PitchBook

Global Fund Performance Report

as of 3Q 2018

PitchBook

Contents

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Key takeaways

- Private market strategies continue to produce strong one-year horizon IRRs, with VC retaining the top spot at an 18.9% IRR over the last 12 months. Real assets saw the largest jump QoQ, reversing a multi-quarter downturn in performance. Secondaries also inched higher to remain the second-best performing private market strategy over the last year.

- In the first three quarters of 2018, net cash flows from PE funds continued their positive streak, albeit at a slightly lower level than the five-year average. Positive net cash flows to LPs for the seventh year in a row are a harbinger for continued strength in fundraising.

- VC cash multiples saw significant growth over the year through 3Q 2018. TVPI stepped higher for all vintages since 2003, with 2011 and 2014 leading the charge. Recent vintages also recorded strong multiple growth over the last year, with the pooled 2017 TVPI moving above 1.0x for the first time, driven principally by paper gains.

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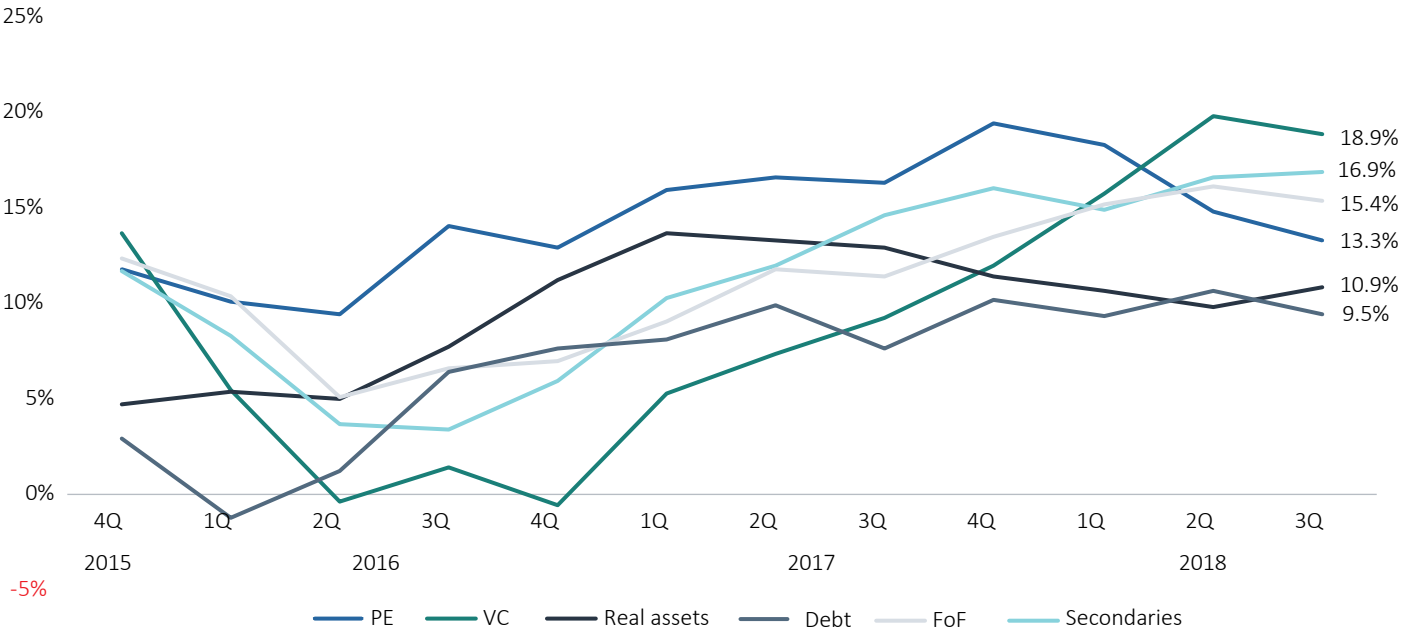
Private capital

Rolling one-year horizon IRRs by fund type



Source: PitchBook | **Geography:** Global
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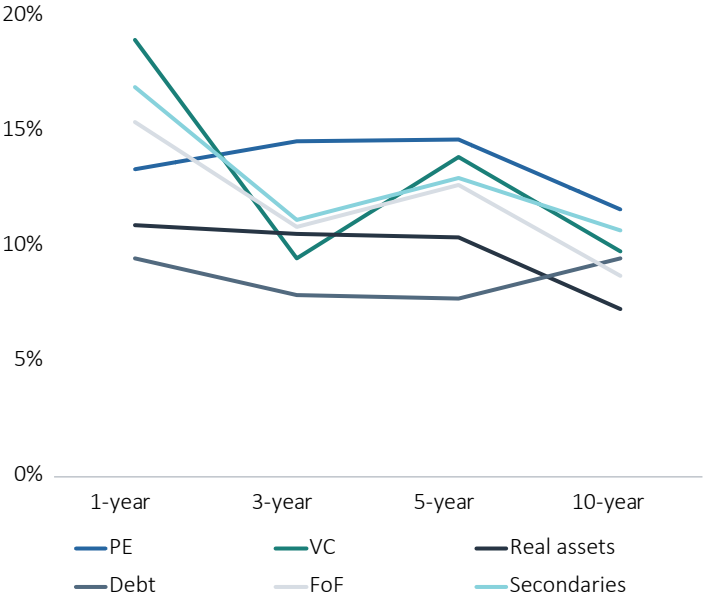
VC produced the highest one-year IRR of any private market strategy for the second consecutive quarter in the period ending 3Q 2018, despite a QoQ decline of nearly 1.0%. The robust exit market during 2018 expectedly kept IRRs elevated. While private market strategies continue to produce strong one-year horizon IRRs on an absolute basis, only two strategies saw QoQ increases in 3Q 2018. Real assets saw the largest jump, reversing a multi-quarter downturn in performance and moving out of the bottom spot. Secondaries also inched higher to remain the second-best performing strategy over the previous 12 months.

PE one-year returns remain perched above 13% but saw a further slip in rolling returns after hitting a recent peak in 4Q 2017 as the strategy continues to face downward performance pressure. After PE's domination over the preceding two years, PE rolling one-year returns have slipped drastically over the past two quarters and now trail VC, secondaries and fund-of-funds (FoFs). Among private market strategies, PE also exhibits the highest correlation to public markets, so we expect some of the public market volatility experienced through the end of 2018 and beginning of 2019 to manifest in PE IRRs over the next few reporting periods. That said, the overall trend for rolling one-year returns has been up and to the right for all private capital strategies over the past three years of data.

Over the long term, PE still exhibits IRR outperformance over the three-, five- and 10-year horizons, showcasing the strategy's consistently strong returns since the financial crisis. The other three equity-oriented private market strategies in the group (VC, FoFs and secondaries) tend to move up and down in tandem over each horizon. Interestingly, conventional wisdom implies that secondaries and FoFs tend to track closer to PE, given those strategies mainly hold PE fund interests. However, a second look at the data implies more volatility and perhaps stronger connection between public markets and secondaries and FoFs returns than previously assumed. Typically, there has also been a large overlap in managers between the secondaries and FoFs strategies given their desire to diversify offerings, which has likely contributed further to this correlation.

Outside of the backward-looking data, LP sentiment serves as a key data point in assessing the prospects of private market strategies. For instance, in our 2018 Annual Institutional Investors Survey, respondents were notably more pessimistic, with nearly 30% expecting returns to decrease in the future across the full range of private capital strategies. These late-cycle concerns seem relatively pervasive, with numerous other surveys echoing similar sentiments and indicating that investors are lowering return

Horizon IRRs by fund type



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expectations. However, with plenty of large LPs claiming anecdotally that they are increasing commitments into private capital, it seems institutional investors still believe in the potential for relative outperformance by private market investments.

Secondaries funds have experienced a surge in popularity over the past few years, with many LPs using them in a manner akin to FoFs for instant diversification in private markets. However, due to the robust levels of contributions, secondaries is one of the few strategies in which net cash flows have been in decline. With only $3.2 billion in net cash flow in the first three quarters of 2018 and record levels of secondaries deal activity, net cash flows may potentially turn negative for the year. Rolling one-year IRR for the strategy is still strong at 16.9% in 3Q 2018, trailing only VC among private capital strategies. However, as capital continues to flow into the space, competition for deals and, in turn, pricing has escalated significantly which may pressure returns going forward.

Performance trends for FoFs are essentially the inverse of what we've recorded for secondaries. Rolling one-year IRR has been on an upturn spanning the last two years, and many vintages have posted exceptional YoY gains in TVPI. Pre-2013 vintages have sustained high distributions back to LPs as fundraising has stalled, contributing to abnormally strong positive net cash flows. We think fundraising headwinds will continue and keep contributions lower than average, and as such, we see it as unlikely that distributions can maintain this magnitude over the long term. Given the shakeout in the strategy, the universe now largely comprises the best-performing managers historically, which should buoy returns going forward. However, we see FoFs as a mature strategy that will end up playing a more limited role in the PE landscape going forward.

Real assets was the only strategy that saw significant improvement in one-year rolling IRRs, illustrating a reversal of its slow decline since the beginning of 2017. This suggests some improving sentiment around this space, which tends to be less linked with PE and the public markets in general. Real assets funds saw solid improvement in cash multiples across most vintages, with 2009 continuing to flounder by posting a negative YoY change in TVPI. On a similar note, 10-year returns are still lagging as they incorporate the severe hit the real assets strategy took during the financial crisis.

Performance of private debt funds has shown positive signs despite falling to the bottom of the stack on a rolling one-year basis. As expected with a debt strategy, returns and cash flows have been steadier than those of equity-oriented strategies. Its lower upside is illustrated by the almost perfectly horizontal line for private debt on the horizon IRR chart. Because of this stability, TVPI for private debt funds doesn't deviate wildly. Rather, the focus is on DPI and how quickly and effectively GPs can return capital back to LPs. 2011-2013 vintages provided a significant portion of the DPI gains over the past year, as these cohorts moved further into the later stages of the fund lifecycle with full portfolios generating cash.

To connect this performance back to recent events, a large portion of the assets held by private debt funds falls into the category of leveraged loans. Volume in the leveraged loans market has been growing at an aggressive pace over the last few years, fueled in part by robust fundraising and subsequent capital deployment by private debt funds, which has raised concerns about competition and the long-term returns prospects for the strategy. Parallels to the financial crisis have been drawn with swelling volumes and increased prevalence of cov-lite loans, magnifying the need for close observation about the health of this market and how it might fare in the event of weakening macroeconomic conditions.

Fed Chair Jerome Powell weighed in on this comparison in a recent speech, stating "The acronyms have changed a bit—'CLOs' (collateralized loan obligations) instead of 'CDOs' (collateralized debt obligations), for example—but once again, we see a category of debt that is growing faster than the income of the borrowers even as lenders loosen underwriting standards." He went on to highlight some more reassuring statistics about the structures of CLOs, more vigilant regulators, investor mix in leveraged loans and the health of banks, but many questions remain about the true vulnerability or potential losses from a liquidity crunch.

