MSCI Institute

Theory Meet Practice
Private Assets

Episode 1: Understanding Private Capital Alpha with Greg Brown
Transcript

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TITLE CARD	
Rumi	Hello everyone, and welcome back to *Theory Meet Practice*, where we explore how academic research can help investors make smart decisions. Everyone loves a good headline number, a double digit return, or a market beating fund. But what if those numbers don't actually mean what investors think they do? Today, I'm thrilled to be speaking with Professor Greg Brown from the University of North Carolina, whose latest research takes us beyond headline IRRs to what investors can really expect from private markets and where the evidence for alpha is strongest. Thanks for being with us here today, Greg
Greg	Oh my pleasure. It's always a delight to have the opportunity to share our research with folks.
Rumi	What motivated you to take on these studies on private capital performance? Why now? And what gap in the debate were you hoping to fill?
Greg	In Finance 101, we teach folks that it's the risk adjusted performance that matters. You don't want to compare a 10% return that's super risky to a 10% return that's super safe, and say that they're the same return. Now, in public markets, it's really easy to do that. But it's very different in private markets because of just how the data is structured. IRR, by definition, is not risk adjusted and neither is multiple. There's been a lot of studies, both industry studies as well as academic studies over the last, you know, call it 15-20 years or so.

	And many of these studies have come to different conclusions in terms of what performance has been on a risk adjusted basis for private assets. So the goal was to create a single comprehensive data set, take all the different methods, apply them to that data set, and see what the results were.
Rumi	Some of your research looks at nearly 8,000 funds across buy out, venture, credit, and real assets. What stood out to you most in terms of where genuine alpha exists in private markets?
Greg	Yeah so, the analysis that we did, we think, was the most comprehensive by far that anyone's done. And what we found, I think, was quite interesting because the results were a bit different on a risk adjusted basis than they were on just sort of a nominal, unadjusted basis. We found that buyout funds performed quite well, both in the US as well as globally. Venture capital is a bit of a different story. So the bulk of venture capital is in the US, but it turns out it's very risky. And when we estimate sort of what the market beta is of venture capital, we find that it's a very high number. And when you make that risk adjustment, the alpha is essentially zero for venture in the US. When we look at private credit, the results seem to be quite good on a risk adjusted basis. Private credit is kind of risky from a fixed income perspective, and we benchmark it against a levered loan index. But we find what seem to be consistently positive alphas for private credit. And real assets are a bit of a mixed bag. We do find that real estate, private real estate, has been probably a little bit safer than public real estate. But even with that tailwind, the performance for real estate has not been fantastic for private funds. Infrastructure, on the other hand, infrastructure seems to have provided sort of consistently positive alpha against a public infrastructure benchmark.
Rumi	I'm going to shift gears a little bit to data and methodology. How would you say access to data can change the quality of conclusions we can draw, particularly in private asset research compared to what's in the public space where the data is a lot more available? And then a follow on from that, because you tested simple versus complex economic econometric models, right? And so for investors who don't have the resources for complex modeling, what would you say is *'good enough'* in terms of performance measurement?
Greg	Yeah, well, we love the MSCI data. We've been using it for 15 years, and I think there was a lot of uncertainty as to what actual performance had been, sort of, looking at other databases, until we got access to the MSCI data. In terms of this question around methodology – you know, we look in this performance paper at very simple things that everybody looks at, the IRRs and multiples; We look at things that I think are gaining traction, especially

	among consultants and more sophisticated players, the public market equivalents and direct alphas that are available on the Private i® platform, which is very cool; But we also look at these more sophisticated models that have been developed mostly in the last 10 years or so that use quite sophisticated econometric methods. Like, you really need to have sort of graduate training in statistics or econometrics to be able to estimate them. So we were curious – if you wanted to figure out who the good funds were and who the bad funds were in a particular vintage or something, how do the simpler metrics – the things that you can get on Private i® like PMEs and direct alphas – how do those compare to these very sophisticated methods? And it turns out you get about the same answer. So it doesn't feel like in most applications, it's kind of worth the brain damage of doing the more sophisticated analysis.
Rumi	So given all these complexities in mind, Greg, when it comes to assessing performance, how should investors rethink about what performance really means in private capital going forward?
Greg	I think the first lesson is that risk really does matter. You will get different answers in terms of what you should have in your portfolios if you look at just reported returns versus risk adjusted returns. And this is important even within the equity space and across different geographies. So I think the first lesson is, be mindful of trying to most accurately measure the performance as it relates to your overall portfolio. And the other lesson I think is that portfolios matter, right? You can't just look at these assets in isolation. So the right way to think about this is, what happens when you add these assets to an otherwise diversified portfolio of public assets? So for example, what happens if you have a 60-40 portfolio of public stocks and bonds, and then you take 20% private equity and put that into the equity allocation? So has that increased the performance of the portfolio on a risk adjusted basis? And what we find is that it does for buyout funds in particular. Historically, it has been the case that adding buyout funds, essentially, it increases the Sharpe ratio of the portfolio. We call that private capital alpha. And that's even after accounting for a lot of real world issues – you're holding a finite portfolio that's going to have idiosyncratic risk in it. So even being really careful to make those real-world assessments, at least for buyout funds, you're still adding alpha to an overall diversified portfolio.
Rumi	And finally, to conclude, if you could change one thing about how the industry reports or evaluates performance, what would that be?
Greg	I would like everyone to report quarterly financials for all of their portfolio investments because, if we had that kind of information, it would be just a gold mine in terms of being able to better understand what's happening in private portfolios. I'm not holding my breath waiting for that to happen because I- you know, I think that's a lot to ask, at least across all types of assets. But we are seeing more transparency, and we are seeing more datasets come to life. And so my hope is that that trend continues.

Rumi	I hope so, too. Thank you so much for your time, Greg. I've really enjoyed talking to you, and I'm looking forward to our next discussion.
Greg	My pleasure to be here, and always happy to come back and talk about other research projects at any point.
Rumi	Thanks again for watching *Theory Meet Practice*. We'll see you next time.