of empirical data.
