



Can Investors Time Their Exposure to Private Equity?

Posted by Gregory W. Brown (University of North Carolina), on Friday, March 27, 2020

Editor's note: Gregory Brown is professor of finance and director of the Frank Hawkins Kenan Institute of Private Enterprise at University of North Carolina Kenan-Flagler Business School. This post is based on a recent [paper](#) authored by Prof. Brown; Robert S. Harris, C. Stewart Sheppard Professor of Business Administration at University of Virginia Darden School of Business; Wendy Hu, Senior Researcher at Burgiss; Tim Jenkinson, Professor of Finance at the University of Oxford Saïd Business School; Steven N. Kaplan, Neubauer Family Distinguished Service Professor of Entrepreneurship and Finance at University of Chicago Booth School of Business; and David T. Robinson, Professor of Finance and the J. Rex Fuqua Distinguished Professor of International Management at Duke University Fuqua School of Business.

Private equity markets are highly cyclical. The aggregate amount of capital committed to the sector varies substantially from peak to trough, and many have observed that periods of high fundraising activity are followed by periods of low absolute performance for the asset class (see [Harris, Jenkinson, and Kaplan](#), among others). This raises an important question: is it possible to market-time the allocations to private equity to avoid the cyclicity of performance?

While this question is of immense practical interest to the investor community, it also reflects the deeper economic forces at work in the sector. Creating time-varying exposure to the asset class is potentially complicated by two sets of agency frictions that are especially important in this institutional setting. The first potential agency friction arises inside the organizational structure of the investor (the limited partner, or LP, in the fund) itself. LPs can suffer from internal agency problems that prevent them from committing to so-called 'disciplined' capital allocation strategies. A second potential friction arises from the nature of delegation in the asset class. Unlike public markets in which assets (e.g. stocks) can typically be purchased or sold almost immediately, limited partners who commit capital to private equity funds face significant delays and uncertainty surrounding the timing of purchases and sales, which are controlled by the general partner (see [Gredil; Robinson and Sensoy](#)). Consequently, there is substantial 'commitment risk' when the investor has pledged capital but does not control the timing of when the money is put to work or returned.

This [paper](#) uses data from Burgiss on over 3,500 private equity funds (both buyout and venture capital) to investigate investor timing in closed-end drawdown fund structures. We create the full series of cash flows and net asset values that an LP would have experienced for a variety of capital commitment strategies. This allows us to explore if 'commitment timing' based on market cycles can improve performance and is the first study investigate investor timing in private equity using comprehensive data spanning three decades.

We show that there are only modest performance benefits from commitment strategies that investors might actually use to harness potential timing gains. These fall well short of the gains that might be hoped for from statistical patterns found in research; moreover, they must be

weighed against organizational difficulties encountered in constantly shifting private equity allocations. We create a range of potential timing strategies with rules on how much to commit and whether this varies based on *observable* conditions in the private and public markets.

For buyouts, private equity investing beats public market returns, consistent with prior research, but the extra benefits of timing strategies are modest. A neutral strategy, which does not time commitments, pays back \$1.80 for every dollar invested (a multiple of 1.80 of *absolute* performance). Adjusted for the opportunity costs of not investing in the public markets, that multiple translates to a 1.15 public market equivalent (PME, see Kaplan and Schoar) of *relative* performance for the neutral strategy. In other words, 1.15 as much wealth as would have resulted from putting equivalently-timed cash in the public equity market index. By contrast, when we calibrate the fundraising cycle based on recent levels of fundraising scaled by the value of the stock market, a counter-cyclical (pro-cyclical) commitment strategy generates a multiple 1.86 (1.74) and a PME of 1.17 (1.09), quite comparable to the figures for the neutral strategy.

For venture capital, the more pronounced impact of the fundraising cycle on subsequent performance identified by our analysis and earlier research suggests even higher *potential* timing gains in VC than in buyout. However, our results suggests these are hard, if not impossible, to harvest in practice. The timing gains resulting from the implementable strategies are quite modest; moreover, timing measures to gauge the fundraising cycle send different signals on whether a counter-cyclical strategy is useful, complicating any attempt to adopt timing in practice. The patterns in VC reflect the difficulty in predicting market peaks *ex ante*. For example, 1997 and 1998 looked like fundraising peaks for venture capital from a historical standpoint, but were eclipsed by fundraising in 1999 and 2000, which made counter-cyclical strategies benchmarked against recent fundraising levels scale back too soon from an *ex post* perspective.

As a contrast to potential timing benefits, we find that commitment strategies that focus on fund selection provide higher performance gains than those based on vintage year timing for both buyout and venture. Allocating more to larger funds and more experienced GPs leads to higher relative performance; these effects are modest in buyouts but more substantial in venture capital.

We also explore the time-series properties of cash flows that emerge from alternative capital allocation strategies. We find that diametrically opposite capital *commitment* strategies (perfect negative correlation) lead to capital *calls* that are only modestly negatively correlated. These strategies result in *distributions* that are highly positively correlated. Thus, the thread between cash flow performance and the timing of limited partner capital commitments is frayed by the commitment process that delegates investment and exit activity to the GP. These findings call for more work understanding how the nature of delegation in private equity affects the performance and cash flow properties of the asset class.

The complete paper is available [here](#).