Private Market Valuations and Volatility Laundering

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A recent Financial Times article, "Private Markets Don't Launder Volatility, Honest," defended private equity's approach to fund valuation. The author claims managers are fair and balanced in their methodology and that GP marks are much more credible and reliable than public market prices.

As an LP in over 100+ funds, the reality of private asset valuations are much different than what GPs claim.

Clifford Asness of AQR describes it perfectly when he calls these valuation games/abuses, "volatility laundering."

Volatility laundering has two concerns.

First, private assets understate the true economic volatility of the assets since assets are valued less often and GP's smooth/delay valuation changes, especially on the downside. Almost every time a manager insists that risk-adjusted returns are higher for private strategies, it's almost always the case that true economic volatility is being substituted with accounting-based volatility, which understates the real underlying risks LPs face.

The 2nd concern is that GP's arbitrarily use their discretion to overstate NAVs by marking assets up quickly in the good times but are slow to mark down during the bad times. This drives higher interim IRR's (great for fundraising), less investor questions, and of course, more NAV-based fee income.

This article defends private equity's practice, but in my experience, the reality of private markets valuation is much more tenuous and conflicted than the industry claims.

To be clear, it's unfair to group all GPs together. Some are more transparent and forthcoming than others. However, the issue is pervasive enough that LP's need to be aware when reviewing fund values.

Here's my experience on the reality of private market valuations versus the what the author claims:

Claim #1: LBO funds invest in resilient companies

From *Private Markets Don't Launder Volatility, Honest*:

> Secondly, LBO funds tend to invest in more resilient companies in unloved stable sectors — such as funeral homes — to collect dividends and pay the debt used to acquire these companies. These sectors are less affected by macroeconomic shifts than their larger listed peers in more cyclical industries.

This is a common GP narrative that they invest only in quality, defensive business models. This argument falls apart when you look at the underlying fundamentals and capital structure. More leverage (a lot more!), and less free cash flow (and I don't mean EBITDA, I mean true FCF after capex, NWC, taxes, interest, and of course acquisitions that will need to be funded to support the assumed growth). I won't even start with "adjusted" EBITDA.

There is a reason these companies are paying 6-9% for senior lending and 10-14% on mezzanine debt. Hint: it's not because they are more resilient.

Obviously, there are many high-quality private companies that will do very well. But to claim that LBO-backed companies are less sensitive to the public market is wildly off base.

Claim #2: GPs are fair and balanced on the upside and downside

From *Private Markets Don't Launder Volatility, Honest*:

> Yes, the ebb and flow is still more muted than what you see in public markets. But that's because private fund managers are prudent when assessing their holdings, both on the upside and the downside. As a result, the NAVs move more sedately than stock markets — especially when you consider that NAVs are effectively calculated gross of performance fees (the 20 per cent "carried interest").

GPs are not equally prudent on the upside and downside. GPs are quick to markup companies when comps and markets are up, and then on the way down, switch their rationale to, "the company fundamentals haven't changed, therefore we're holding our valuation at the same level."

LP's want consistency. If you markup based on rising comps/markets, then you mark it down on falling comps/markets. You don't get to follow the markets lockstep on the way up and then, after markets fall, claim that markets are too volatile/irrational and you're sticking to the fundamentals. Markets get crazy to the downside and upside. You don't get to cherry pick when you get to reference market comps to rationalize your end goal. LP's don't need perfection, just one standard, applied consistently.

Claim #3: This time period isn't as bad as the 2009 crisis so valuations shouldn't be marked down

From *Private Markets Don't Launder Volatility, Honest*:

> Many people are simply over-extrapolating from the experiences of 2007-2009, when NAVs *did* lag hugely behind public markets, and were also far more modest in their downgrades — at least until the brutal end of 2008 forced a reckoning.

The reference to the financial crisis is a red herring and irrelevant. Investors want consistent valuation standards. Follow the same valuation practices during the good times and bad times. GPs shouldn't get to make a guess that a current downturn won't be as bad as a past crisis to rationalize not marking their book down.

Claim #4: New accounting rules reveal "true" values

From *Private Markets Don't Launder Volatility, Honest*:

> Thirdly, the 2008-2009 period actually illustrates the situation before and during the implementation of a new mark-to-market valuation framework. In 2007-2011, regulators required institutional investors to implement accounting rules FAS 157 and IFRS 13 to assess the true value of their holdings.

There's a lot of naivete in a typical academic belief that because there's an audit that everything is good. LP's who have been investing for any meaningful amount of time know the uselessness of relying on audit opinions. Auditors want documentation to cover their work. They are not pushing back on the GP to ensure proper

valuations. If you look at the valuation ranges used to justify company valuations, they are a mile wide and can justify almost anything. The argument that because some accounting standard was implemented that now the valuation is legit displays an incredible lack of actual knowledge of the inherent subjectivity and misaligned incentives in valuations.

Claim #5: Public markets are unreliable and volatile so rely on the GP's word

From *Private Markets Don't Launder Volatility, Honest*:

> Is this approach wrong? It's pretty clear that public markets overreact to information, and can diverge substantially and durably from their fundamentals. Instead of calling it "laundering volatility", perhaps private market NAVs actually bring a healthy dose of prudence and reason to an otherwise wildly gyrating financial system?

As Clifford Asness of AQR has stated, no one is claiming that public markets are always right. Or that they don't swing too far to either extreme. Instead, it's that LP's want consistency and objectivity in valuations. LP's don't want GP's changing the valuation standard depending on whether the market is up or down. So if a GP claims that markets are too extreme on the downside so they are holding their values flat, then the GP better make that same claim and hold their values flat when markets are up. But they don't.

Claim #6: More data and transparency would be helpful

From *Private Markets Don't Launder Volatility, Honest*:

> Investors fear that they are now over-allocated to private markets. This should be the top concern to address by investment managers. Private markets have matured hugely over the past decade, and the level of financial information should reflect that. It's therefore high time to improve (significantly) the quality and the granularity of data surrounding private investments.

This I agree with - more data and transparency would be a positive step in the right direction. But given the discretion GP's will always have, it still comes down to the willingness of GPs to apply standards in a fair and consistent manner. But as long as LPs continue to throw money at private assets, GP's have little incentive to change their behavior.