Understanding the Impact of Lagged Private Equity Returns

One of the inherent reporting challenges of illiquid investments, such as private equity (PE), is how to incorporate quarterly private valuations into total portfolio performance. The longer the private market valuations take to finalize, the greater the challenge to assets owners.

When incorporating PE valuations into total portfolio performance, investors generally take one of two approaches: 1) delay the finalization of total portfolio performance until receipt of updated valuations; or 2) lag valuations in some manner so that total portfolio performance can be reported sooner. It is worth noting that there are many nuanced variations of how different funds approach this. We have observed that more US public pension funds appear to lag their PE returns in some form, with a one-quarter lag being a common approach.

We don't posit that there is a single "correct answer" on this topic but rather seek to highlight the issue as one that can easily complicate performance comparisons. Those that lag returns may be able to present finalized total fund performance figures and other fund reporting more expeditiously, while those that do not employ any lagging may be providing a more synchronized measurement of total fund performance (with all assets reflecting the performance realized in the same time period). Although differences due to reporting methodologies should wash out over longer time periods, they can materially impact shorter-term comparisons, particularly during periods of heightened volatility. To illustrate the potential impact these choices can have on return comparisons at different points in time, we have highlighted two simplified examples below.

Hypothetically, let's assume two plans (Plan A and Plan B) each have a 15% allocation to PE and both allocations earn the return of the Cambridge US Private Equity Index. For reporting purposes, Plan A lags returns by one quarter and Plan B waits for final valuations.

Figure 1: Representative Approaches to Incorporating PE Valuations

	Plan A	Plan B
Private Equity Allocation	15%	15%
Reporting Treatment	1 Quarter Lag	No Lag

PE Quarters in 1-Year Return, ending June 30, 2022

Quarter 1	Q2 2021	Q3 2021
Quarter 2	Q3 2021	Q4 2021
Quarter 3	Q4 2021	Q1 2022
Quarter 4	Q1 2022	Q2 2022

Reported 1-Year Performance on August 1, 2022

	Plan A	Plan B	Difference
PE Return	27.6%	12.8%*	14.8%
Impact on Total Portfolio Return	4.1%	1.9%*	2.2%

**Preliminary, assuming 0% for PE until Q2 2022 valuations are available*

Source: PE benchmark return data from Cambridge Associates.

In this example, Plan A's private equity returns reported for the trailing 1-year, ending June 30, 2022, represent the 4 quarters of returns ended March 31, 2022.

Plan B does not lag its private equity returns and as such cannot finalize total portfolio performance until long after quarter-end (typically 2 to 3 months). In the interim, Plan B uses a placeholder return of 0% for the most recent quarter, and for an interim period (often when the financial press is most focused on fiscal year-end performance) only includes 3 quarters of performance for the period ending June 30, 2022.

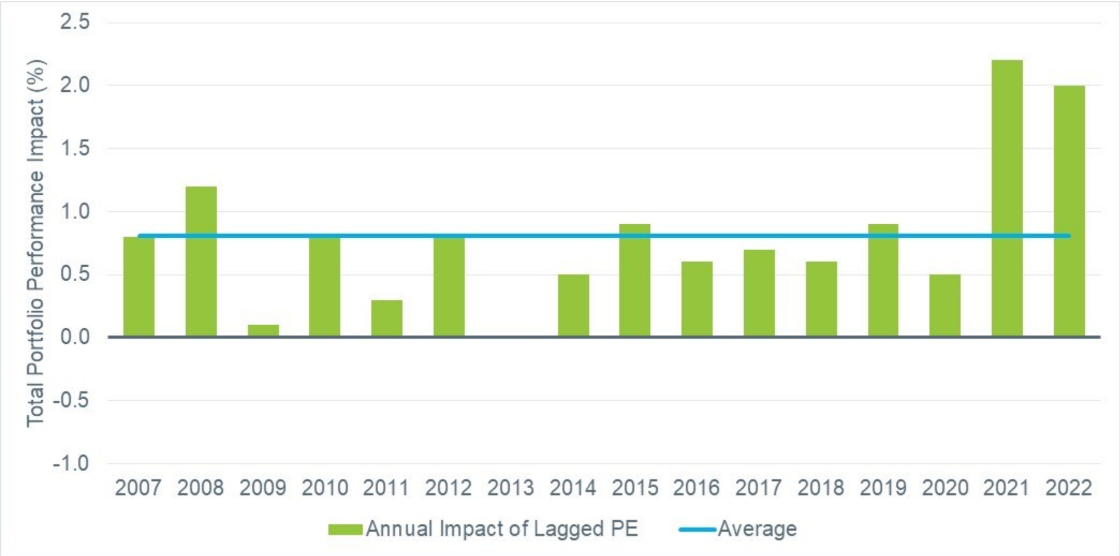
Two factors drive the difference in performance for the two plans, despite their identical private equity allocations and performance:

1. The number of quarters included in the measurement date. The later recognition for Plan B of its fourth quarter of returns means that any measurement done prior to receipt of final valuations will only include 3 quarters of performance versus 4 quarters for Plan A. In Figure 1, we assume that on August 1st Plan B does not yet have updated PE valuations for June 30.

