Private Equity: The Tyranny of IRR: Part 3 –Winners Play and Players Win

This is the third instalment in our Private Equity series. Thus far, based on a review of a recent paper by Professor Phalippou of Oxford University, recently published in the Journal of Portfolio Management we have seen that:

- The internal rates of return (IRR) quoted by private equity, despite their name, are frequently not comparable rates of return to those achieved by equity markets.
- The misleading nature of some of the IRRs quoted by major PE players become blatantly obvious if you consider what they imply in terms of the amount of capital investors would possess if they had actually realized a rate of return equivalent to the quoted IRR. Commenting on one particularly notable IRR declared by a PE manager Professor Phalippou said "*A $1bn investment earning 39 per cent annually over 30 years would be worth $20tn. And $20tn is the GDP of the United States. I think we would have noticed.*"
- IRR numbers can be manipulated upwards by early distributions, due to a nuance of the IRR calculation which assumes that early cashflows continue to compound at the IRR. We will explain that in language a non-expert can understand in Part 4 of this series.

Today we will look at the concerted efforts being made by the fund management sectors in New Zealand and overseas to sell the prospect of a private equity Eldorado to retail investors: as well as lobbying for increased and compulsory contributions, preferably with tax incentives, KS providers, in their spare time, have been telling anyone who will listen that private equity deserves a place in their KiwiSaver scheme. The same hustle is happening on a much bigger scale in the USA in respect of their equivalent of KiwiSaver, 401(K) accounts. Why? Fund managers in NZ, Australia and the US are all desperate to start selling PE to retail investors because their margins are under pressure in the more traditional public markets and when the destination is Eldorado the costs of getting there are incidental.

Just what the read through of Professor P's criticism of the IRR metric is for NZ private equity performance is beyond the resources of your writer. However when PE really gets going in KiwiSaver one would imagine that, as with public equities, local fund managers will be subcontracting much of their PE exposure to the big overseas players whilst also charging a fee to "manage" the PE managers. Second big rationale for what the PE cheerleaders ironically characterise as "*the democratisation of the capital markets*" is that they know that retail buyers are a disparate group of non experts to whom no one owes any favours thus they can be sold the less attractive deals at higher prices than which they could achieve with institutional buyers. The PE managers won't bump into those customers at a BBQ in the Hamptons so the risk of embarrassment and negative feedback is minimal. PE is essentially about "*buying low and selling high*" and retail is the perfect counter party for the latter transaction. Thirdly, as a recent report from McKinsey asserts, the PE scene is currently suffering from a serious episode of constipation in that "exits" have slowed, so an influx of dumb retail money that no one really cares about is the best laxative that the industry could wish for.

Next up we will discuss why historic performance is such a big deal for the PE sector. There are a number of angles: Firstly profitability in the fund management area is all about funds under management and a fund manager can attract more investment by reporting good performance. If you manage a portfolio of public equities your performance is just a function of the price of the fund today vs the price a year ago plus any dividends and there is no debate about these prices – they are observed on the stockmarket and the only ways you can manipulate your performance are by choosing flattering time periods or comparing yourself to an easy to beat benchmark. Lots of clever PhD types have tried that over the years and regulators have, eventually, closed most of those doors. Professor Phalippou weighs in on this issue in the FT: **"***The US regulator should create a level playing field for performance reporting standards between private equity funds and conventional mutual funds. It took almost a century for the SEC to develop a comprehensive set of regulations to close the loopholes exploited by mutual fund managers. Private equity is one hundred times more complicated and there is even more room for trickery. We need to have the same rules, a level playing field, between private equity and mutual funds*".

PE however potentially offers managers lots more options to look good: PE quotes IRR's and as noted in the previous column the IRR is often not comparable with a stockmarket return and the methodology is prone to manipulation. Additionally PE managers have far more latitude to influence valuations by way of cashflow forecasts, discount rates and terminal growth assumptions. This "skill" has led PE to not only claim higher returns than the stockmarket but also lower volatility – what's not to like? The ambiguity of PE returns led one critic to observe in the Financial Times a few years back that the standard warning from regulators about the share market is that "past returns aren't indicative of future returns". He suggested that a similar warning should apply to PE performance together with an additional caution to the effect that "past returns aren't indicative of historical returns either".

Secondly, the PE salesmen know the investing public and particularly the trustees of institutions subject to a high degree of public scrutiny, like the California Public Employees Retirement System, are particularly fixated on fees these days. Given, as calculated by Professor P, annual fees of 6-7% must be paid to play the PE game extraordinary historic returns are necessary to ensure the investment committees come to the right decisions. The well-known but complex IRR methodology is thus perfect for the PE industry.

Thirdly, there is a behavioural aspect of historic performance numbers for PE managers: the standard sales pitch for selling private equity to retail investors goes something like this: "you're a smart guy and obviously a winner. Our firm has managed to get an allocation in this top performing, hard to access, private equity fund, just for a select group of our clients. As it is a wholesale offer and only available to high net worth individuals like yourself "you will need to get your accountant or lawyer to sign the attached certifying that you are a clever guy, and a winner". This sort of sales pitch appeals to people, mainly men, who have a high opinion of themselves and it re-enforces their self image. Of course it is absolutely at variance with commonsense and the efficient market hypothesis/index fund logic. In the 30 years or so that I have been recommending a more humble approach, a la "playing the losers game, I have had a few prospective clients who have declined my services with the typical comment being "Why should I employ anyone to do as well as the average?". PE, with the promise of out-performance and historical IRRs to back up those claims, are exactly the sort of products that "winners" are looking for.

That is enough for today. In three weeks' time we will hear from some independent experts who are very much of the view that PE is not appropriate for individuals saving for their retirement.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.