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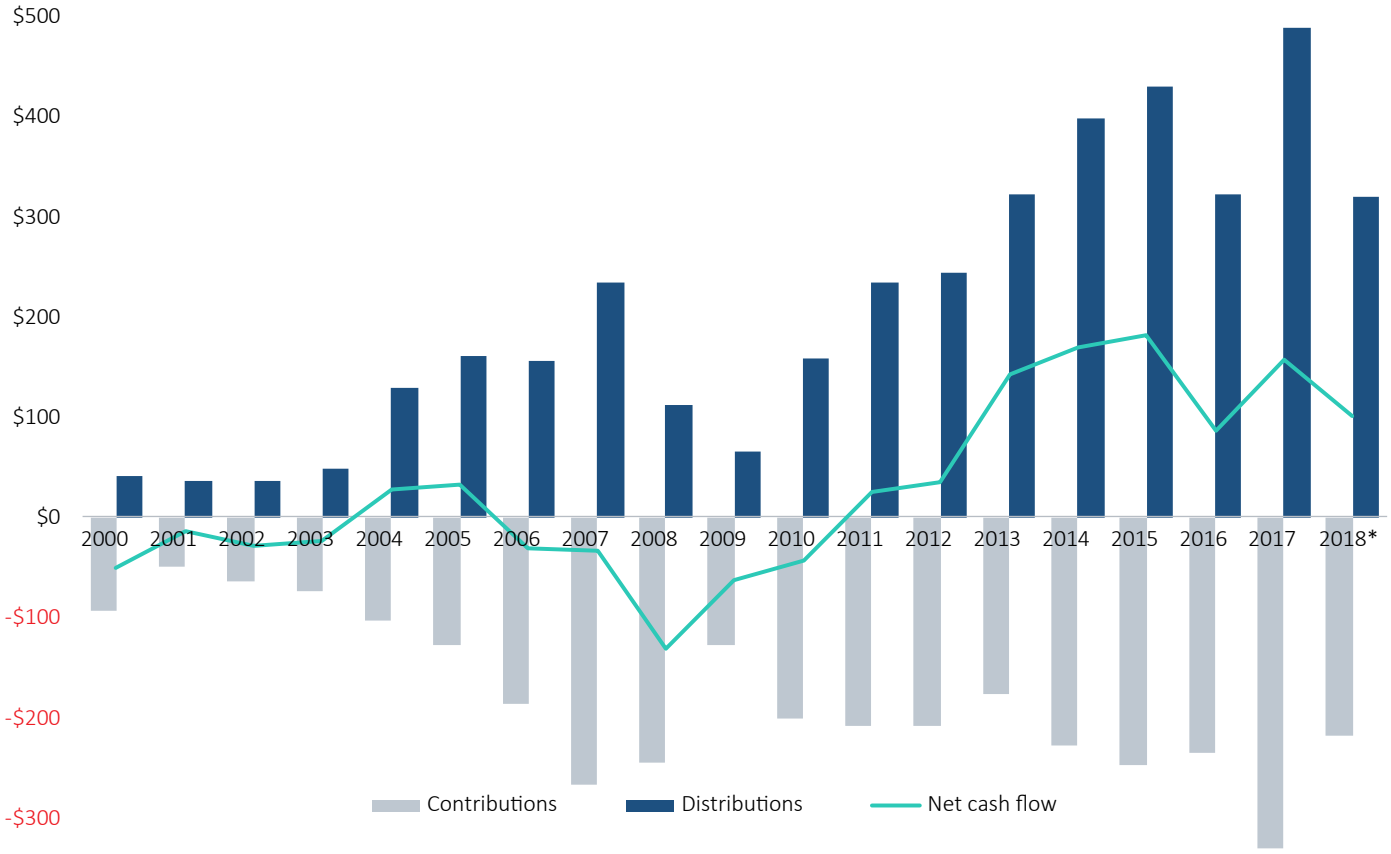
Private equity

PE fund cash flows ($B)



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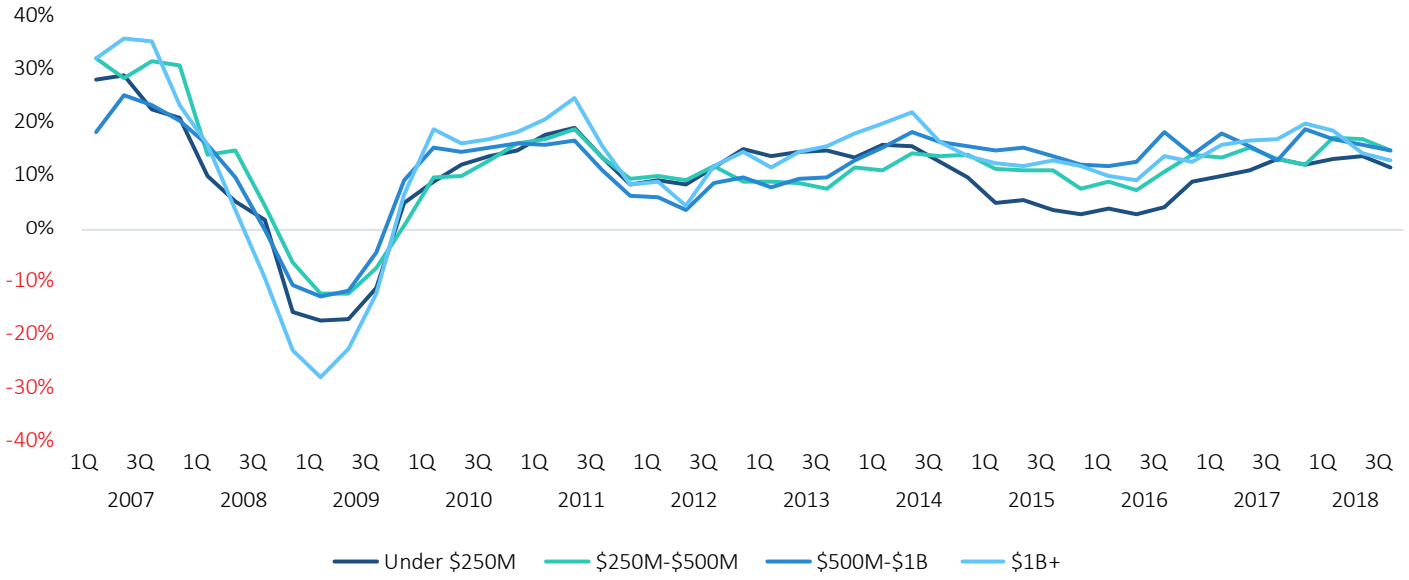
In the first three quarters of 2018, net cash flows to LPs (distributions minus contributions) continued their positive streak, albeit at a slightly lower level than the five-year average. Positive net cash flows to LPs for the seventh year in a row are a bellwether for continuing LP reallocation to PE and, therefore, strong fundraising years ahead.

Looking forward, the final quarter of 2018 witnessed weak public equity market performance, which should rein in mark-to-market gains during the period. However, overall exit activity remained strong in 4Q 2018, which should boost distributions in the final quarter of the year. Distributions to LPs reached record levels in 2017 and, despite a slight slowdown in year-end 2018 figures, appear primed to eclipse $400 billion for only the third time ever. Additionally, we expect contributions to grow commensurately due to a surfeit of dry powder and sustained strength in fundraising.

Global rolling one-year horizon IRRs fell across all size buckets in 3Q 2018. While performance remained in the double digits, 3Q saw lower figures than previous quarters. The magnitude of the declines from the largest bucket to the smallest was only about one percent, but this is a continuation of a multi-quarter downtrend. The decreases were most evident in the smallest bucket (vehicles under $250 million), with a decline of 2.1% QoQ. Although the smallest bucket registered a slight gain in 2Q, all other buckets have seen steady IRR declines since 1Q 2018. Looking forward, given the public market volatility and declines in 4Q 2018, we anticipate declines across all bucket sizes given that mark-to-market figures are integral to IRR calculations.

Continuing a trend from 2Q 2018, both the US and European rolling one-year horizon IRRs outperformed the rest of the world. The US continued to record the best regional performance, with a 16.0% return, up 0.1% from 2Q. Europe and the rest of world clocked IRRs of 8.2% and 6.6% respectively, stark declines from 2Q. While the rest of the world has generally trailed both the U.S. and Europe in terms

PE rolling one-year horizon IRR by fund size



Source: PitchBook | **Geography:** Global
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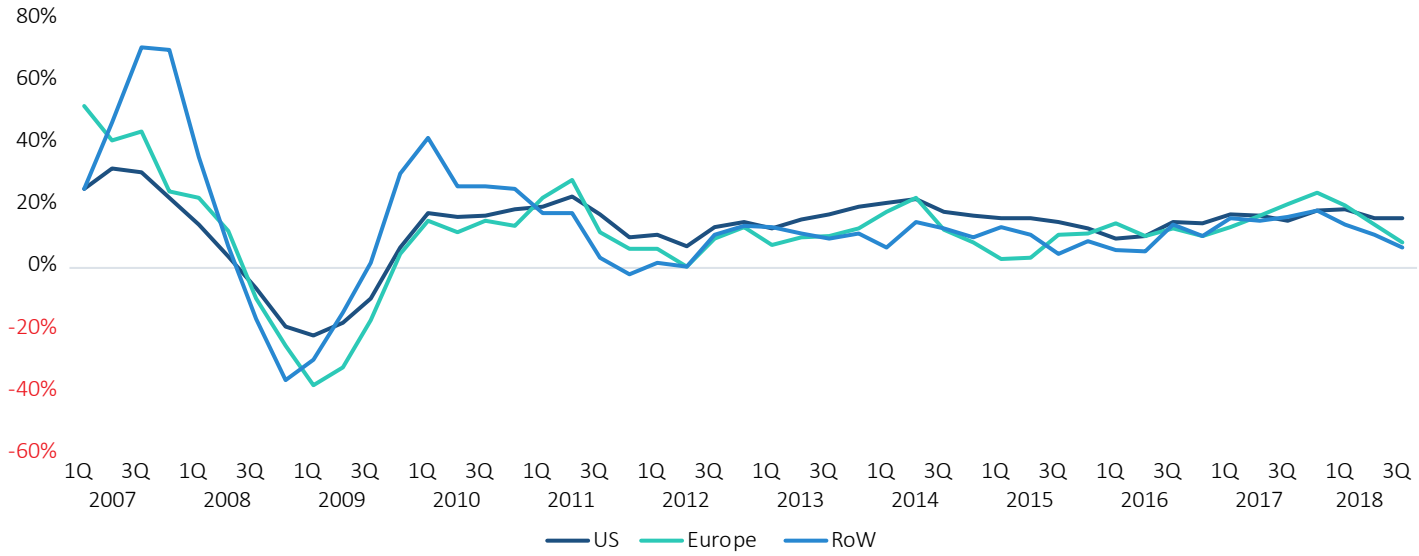
of IRR for the last few years, the steep retreat out of Europe is significant. The gap between the U.S. and European returns has widened, with the US generating substantially higher returns than Europe (16% versus 8.2%, respectively) on a one-year horizon ending September 30, 2018. This is the largest difference in IRR between the two regions since 2Q 2015 and marks a reversal from the four straight quarters of outperformance by Europe from 2Q 2017 to 1Q 2018.

The recent trend can be partially attributed to recent divergence American and European public equity markets. Gains made on the S&P 500 contrast with losses accrued by the FTSE 100 and the STOXX 600 over the same period. This divergence can be partially credited to continuing Brexit concerns casting a dark cloud over Europe, contrasted with the positive economic growth and earnings data buoying the US over the same period. At the same time, performance in the rest of the world has been relatively weak; however, many investors see Asia and other emerging markets as presenting some of the most attractive investment opportunities going forward. We believe the volatility and drawdowns observed in the public equities markets during 4Q 2018 will lead to depression in IRRs across all regions in the next reporting period.

