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# Private Equity Investing

I ordered extra alpha – What's this on my plate?

Replicating a trend which has been in evidence south of the border for several years, Canadian plan sponsors are making significant commitments to alternative assets. However, there is frequently a lack of congruence between the investment objectives of the sponsor and the investment processes of the manager. Are sponsors applying the proper criteria in manager selection? Are managers actually creating alpha through the means they promise? This paper outlines some of the key issues involved in private equity investing – issues which are broadly applicable when considering investing in alternative assets.

One of the deficiencies in alternative asset investing – or attractions, depending on one's point of view – is that there is very little statistical data that can be used to predict or evaluate performance. In private equity, there is no Sharpe ratio, no attribution analysis, and no measure of returns by style. For that matter, there is not even an accepted notion of what "style" might mean. All that exists is data on returns by so-called "vintage years" of U.S.-based investment programs, categorized by stage of investing (seed, mezzanine, etc.). But, in Canada, not even this exists.

In the absence of meaningful performance data, or even a taxonomy of performance attributes, the sponsor is left with the task of selecting managers on the basis of assertions about investment processes and their correlation with returns. These assertions are usually supported by anecdotal evidence only.

In order to explore the issue of alpha generation and whether the private equity industry is a profession or cottage industry, it is important to consider the expectations of sponsors with those of real-world venture capitalists. Typically, sponsors think they are buying:

- A consistent investment style
- Proprietary origination
- Financial assets
- A distinct asset class

- Absolute returns
- "Alpha in the raw"

However, the views of managers are not necessarily inconsistent with those of sponsors. Their view of the service they are selling is as follows:

- A flexible style
- Access to a hard-to-reach market
- Participation in operating enterprises
- Access to a distinct asset class
- Absolute returns
- Investment timing

Any sponsor who seeks success in private equity investing will do well to begin by reconciling their expectations and beliefs with those of the prospective manager, and must trust their own judgment in the end.

When looking at private equity investing, sponsors should not postpone investment decisions until highly reliable and disaggregated performance data is available – and it may never be available. At the same time, sponsors should not ignore the non-quantifiable attributes of prospective managers, because that is always the best information that is available. In the end, it is important to be very thoughtful in designing and assessing evaluation criteria for alternative asset managers. ■

