Private Equity as an Asset Class
by Guy Fraser-Sampson
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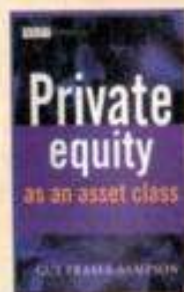

Buyout funds have been growing strongly in recent years. Record-breaking mega deals are in the headlines; the political discussion is heating up. And yet, the working of private equity is still little understood, perhaps the industry has been too busy with making money instead of explaining how it works.

"I have always felt the lack of a single comprehensive guide to private equity…something that sets out simply to answer the key questions, such as 'what is private equity?' and 'how does it work'." Guy Fraser-Sampson has filled the gap competently and controversially, much to the benefit of the audience.

Private equity has produced good returns to those who entered early in the 1990s, such as some US foundations. However, not too many European pension funds are invested in any significant way. The author still holds that "the only logical course is to invest in private equity, and heavily". He explained how they should do it in his 2006 book, Multi Asset Class Investment Strategy. This book gives a better idea of where the author is coming from.

The build-up of the book is straightforward, except for the introduction, which in fact is a set of conclusions and points for further discussion, best to be read at the end. The main text of the book is divided into 10 chapters, with a 27 page glossary.

The first chapter answers the two key questions quoted earlier and brings clarity into the often-confusing terminology. Here, private equity is made up of two strikingly different categories with little in common, 'venture capital' and 'buyout'. Chapter two is a passionate appeal to get a better understanding of 'Private equity returns – the basics'.

Chapters three to five discuss buyout in more depth: how it generates returns, how to analyse buyouts and to assess returns appropriately. Chapters six to eight do the same with venture captital. Here, unlike buyout, debt and leverage are of no importance, and the key to success is "home run mentality", that is, spotting the big winner and sticking to it. Pension fund investors will be particularly interested in the final two chapters, 'Due diligence' on funds and funds of funds, and 'Planning your investment programme'.

There is no risk of missing the key messages of the book as they are repeated several times. Some of the strong opinions expressed are particularly relevant to pension plans:

- Private equity demands a totally different investment process. Unless you over-commit funds (minimum 160 %) you will be chronically under-invested and fail to get the returns expected;
- "Private equity is…the only asset class where annual returns are meaningless, invalid and irrelevant, and true returns can only be measured many years in arrears." It should be measured with internal rates of returns on a 'vintage year' basis. For pension funds that are used to time-weighted returns on an annual basis, this raises issues in performance measurement and risk modelling;
- "Diversification by time is the single most important concept that should drive any private equity fund investor." The author recommends, for example, an eight-year private equity investment programme that commits a roughly equal amount of money year on year;
- "Fund size is the enemy of return." The data analysis undertaken seems to confirm such view;
- Many of the reservations made by pension trustees are fast dismissed. Concerns over liquidity are "not prudence but intellectual laziness".

Despite his clear advocacy for private equity as an asset class, the author deplores a number of shortcomings of the industry, such as the lack of data and transparency. He describes how difficult it is to access the best managers, in particular the 'Golden Circle' of US venture (which makes his preference for upper quartile data as best performance measure somewhat academic). Conflicts of interest are notorious for the industry, and for pension plan fiduciaries it is not easy to swallow that the interests of funds and investors are "for the most part so badly misaligned".

An air of late bull market hangs over the book. The big bet on private equity is hedged with warnings that the results of the past are unlikely to be repeated. Guy Fraser-Sampson conveys the complex specifics of private equity with some ease. His introduction to private equity is stimulating reading for experts and non-experts. As for his style, I am sure that readers will find the author's eccentric side-remarks quite amusing.

Georg Inderst is an independent consultant