PE rolling one-year horizon IRR by fund region



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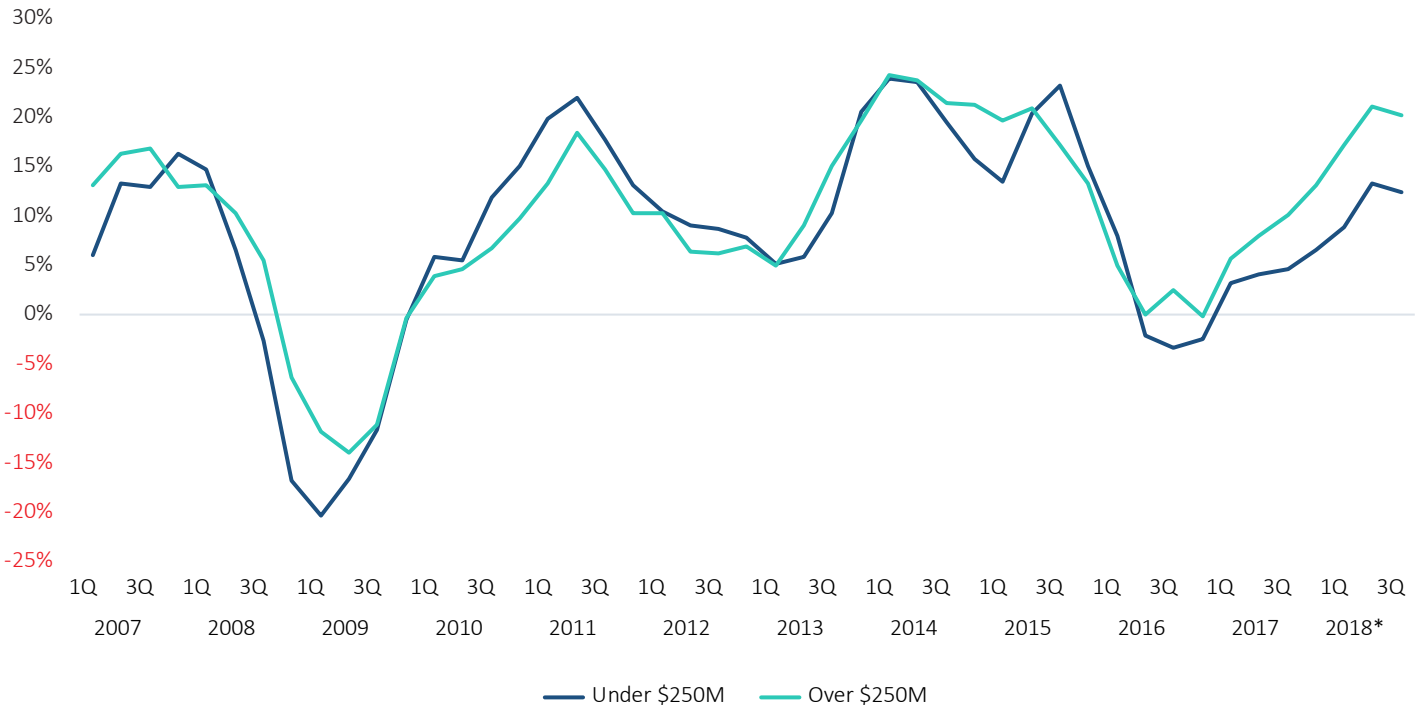
Venture capital

VC rolling one-year horizon IRR by fund size



Source: PitchBook | **Geography:** Global
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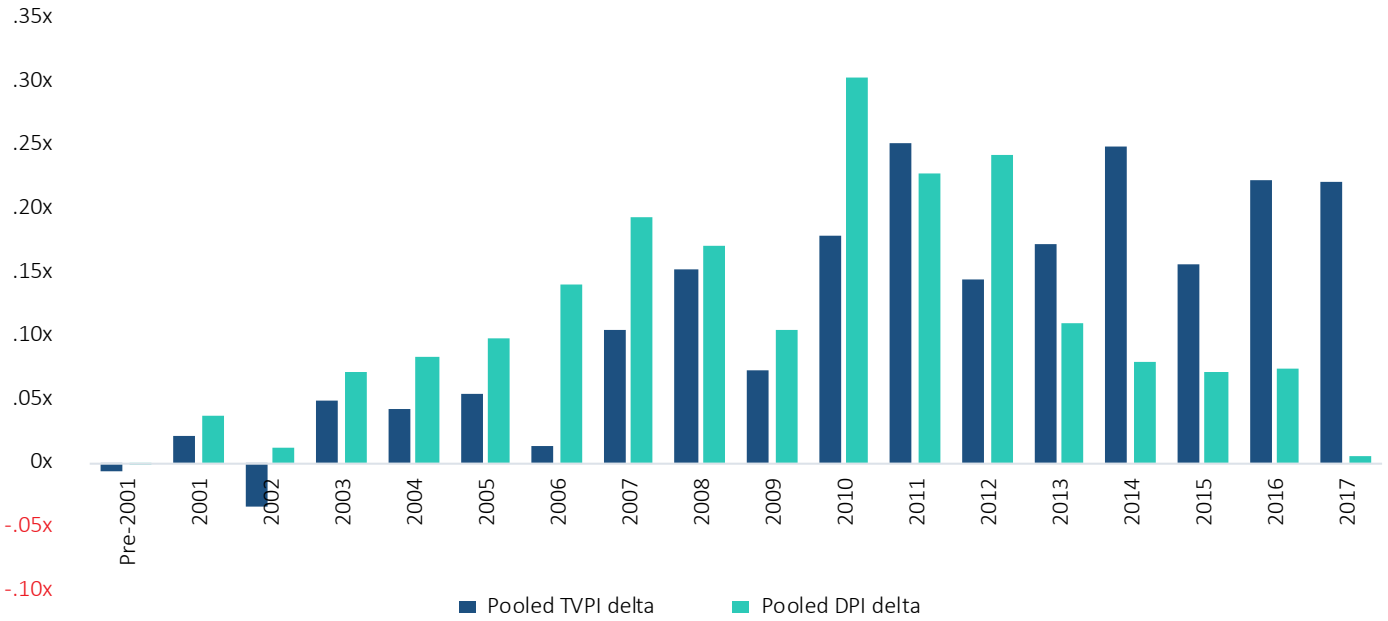
As the top-performing private capital strategy over the one-year horizon, VC continued its two-year-long improvement, settling at an 18.9% IRR over the past 12 months. While 3Q data represented a slight decrease QoQ, VC remains close to the record levels of one-year IRRs we've recorded over the past decade. Interestingly, this most recent run-up in returns has seen a gap form between rolling IRRs of the small and large funds, with funds over $250 million exhibiting the overperformance.

The outperformance of larger vehicles has been common over the last decade. However, with an average discrepancy of 1.5% since the beginning of 2007, every quarter so far in 2018 has recorded a gap of over 7.7%, demonstrating the magnitude of this dichotomy. We believe much of this change can be attributed to the continued proliferation of unicorns and mega-deals within the VC space. While early-stage deals tend to be relatively bound in terms of price given how early in the companies' life those funds are invested, the upper bound of valuation all but disappears as companies mature in the private markets. The valuation data supports this wholeheartedly, with late-stage valuation growth far outpacing the other stages over the past decade and even more markedly over the past three years. As a host of these long-tenured unicorns finally reached an exit in 2017 and more frequently in 2018, large GPs were finally able to return at least a portion of the massive accumulations of paper value to LPs.

To be sure, survivorship bias is likely playing a role in this outperformance, as the ability for a GP to raise a fund over $250 million implies relative success of past funds. Furthermore, given this increased maturity, the overall risk profile is lower for funds in the larger size bucket which should lead to a tighter distribution of returns and elevated averages. It's also important to note that the IRR calculations treat NAV as a terminal cash flow, meaning that the still-private unicorns are also moving these returns higher. The accelerated pace of deals over $100 million has allowed some of the fastest- growing businesses to achieve massive valuation step-ups in very little time, pushing IRRs even higher, potentially disproportionately for larger funds.

As the improvement in one-year IRRs would suggest, VC cash multiples also saw significant growth over the past year. TVPI stepped higher for every vintage besides 2002

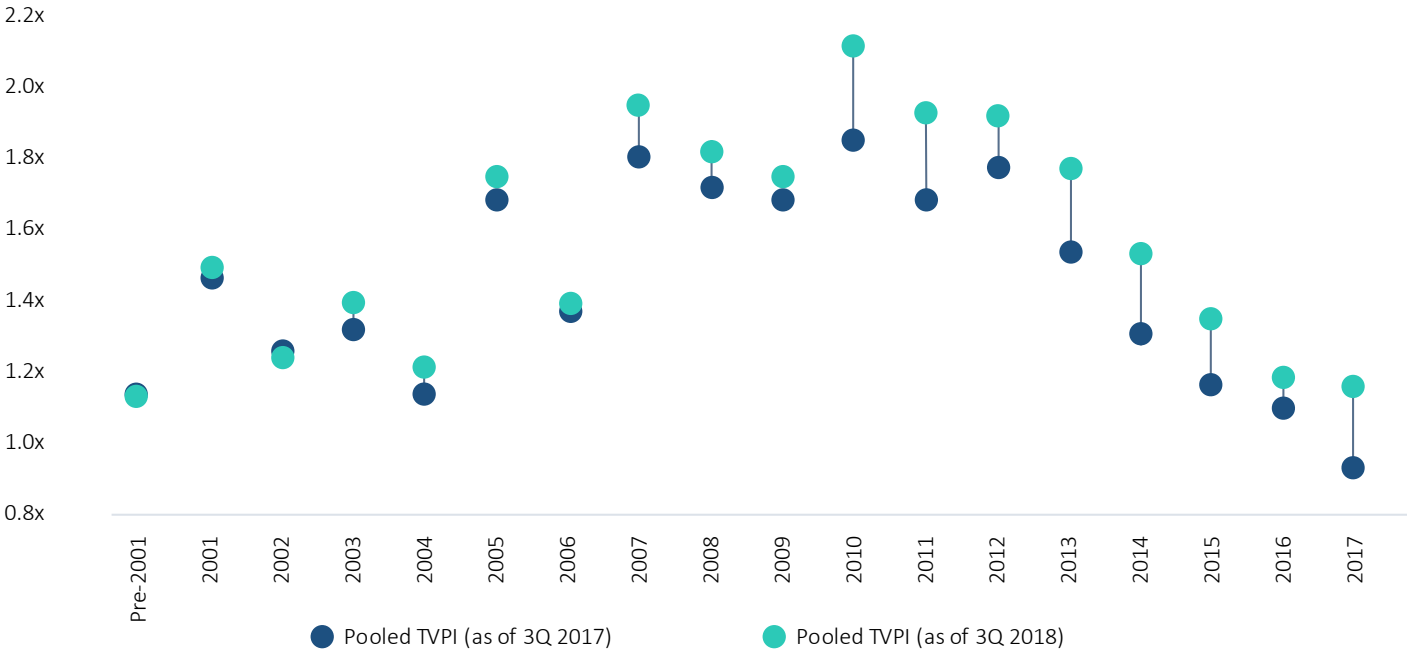
VC one-year change in pooled cash multiples by vintage



Source: PitchBook | **Geography:** Global
*As of September 30, 2018

and pre-2001, with 2011 and 2014 leading the charge. Recent vintages also recorded strong multiple growth over the last year, with the pooled 2017 TVPI moving above 1.0x for the first time. Given the understandably low increase in DPI from 2015-2017 vintage funds due to their earlier stage in the lifecycle, we again see the effects of rising valuations in driving higher fund performance metrics. In the current environment, even these lofty valuations have been validated by the exit market through the first few months of 2019 with only a few exceptions. The continuation of this support from the exit market enabling liquidity at attractive levels will be key to retaining these elevated performance metrics in the future.

