PEI Alternative Insight
PRIVATE EQUITY INTERNATIONAL

Published: 09 August 2017
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Liquid gold: indexing private equity

The active versus passive debate has raged for years in the traditional asset management industry. With the development of increasingly accurate investible indices, could it soon be relevant to private equity?

For traditional stock pickers, things haven't been quite the same since the global financial crisis. The low interest rate environment has put the squeeze on returns, forcing them to seek out new, often riskier investments. While quantitative easing has helped push up the price of stocks, it has helped reduce the volatility that asset managers need to distinguish themselves and in turn justify their high fees.

Research by S&P Dow Jones Indices published in 2016 concluded that 90 percent of active equity fund managers have failed to beat their relevant index over one, five and 10 years.

Investors have flocked to low-fee, benchmark-tracking passive investment products. According to S&P Global, passive investment vehicles attracted $508.4 billion in capital during 2016 while active funds suffered outflows of $340.1 billion. There is now more than $1 trillion invested in exchange traded funds (which track the performance of an index or a basket of assets), more than the world's hedge funds have under management.

Alternatives safe – until now

Private equity managers have been relatively sheltered from the storm raging next door, largely due to the difficulty of creating reliable indices. According to Willis Towers Watson, in its report Private Equity Benchmarking: Where Should I Start? these include:

- Lack of a readily available universe of transactions and assets makes it difficult to construct a replicable index.
- The long private equity investment horizon — where success is achieved over a number of years (eg, investing heavily in a company in the early years to achieve success in the long term) — conflicts with the short time frame typically used to measure success.
- The timing of cashflows is unpredictable.
- The J-curve effect, where management fees and set-up costs at the start of a fund investment typically result in significant negative net performance early in the life of a fund.

New indices are emerging, however, that are attempting to overcome these hurdles, with Chicago-based DSC Quantitative Group one of the most interesting examples.

The firm was started six years ago by Art Bushonville, who had among other positions been manager of the financial trading and investment arm of Koch Industries. He had been working with a group of academics, including Ravi Jagannathan, a professor at Northwestern University's Kellogg School of Management, on how to create liquidity in illiquid asset classes.

"With private equity and VC, liquidity was an area that could be improved upon," he says. "How could you do that? Could you find a way to bring fees down? Could you create a solution so if you have cashflow issues – and you're not quite sure when your capital's going to be called – then you could be fully exposed to the asset class?"

The fledgling company teamed up with Thomson Reuters to produce two non-investible research indices, one that tracks the performance of private equity, the other of venture capital. They then produced two investible indices that track the performance of those research benchmarks.

The venture capital index received its first LP investment four and a half years ago, the private equity index three and a half years ago. Now, with Mercury Capital Advisors, the firm is on a roadshow to encourage more investors to buy in to the index. The firm is not raising a closed-ended fund, but fundraising constantly, with a large sovereign wealth fund and several large pension funds among the potential investors.

Making tracks

Unlike many indices, which track the overall performance of funds in the market (and therefore represent a net valuation after fees), DSC's research indices track the returns of the underlying portfolio companies that funds are invested in. Thomson Reuters' database currently encompasses around 2,300 private-equity owned companies representing close to $2 trillion in market cap.

This data is then crossed with in-house data on the estimated value of portfolio companies. This is based on a set of reference points including private equity transactions in the same space, the performance of public market equivalents and the valuations that fund managers pin on their companies in preparation for exits.

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The investible index is then weighted to mimic the Thomson Reuters PE Research Index, resulting in a basket of 170 large-cap US listed equities, and is rebalanced once a month in line with shifting risk weightings across sectors or types of company.

Mimicking a basket of public shares may seem odd, but the underlying principles have been emerging from academia for some time. Namely, accurate benchmarks can be created using an underlying portfolio that differs significantly to the actual assets you are trying to measure. A company is private, but its shares are still shares and exposed to the same economic forces as a public entity.

To loosely replicate the performance of private equity assets, you don't have to worry about firm-specific idiosyncrasies, only about systematic exposure – risks that affect all assets in the benchmark index.

"A buddy of mine in a big buyout firm said 'you can't replicate what we're doing because I have a fund with X number of companies, we'll upgrade talent, we may merge with another firm', – all these types of things," says Jeff Knupp, president of DSC. "'You can't replicate these idiosyncratic factors'. He's 100 percent right for a specific company or fund, but if you aggregate this up to thousands of companies, these idiosyncratic factors cancel each other out and you're left with a more systematic return stream."

A game of elites

Products like this have a few vocal supporters in the asset management community, none more so that Jos Van Gisbergen, senior portfolio manager at Dutch asset manager Achmea.

He believes that the increasing amount of data on private companies means that private and public stocks will only become more correlated. Investors are beginning to realise that after fees, the returns they get from some private equity managers are no better than the returns they would get using leverage to buy public stocks.

He envisages many investors using replicators to achieve market returns, then deriving their alpha from a few, top-quartile funds. He cites Apollo, Blackstone and KKR – private equity specialists who are turning into alternatives asset houses, shrinking their fees but increasing their assets under management.

"I've been telling people at conferences for the last three or four years that they should be aware that they are going to be replaced by a replicator, especially the average-performing private equity guy," he says.

"That means that the good times for many in private equity are in the past, not in the future." It's still early days for private equity replicators. But with fees a growing point of contention and big data continuing to narrow the gap between public and private, the interest of investors is likely to grow.

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