2. Timing, and which quarters are included. Even when Plan B does finalize its PE returns, the 12-month period will not include the same quarters. Plan A will include Q2 2021 (which was an outsized quarter for PE returns), while Plan B will include Q2 2022 (which is not likely to be as robust).

Figure 2: Preliminary Measurement Impact

Annual Returns ending June 30

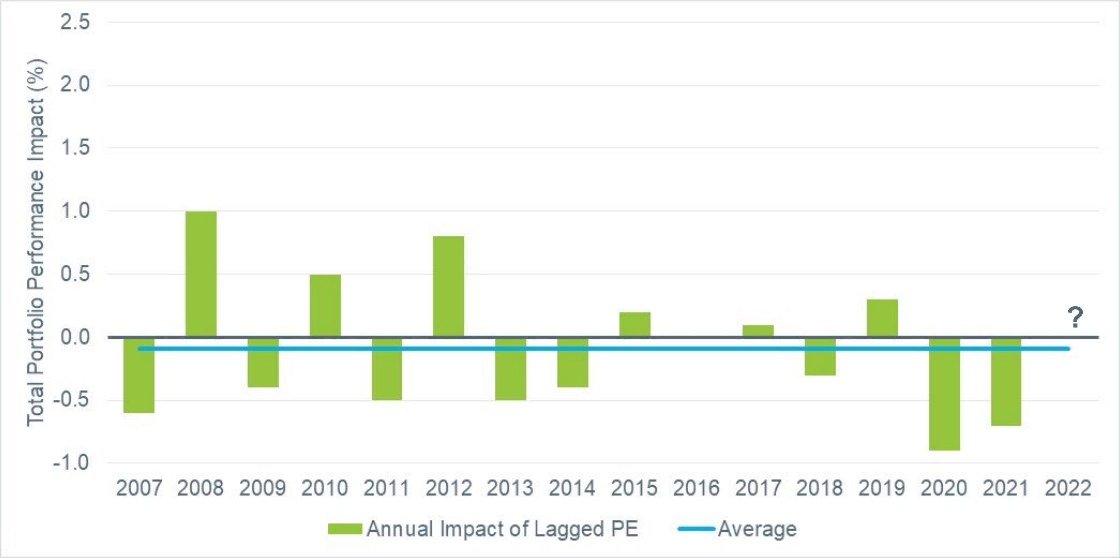


Source: PE benchmark return data from Cambridge Associates.

The chart in Figure 2 shows the annual total portfolio return difference between Plans A and B when measuring the year on August 1st, assuming that June 30 data is not yet available. This captures the impact of including 4 quarters of returns versus 3, as well as the inclusion of a quarter of performance for PE that did not actually occur within the measurement period (but gets included due to the lag). At a 15% PE allocation, the average impact on ***total*** portfolio performance is material, and almost always to the benefit of plans that lag PE returns. The impact in the last two years is notably much greater than typical due to very strong returns for PE. For the most recent years, the impact to ***total*** portfolio performance in this example is 2% or greater.

Figure 3: Final Measurement Impact

Annual Returns ending June 30



Source: PE benchmark return data from Cambridge Associates.

The chart in Figure 3 shows the annual ***total*** portfolio return difference at final measurement (i.e., when Plan B has Q2 2022 returns). Plans A and B both include 4 quarters of PE returns, but with only 3 of the quarters overlapping. As we would expect, the annual impact is mixed and time-period dependent, while the long-term average is negligible.

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[1]Between July and October 2021, Coalition Greenwich conducted phone interviews with 811 individuals from 661 of the largest tax-exempt funds in the US–including corporate and union funds, public funds, and endowments/foundations with either pension or investment pool assets greater than $150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather they are representative of those clients that chose to participate in the survey. The results are not indicative of RVK's future performance. To read the Greenwich press release, please refer to the following URL: https://www.greenwich.com/institutional-investing/investment-consultants-strengthen-role-top-advisors-us-asset-owners.