VC one-year change in pooled TVPI multiples by vintage



Source: PitchBook | **Geography:** Global
*As of September 30, 2018

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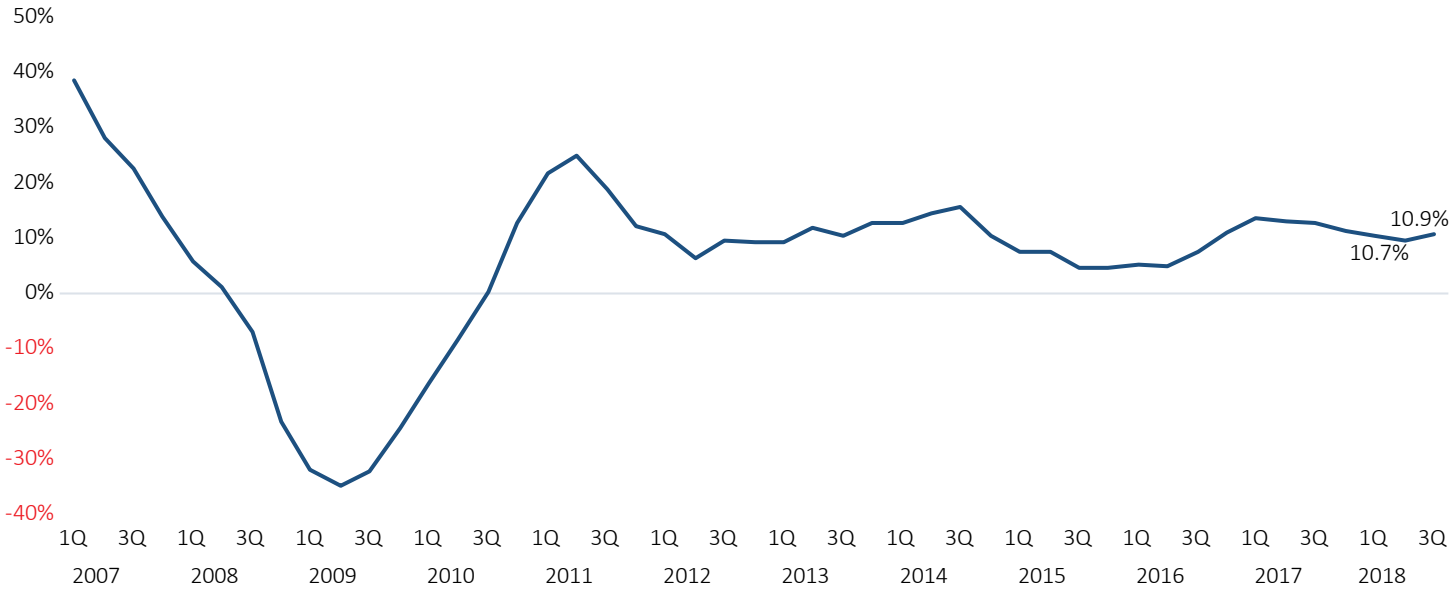
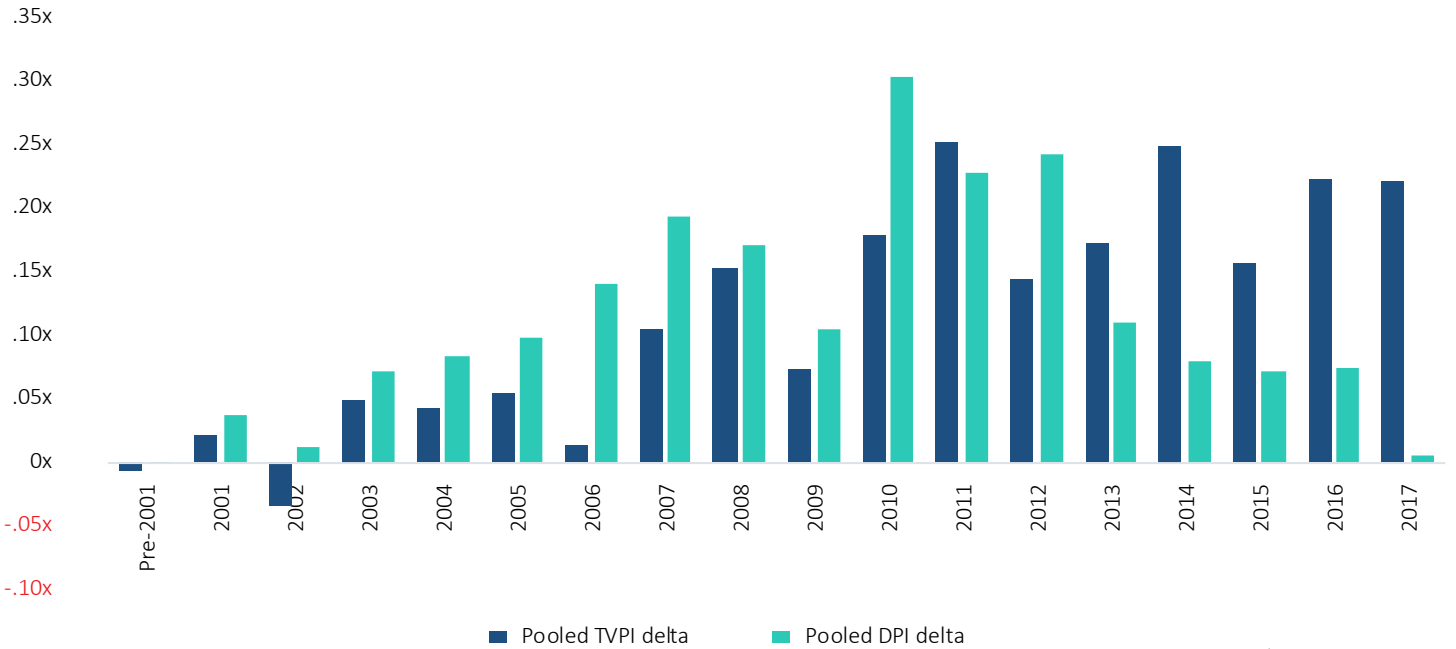
Real assets

Real assets rolling one-year horizon IRR



Source: PitchBook | **Geography:** Global
*As of September 30, 2018

Real assets one-year change in pooled cash multiples by vintage



Source: PitchBook | **Geography:** Global
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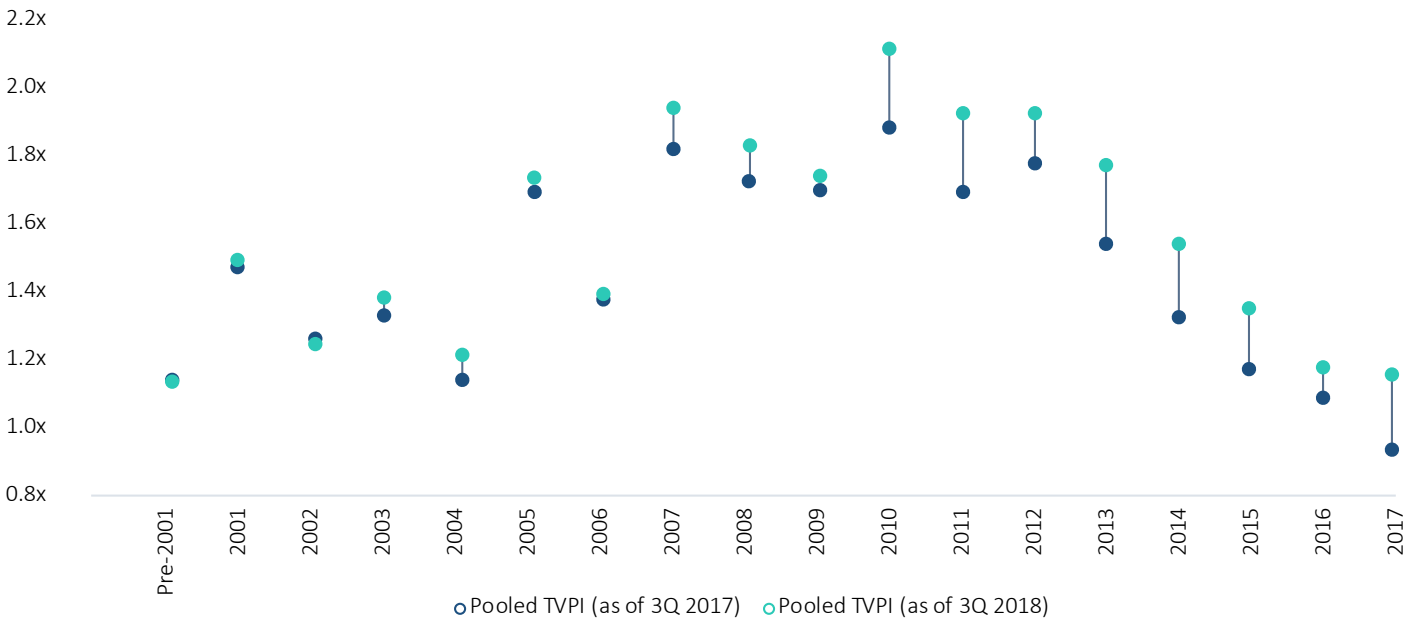
Real assets one-year change in TVPI by vintage



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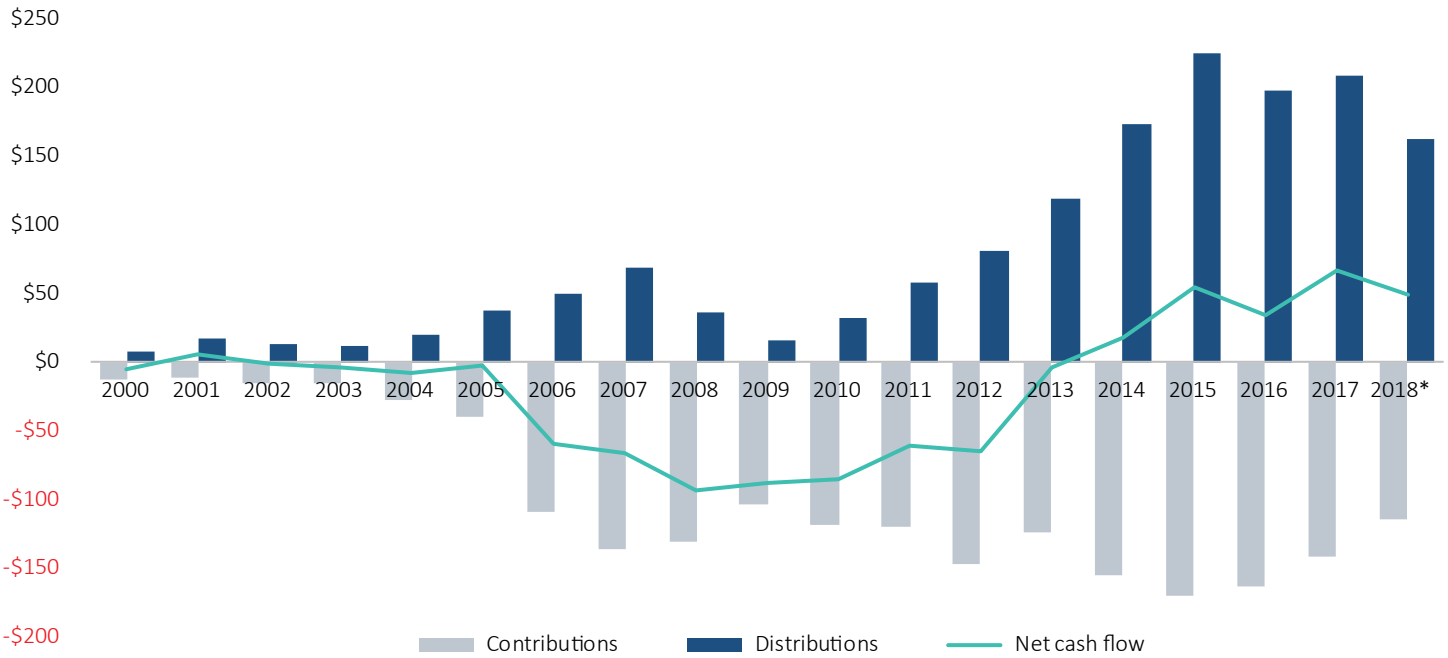
Real assets cash flows ($B)



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*As of September 30, 2018

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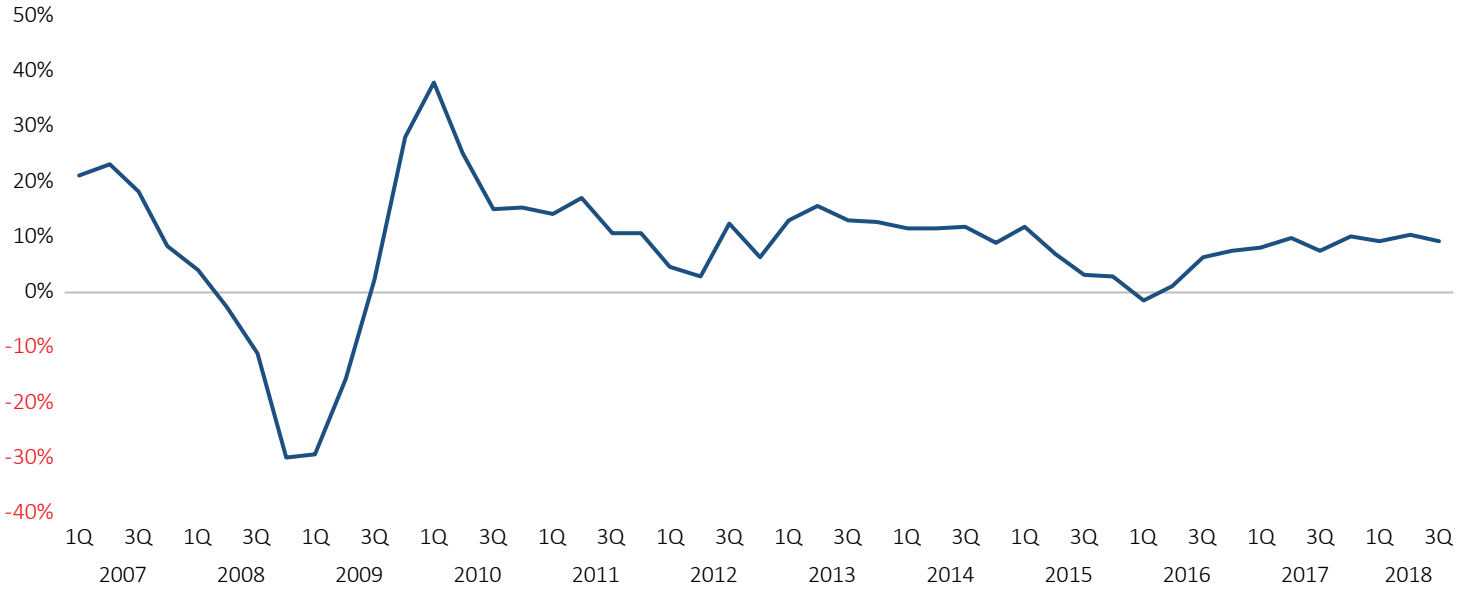
Private debt

