How Much for a Haircut? Illiquidity, Secondary Markets and the Value of Private Equity
Researchers and investors have debated whether private equity returns and diversification benefits adequately compensate investors. These investments have illiquidity and market risks related to the timing of capital flows, and require management fees that are usually 2 percent of investors’ capital commitments per year, plus performance fees typically equal to 20 percent of the profits. According to research by Berk A. Sensoy at the Fisher School of Business at the Ohio State University and Nicolas P.B. Bollen in Vanderbilt University’s Finance Department, the returns and diversification benefits do justify the risks and costs borne by investors.

Bollen and Sensoy’s study “How Much for a Haircut? Illiquidity, Secondary Markets and the Value of Private Equity” bases its conclusion on risk tolerance, asset allocation, and the efficiency of the secondary market. Investors in private equity, also called limited partners, who need to sell their stakes cannot redeem their investments directly from the fund. Instead, they rely on secondary markets by which they can sell their stakes to other limited partners.

The drawback is that secondary sales could result in discounts from fund net asset values of as much as 50 percent during financial crises. During other times, the discount could be 20 percent. Despite these discounts, the study finds that the historical performance and diversification benefits of venture capital and buyout funds, the main types of private equity forms, are sufficient to justify their risks and fees. For example, buyout funds have on average outperformed public equities by about 3% per year.

The study also examines what percentage of their portfolios investors should allocate to private equity. For instance, investors with extreme risk aversion should allocate no more than about 10
percent of their portfolio to private equity investments. Investors with low to moderate risk aversion can justify allocations as much as 40 percent. The study notes that investors should be particularly willing to take the risk of private equity investments if they can access average-performing funds.

Despite the controversy, Bollen and Sensoy’s study shows that the returns and diversification benefits of private equity appear sufficient to compensate for the risks and costs for limited partners who have a broad range of risk preferences at portfolio allocations typically observed in practice. The findings offer limited partners a guide in making their portfolio allocation decisions.

‘Original article


Contacts

Isil Erel
Academic Director
The Risk Institute
Erel@fisher.osu.edu

Phil Renaud
Executive Director
The Risk Institute
Renaud.13@osu.edu
The Risk Institute at The Ohio State University Fisher College of Business brings together practitioners and researchers to engage in risk-centered conversations and to exchange ideas and strategies on integrated risk management. Through the collaboration of faculty, students and risk management professionals, The Risk Institute addresses risk at a broad cross section of industries and is dedicated to developing leading-edge approaches to risk management. Visit www.fisher.osu.edu/risk for more information.

From business as usual to business unusual, The Ohio State University Fisher College of Business prepares students to go beyond and make an immediate impact in their careers through top-ranked programs, distinguished faculty, and a vast network of partnerships that reaches from the surrounding business community to multinationals, nonprofits and startups across the globe. Our students are uniquely prepared and highly sought, leveraging Fisher’s rigorous, experiential learning environment with the resources of Ohio State, a premier research university with 500,000 proud Buckeye alumni.

Copyright © 2016 The Ohio State University and The Risk Institute. All rights reserved. This publication provides general information and should not be used or taken as business, financial, tax, accounting, legal, or other advice, or relied upon in substitute for the exercise of your independent judgment. For your specific situation or where otherwise required, expert advice should be sought. The views expressed in this publication reflect those of the authors and contributors and not necessarily the views of The Ohio State University, The Risk Institute, or any of their affiliates. Although The Ohio State University and The Risk Institute believe that the information contained in the publication has been obtained from, and is based upon, sources The Ohio State University and The Risk Institute believe to be reliable, The Ohio State University and The Risk Institute do not guarantee its accuracy and it may be incomplete or condensed. The Ohio State University and The Risk Institute make no presentation or warranties of any kind whatsoever in respect of such information. The Ohio State University and The Risk Institute accept no liability of any kind for loss arising from the use of the material presented in this publication.