On the Disincentives of Investing in Public vs. Private Equity; and Implications for Pricing and Returns

When stock markets are closed, that doesn't mean there is never any change in the value of the thing you own.

This is true in public markets. Between the time that markets close until they open the next day, stuff happens. Earnings happen. Guidance happens. Takeovers happen. Prices change without flow. You find out how much they changed when they open.

Prices change with flow too.

And it is also true in private markets, where markets are basically closed for weeks or months and reopen occasionally. Prices change without flow.

Prices change with flow too, maybe.

So, private equity is equity. Yet, the lack of daily or timely marks potentially provides unrealistic comfort and a false sense of security to some investors. There is nothing necessarily terrible about this. We live in the world we live in, and in that world we have bosses and/or investors who don't like volatility generally, and really don't like it during certain types of environments.

Two years back, AQR's Cliff Asness even asked – perhaps in jest – if "multiyear illiquidity and its oft-accompanying pricing opacity may actually be a feature and not a bug."

In other words, should illiquid securities be slightly penalized and require a higher rate of return in order to invest in them, or does their capability to mask underlying volatility in fact suggest they should or could require a *lower* rate of return? So, instead of earning an illiquidity premium, should they earn an illiquidity discount?

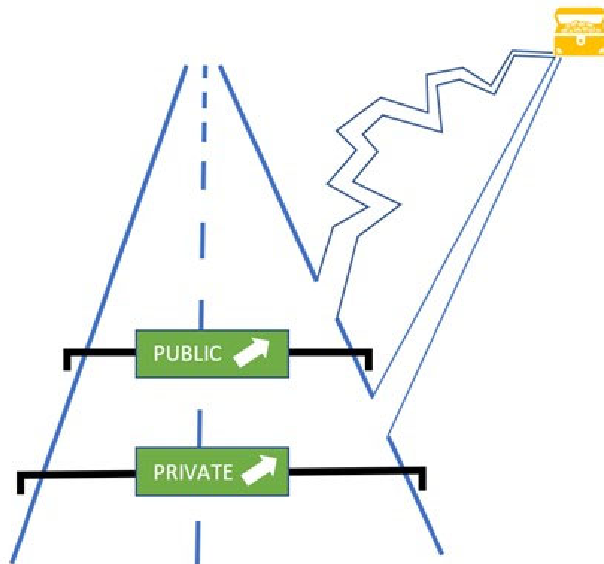
There is also an argument that when your hands are tied, you can't hang yourself. As Cliff asked in that same piece, maybe "lock up periods keep investors from acting irrationally when markets become volatile?"

Again, I think Cliff wasn't seriously suggesting that any of this should be the case, and instead was illuminating just how silly things were starting to become.

Indeed just this week, in a podcast with Morningstar and reported by Institutional Investor, he mentioned that the "big lag" in the pricing of private assets means that, yes, volatility might appear lower (or uncorrelated) in the short term, but eventually, we get there.

He called this "volatility laundering" – which I hope he trademarked – and tweeted (and I am paraphrasing):

"The amount people will pay to an industry to avoid daily S&P 500 volatility, all to generate returns that are similar in direction but lower than a moderately-levered S&P 500 Index fund...is staggering."



Moreover, and again, this isn't necessarily to say that PE managers are doing anything untoward, just that PE investors are playing this game, because the incentives are asymmetric.

Asymmetric for their bonuses, even their careers.

Where it potentially becomes most worrisome – which intrigues me greatly – is that this dynamic also (potentially) drives egregious PE valuations under certain paradigms, and/or within particular sectors.

So, if you are one of those PE investors enlightened enough to actually know your underlying volatility is being concealed, your next question should be if people are now paying too much for this camouflage?

In other words, just as the public markets can be affected by short term flows, is it possible that private market valuations, and the periodic marks of particular private investments, have been affected by increasing allocation tilts toward private equity?

The answer here may also help to reveal the relative unimportance of flows over the long term, yet the outsized impact of them in the short term.

Public equity is also equity, and eventually we get to the right price. We get to the right price for PE too (even without any flows, mind you) it just takes longer.

So maybe the fact that public markets can experience a bid-less vacuum amidst panic selling in March of 2020 implicitly overstates the volatility of listed equities in comparison to privately-held equity?

It sounds silly, I know, but no less silly than ignoring that a private equity framework implicitly understates the volatility of unlisted equities in comparison to publicly-held ones.

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