Private debt rolling one-year horizon IRR



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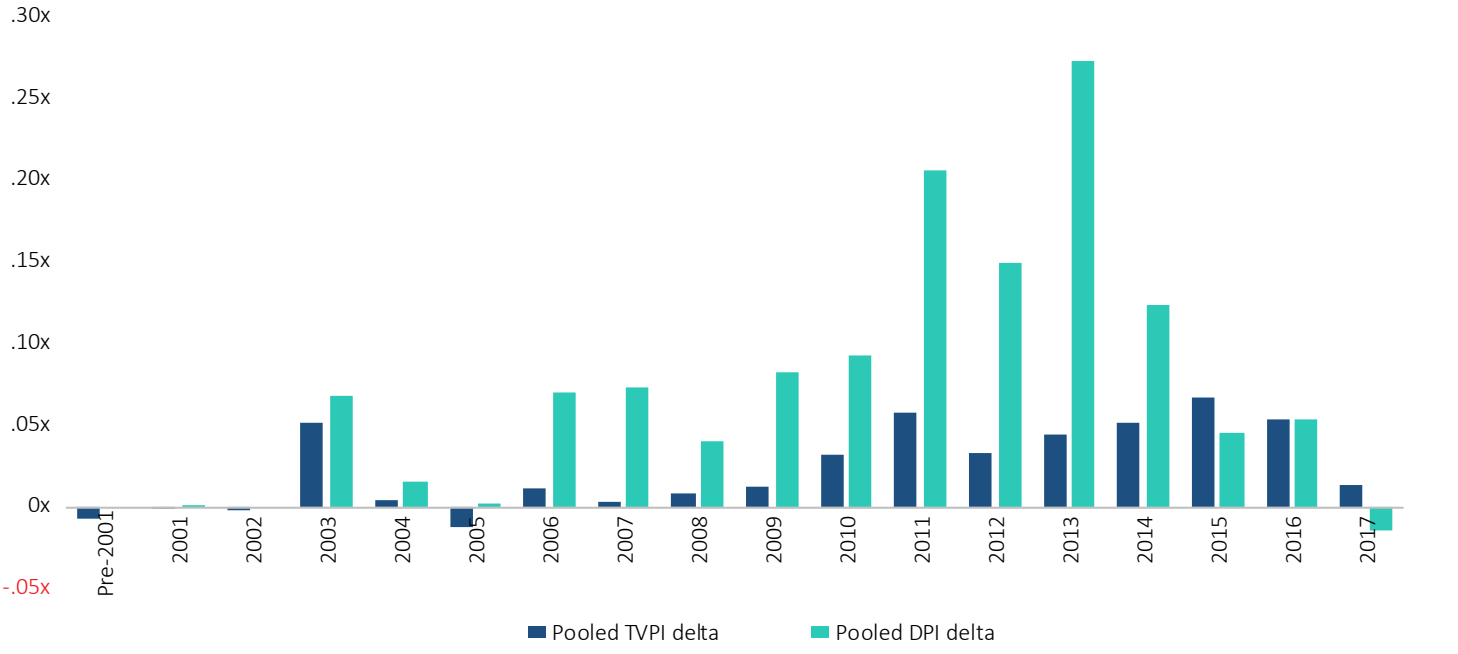
Private debt one-year change in pooled cash multiples by vintage



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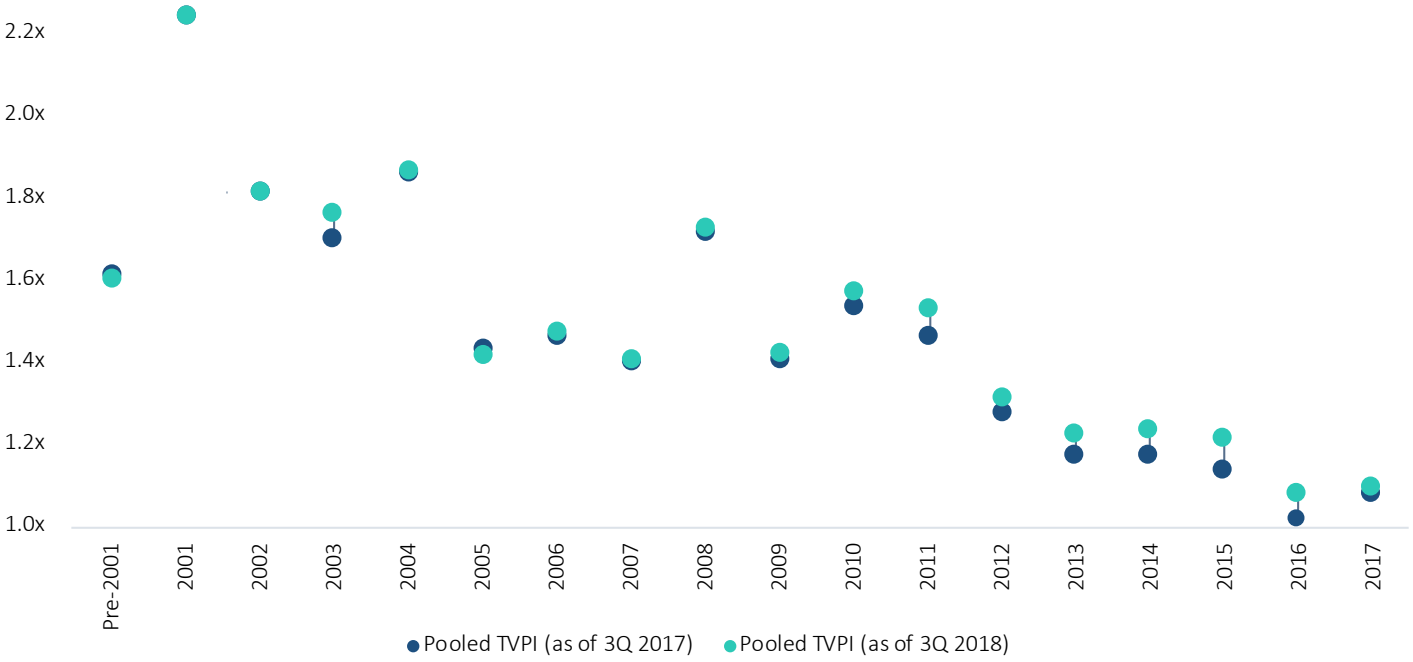
Private debt one-year change in TVPI by vintage



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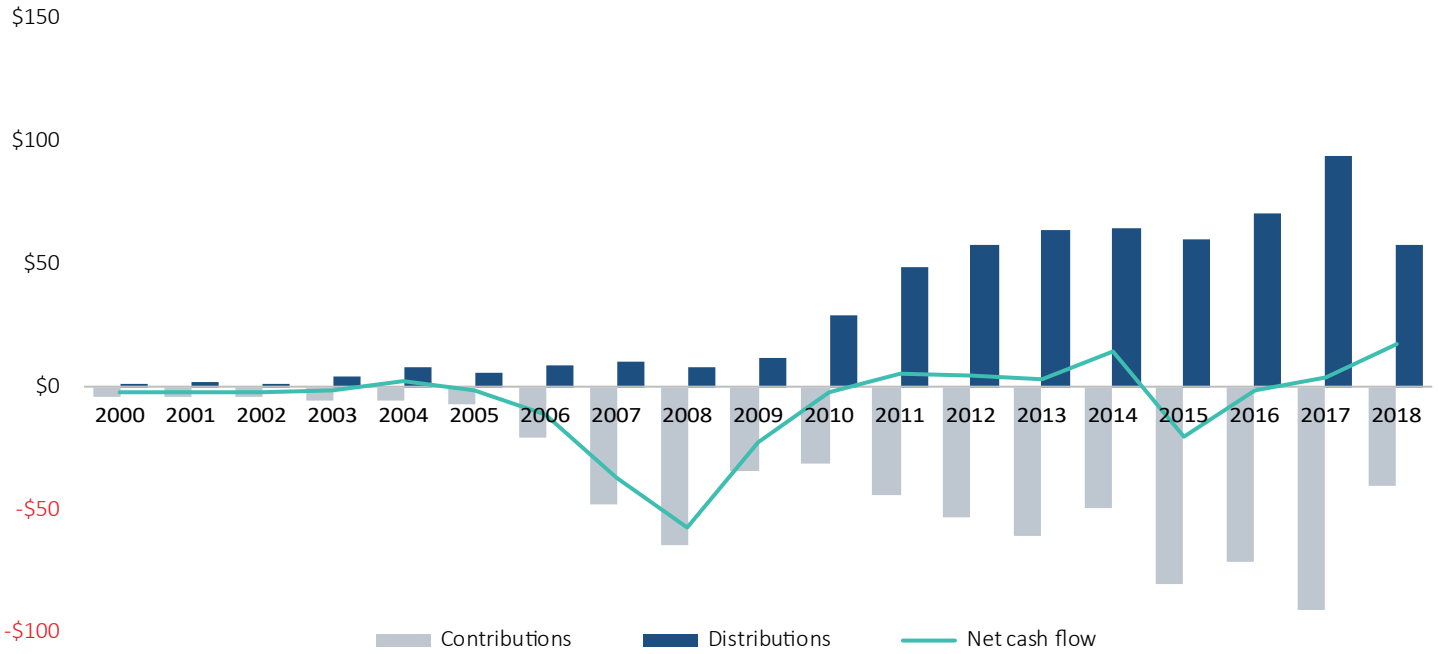
Private debt cash flows ($B)



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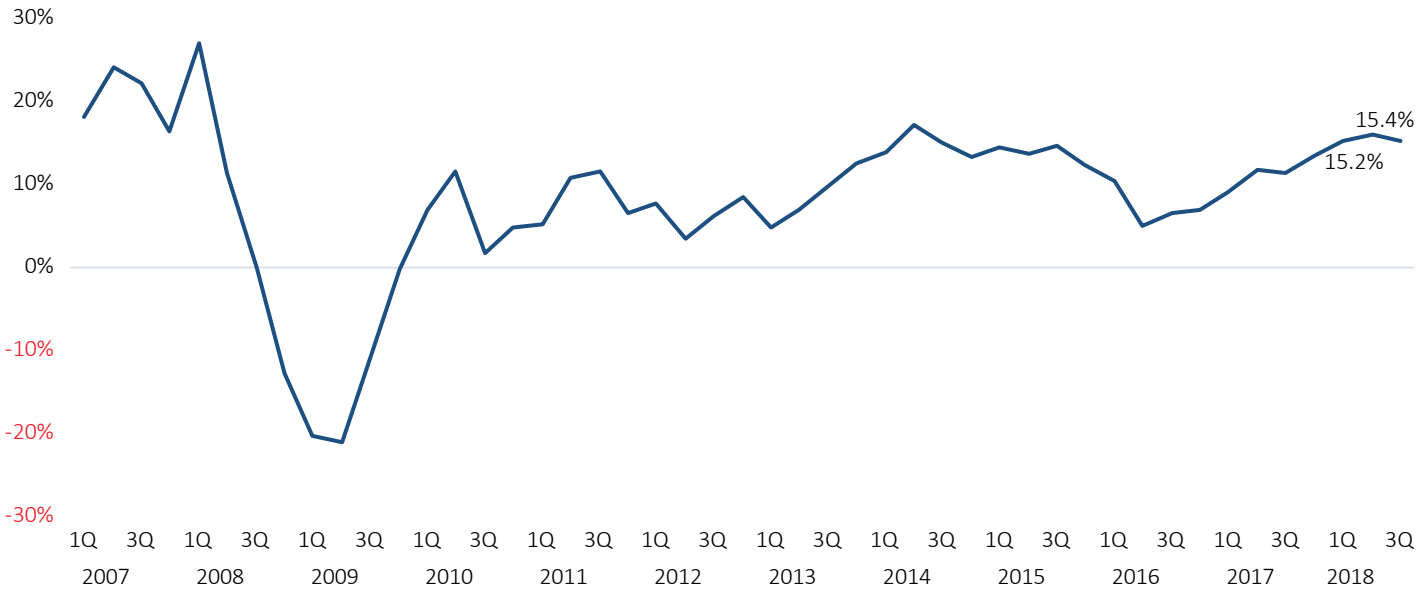
Fund-of-funds

