

# Overcoming the data difficulties with private assets



By *Andrew Tan & Paul Finlayson*

**A**s the fondness for private assets grows among Canadian pension plans, the demand for better analytics and transparency has increased. But with investors facing the unique characteristics of private assets, the traditional methods used in measuring the risk and performance of public assets may not be appropriate.

When talking about alternative assets, the analytical challenge boils down to valuation data. Valuations are manager-driven, infrequent and typically late. Late data necessitates valuations based on what's best available, manager-supplied preliminary estimates or internal estimations based upon any number of methods, such as proxies or indices.

Given the challenges, performance consultants and asset owners have sought to create meaningful and timely performance indicators to allow for better decision-making. For private equity and manager-appraised private assets, we see the broad adoption of best-available valuations rolled forward to include cash-flow activity. Preliminary valuations for hedge funds are growing in popularity, and the manager-provided monthly return estimates driving the process are reasonably accurate. It's now common for investors to maintain two performance books: one

for the early reporting deadline and another with the final valuations completed six months after the reporting period.

### Meaningless mean and variance?

The infrequent and lagged valuations of private equity make it challenging to apply measures such as the mean variance. Analysts have discovered that, if they adjust for the infrequency by bringing lagged valuations into phase and using quarterly observation windows, private equity moves in concert with public market equity. That means private assets aren't really a diversifier but are more of an alpha generator.

The often spiked and skewed returns of hedge funds distort traditional risk metrics that assume a normal, bell-shaped distribution of returns. As a result, metrics that consider both upside and downside risk, as well as trend metrics like maximum drawdown, are, in

some cases, supplanting mean variance statistics like standard deviation and the Sharpe ratio.


### Comparisons difficult

One can look at the performance dispersion of hedge and private equity funds and easily see that selection is the name of the game: value creation doesn't come simply from making an allocation but from making the right one. It's an issue that challenges traditional notions of benchmarking, since a true market index can't exist and, even if it did, it would be meaningless.

Contribution to total plan performance is easily quantifiable, but the concept of value added due to selection isn't as easy to determine. Benchmarks that mimic style allocations help. For private equity, public market equivalence metrics can help determine whether the assets are meeting the expectation that they should outperform those in the public markets.

### Justifying the extra effort

As investors turn towards greater allocations to alternative assets, the promise of alpha is great. But along with that will likely come greater attention from auditors and regulators. There was a time when transparency meant understanding industry and geographic exposures to underlying partnership or fund holdings. Today, it means justifying valuation methods and monitoring opaque fees.

Fortunately, knowledge and analytical techniques are improving. Given the need to continue to demystify investing in private assets, investors should use these resources to better enhance their governance and oversight of them. 

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### ONE MEASURE OF PRIVATE EQUITY

One source of information on private equity is the S&P listed private equity index. It tracks publicly listed companies that are active in the private equity space. So how has it performed over the past five years?