FoFs rolling one-year horizon IRR



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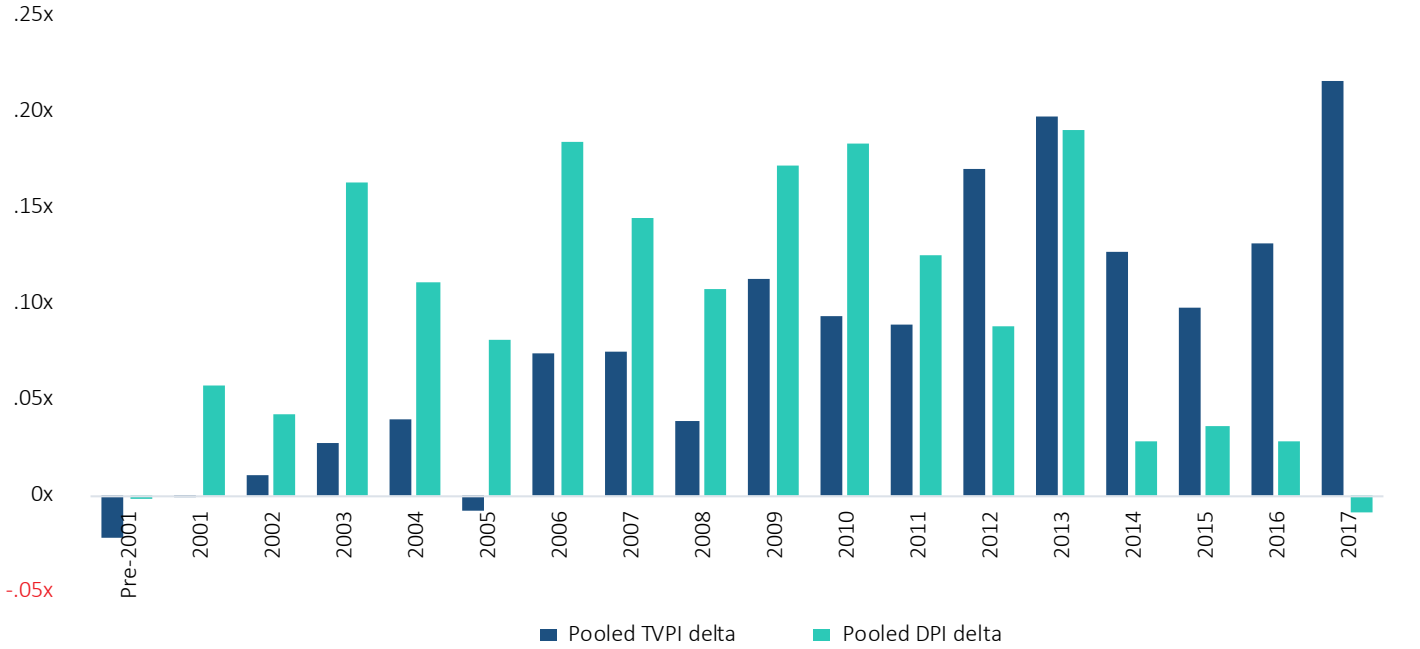
FoFs one-year change in pooled cash multiples by vintage



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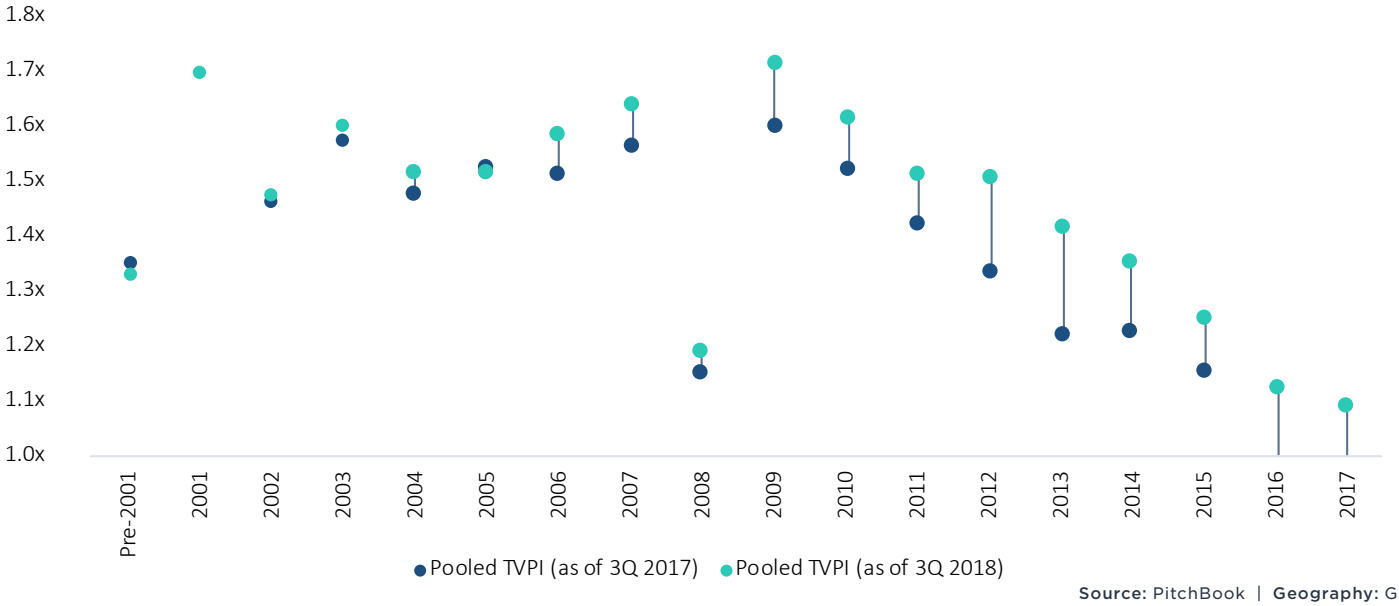
FoFs one-year change in TVPI by vintage



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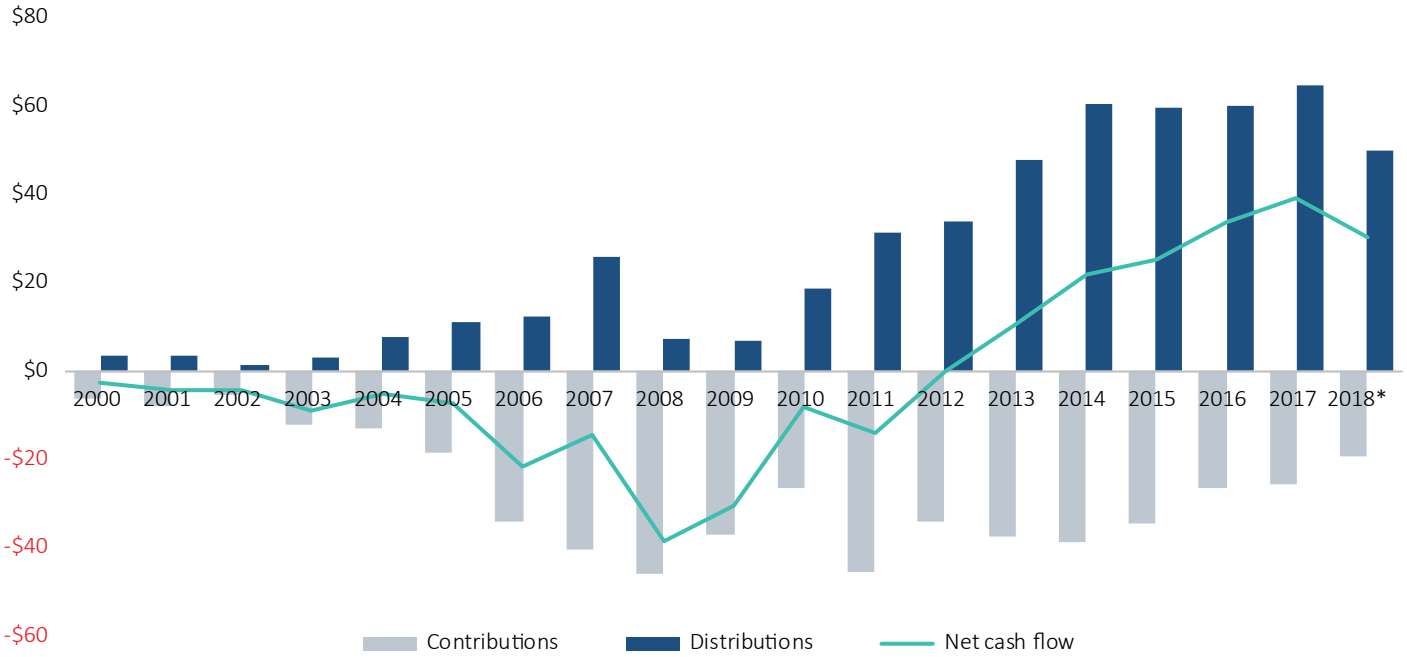
FoFs cash flows ($B)



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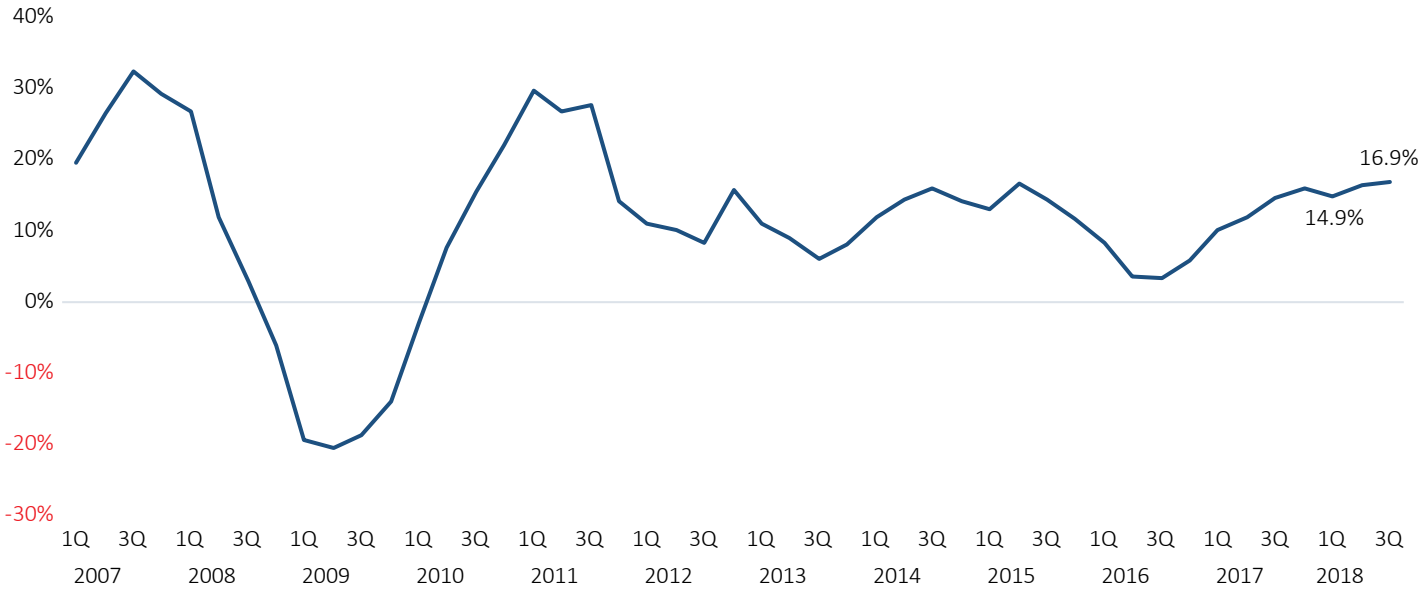
Secondaries

Secondaries rolling one-year horizon IRR



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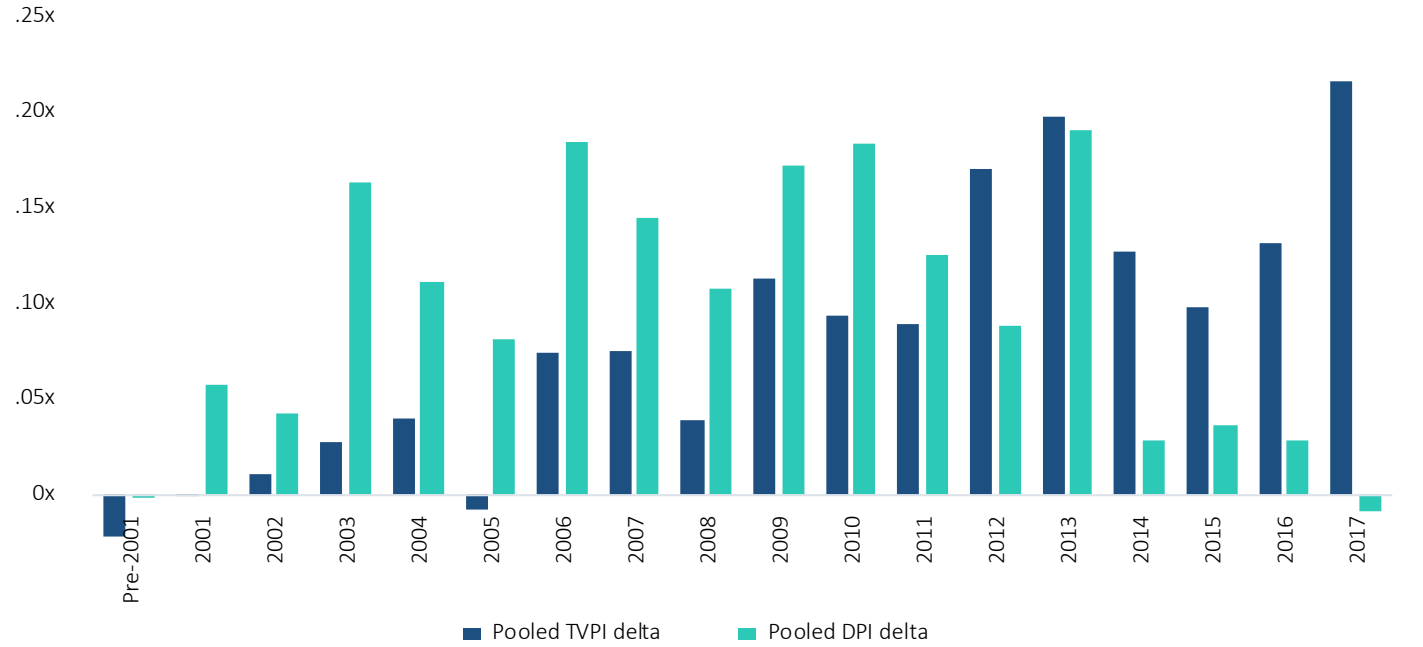
Secondaries one-year change in pooled cash multiples by vintage



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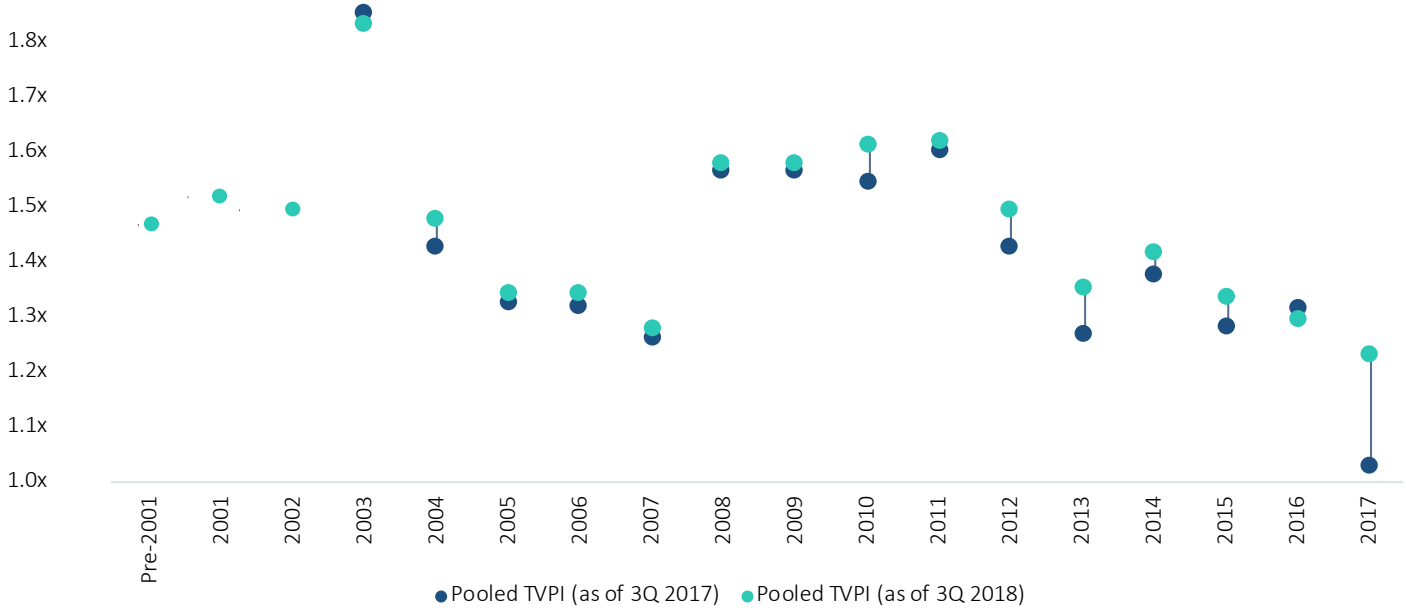
Secondaries one-year change in TVPI by vintage



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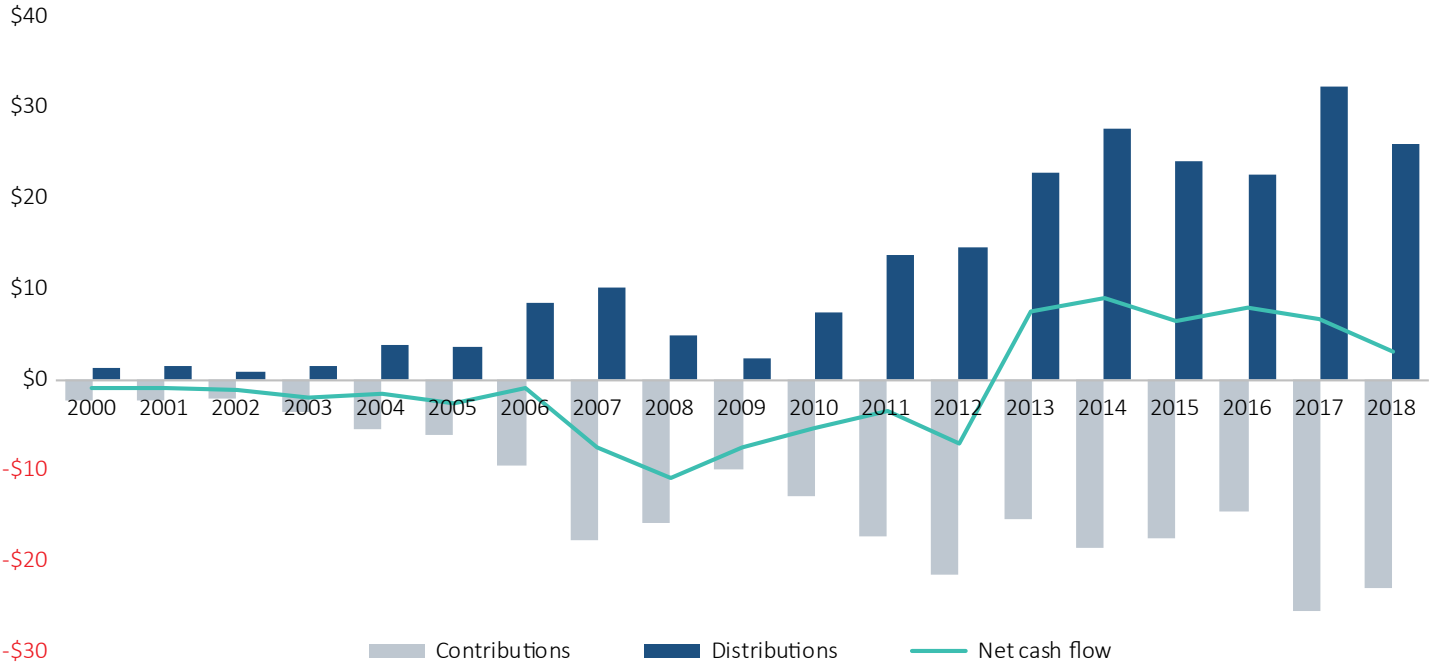
Secondaries cash flows ($B)



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Spotlight: Direct Alpha

This case study, written by James Gelfer, senior strategist, originally appeared in PitchBook Benchmarks, which provide the most comprehensive, transparent and accurate way to assess the performance of private market investment strategies.

Key takeaways

- While IRR is susceptible to manipulation, Direct Alpha is more resistant to exploitation due to the external factor of a public market index. As such, we think it provides a better way to gauge the annualized returns of private market funds with the added benefit of accounting for the macro environment in which the fund is operating.

- PE funds of the early 2000s significantly outperformed the S&P 500, based on the Direct Alpha metric. Performance suffered for vintages in the mid-to-late 2000s but has been positive for each PE vintage since 2011; however, the recent outperformance is a fraction of what it has been in the past.

- We find that the distribution of Direct Alpha has been fairly static over the last decade, with the only notable exception occurring in the top-decile hurdle of Direct Alpha values, which is above 15% for recent vintages after being in the single digits for many crisis-era vintages. When considered in conjunction with the rising pooled Direct Alpha figures, this suggests that the uptick in aggregate alpha is largely being driven by improved performance from the top tier of funds.

Overview

In previous editions of PitchBook Benchmarks, we cast doubt on many of the generally accepted methods for measuring private market fund performance: cash multiples fail to account for the time value of money; simple annualized returns do not consider the erratic timing of cash flows; and the most common gauge of private market performance, IRR, is prone to manipulation and plagued by a plethora of other shortcomings.

For decades, academics and industry professionals have sought a better formula to holistically evaluate performance, leading to the development of public market equivalent (PME) metrics. The first iterations of PME were relatively complex, involving the creation of a hypothetical vehicle based on a fund's cash flows, and they produced unusable results when performance of the private market fund was particularly strong or weak. Improvements were made on the margin to make PME compute in all scenarios, but the calculations remained arcane and generally have been used only by academics.

The thinking around PMEs changed with the introduction of KS-PME. Developed by Steven Kaplan—a board member of Morningstar, PitchBook's parent company—and Antoinette Schoar, KS-PME is a simple cash multiple metric calculated by discounting private capital fund's cash flows by the returns of a reference public equity index, rather than creating a hypothetical PME vehicle against which to compare performance. But while KS-PME is simple and accounts for activity in public markets, it suffers from the same drawback as traditional cash multiples in that the length of the investment period is not considered.

This issue was not insurmountable, however. Subsequent research applied the basic IRR calculation to the adjusted cash flows of the KS-PME to produce a new metric, "Direct Alpha," that shows "the precise rate of excess return between the cash flows of illiquid assets and the time series of returns of a reference benchmark." At its most basic level, "one can think of Direct Alpha as an annualized KS-PME taking into account both the performance of the reference benchmark and the precise times at which capital is actually employed." Not only does this account for the opportunity cost of investing in a private market fund, it also captures the impact of investment period length.

Performance panacea?

Like PME calculations, Direct Alpha does not tell an investor anything about the absolute return of the fund, but rather how it performed relative to the index. Theoretically, this means that a private market fund could produce strong returns on an absolute basis but still have a negative Direct Alpha if the reference index produced superior returns over the period. Conversely, Direct Alpha may be positive when the private market fund has negative absolute returns.

As we detailed last quarter, IRR is fraught with issues, including its susceptibility to manipulation. While we did not find evidence of widescale distortion of IRRs, devious practices certainly have the potential to skew the IRR of individual funds. Direct Alpha is not a silver bullet, but it does have characteristics that make it more difficult to manipulate. Traditional IRR is prone to chicanery because cash flow timing is germane to the calculation, and the relationship is straightforward (i.e. shorter investment timeframe equates to higher IRR). Accordingly, if a GP knows it can delay calling capital or expedite distributions (which can be easily achieved with capital call loans), this will certainly have a favorable impact on IRR. The influence of additional variables and external factors does not need to be considered.

While the specific timing of cash flows is also of paramount importance for Direct Alpha, GPs trying to game Direct Alpha will have a greater challenge due to the external factor of a public market index. Direct Alpha will be higher if the private market fund is calling capital during times in which the index is relatively high and distributing while it is low, which is difficult to predict. As a result, artificially manipulating the cash flows could have unexpected consequences on Direct Alpha.

Take, for example, a GP that uses a subscription credit line to delay a capital call to LPs for 90 days. Without knowing the specifics of the fund, we can be certain this will lead to a relatively higher IRR and lower TVPI than if a subscription line was not used because: (i) capital calls from LPs will occur at a later date than they would otherwise, meaning that capital will be invested for a shorter period; and (ii) interest accrued on the subscription line will be charged to the fund, resulting in lower cash-on-cash returns (i.e. TVPI). The impact on the Direct Alpha calculation, however, is less clear.

The accompanying tables and charts provide a simple, illustrative example of how market movements can affect Direct Alpha. In the base case scenario, the GP acquires a company for $100 million and exits after three years at $150 million (ignoring leverage, fees, etc.). Under scenario 1, the same investment is considered but with the GP delaying the initial capital call by 90 days, during which the public market index depreciates by 5%. As can be seen, this has a deleterious effect on the Direct Alpha calculation because the contribution amount is adjusted for a lower public index value, which is tantamount to buying the public index at a discounted level (i.e. if the public index is purchased at a discount, it is accretive to the public equity side of the equation, translating to lower relative performance and Direct Alpha for the private market fund). The inverse is also true; if the index were to appreciate during the delay in the capital call, it would prove accretive to Direct Alpha because the private market cash flows will be adjusted for a period in which the public equity index was at a premium.

Delaying capital calls has unpredictable effects on Direct Alpha

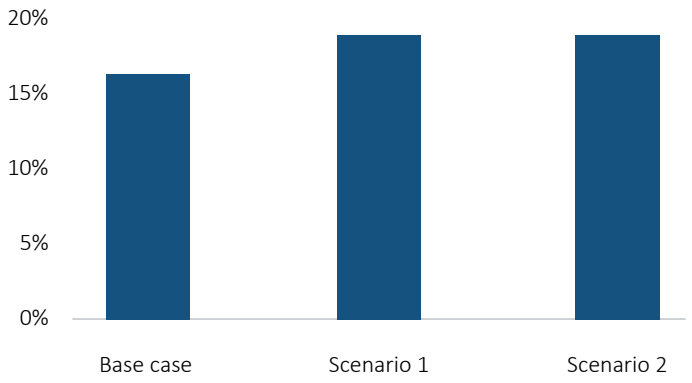
Base case: Company acquired for $100M and sold in three years for $150M

Hypothetical scenario 1: Initial capital call delayed by 90 days, during which the reference public market index **decreases 5%**

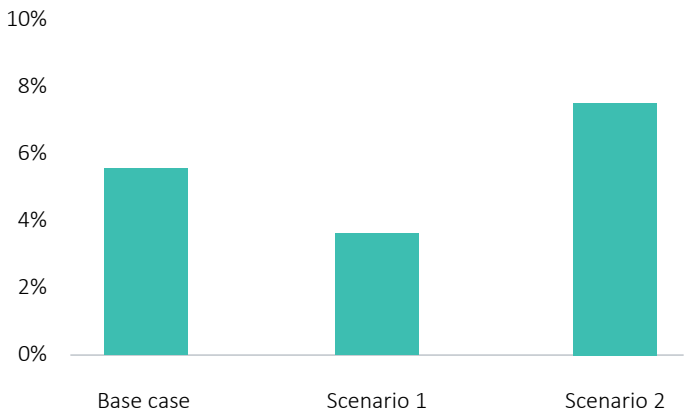
Hypothetical scenario 2: Initial capital call delayed by 90 days, during which the reference public market index **increases 5%**

Note: Each scenario assumes that the reference public market index rises to the same level in the final period

IRR



Direct Alpha



Source: PitchBook | For illustrative purposes only

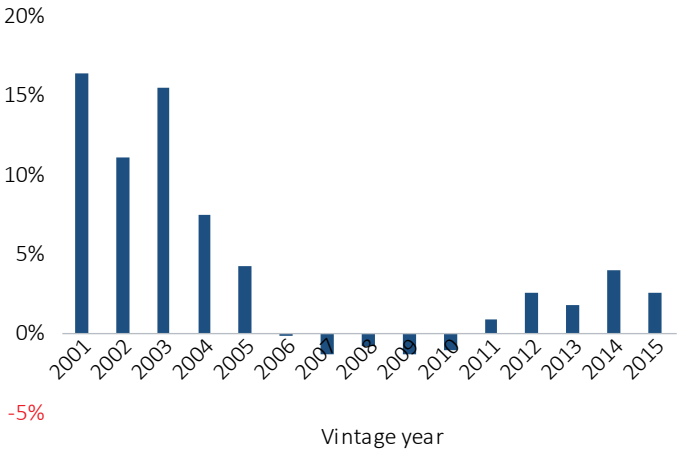
Alpha on the rise?

Absolute returns of PE funds have rebounded strongly since the global financial crisis (GFC), but a persistent question is how much of these returns can be explained by public market tailwinds. In prior research, we analyzed KS-PME values across more than two decades of private market fund performance and found a substantial downturn in the level of outperformance for recent vintages, suggesting that manager skill (i.e. alpha) is playing a smaller role in return creation. But this does not tell the whole story, since value creation takes time and KS-PME does not account for how long capital was put to work. Since an IRR calculation is embedded in the methodology, Direct Alpha is a useful tool to account for the time value and to fill in the gaps.

For vintages in the early 2000s, PE funds in aggregate generated Direct Alpha values ranging from 7.5% to 16.4%. This outperformance began a downward trajectory in 2003, however, and crossed over into negative territory in 2006—a vintage that comprises funds investing at the peak of the pre-crisis bubble. The pooled Direct Alpha figure continues to languish in negative territory for the next several vintages. While pooled Direct Alpha has been positive for vintages since 2011, the level of outperformance is less than half what it was at the turn of the century.

Alpha is on the rise for newer vintages, but continues to lag historically

PE inception to date Direct Alpha by vintage year

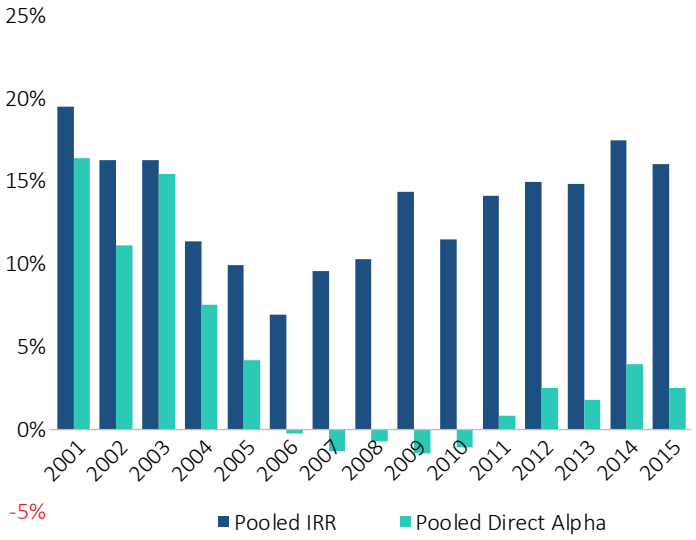


Source: PitchBook | **Geography:** Global
*As of September 30, 2018

To better understand why relative performance has evolved in this manner, we compared absolute returns for private and public markets by juxtaposing pooled IRRs by vintage with the annualized total return of the S&P 500 from the beginning of the designated year. As can be seen, public equity and PE returns have been highly correlated over time, which our prior research has also shown. In the early 2000s, the superior Direct Alpha figures produced by PE funds is due to a combination of below-average returns from public equities and above-average gains generated by PE funds.

Pooled IRR and Direct Alpha can vary widely ...

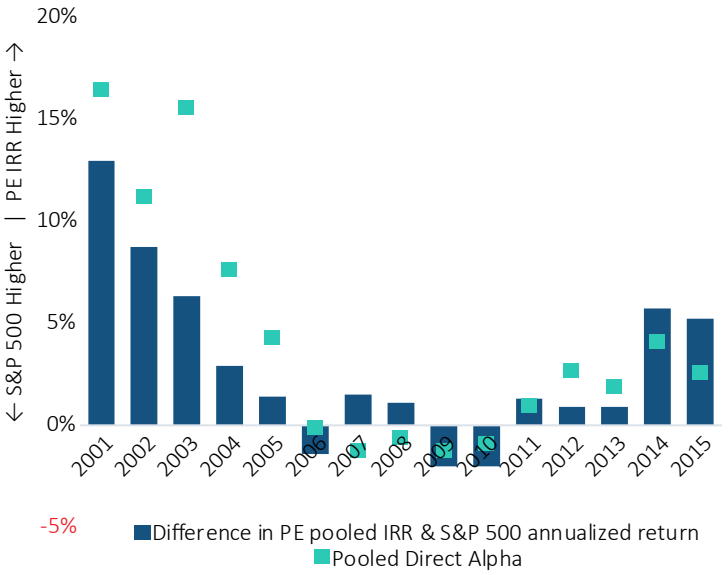
Inception to date performance by vintage year



Source: PitchBook | **Geography:** Global
*As of September 30, 2018

... based on the performance of public markets

Inception to date performance by vintage year/start of CAGR



Source: PitchBook | **Geography:** Global
*As of September 30, 2018

The period of most challenging relative performance in and around the GFC coincides with some of the lowest points of absolute performance in both public and private markets.

The evolution of performance most recently warrants a closer look. While public equity markets continue to climb, they have lost some steam after nearly a decade, and the annualized total return of the S&P 500 has been slipping when the calculation begins in more recent years. At the same time, newer PE vintages are posting the strongest absolute returns since the early 2000s on an IRR basis. These trends have combined to push Direct Alpha positive for vintages since 2011, but the outperformance is a fraction of what it was in the past.

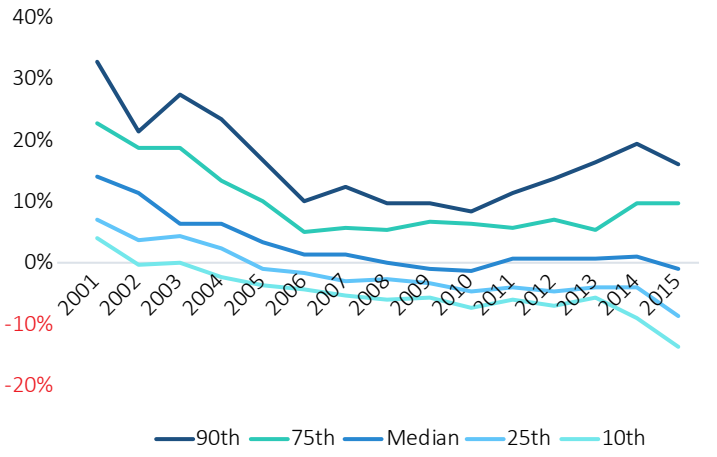
Digging beyond the headline figures, we find that the distribution of Direct Alpha has been fairly static over the last decade, with the median stagnating around 0% and the lower bounds also barely budging. Even the top-quartile rate has been relatively unchanged. The only notable exception is in the top-decile hurdle of Direct Alpha values, which is above 15% for recent vintages after being in the single digits for many crisis-era vintages. When considered in conjunction with the rising pooled Direct Alpha figures cited previously, this suggests that the uptick in aggregate alpha is largely driven by improved performance from the top tier of funds.

It is worth noting here that, like all metrics, Direct Alpha provides the most value when evaluating a fully liquidated fund. Similar to other metrics, the calculation assumes that any remaining value in the fund can be treated as an immediate distribution, which can have outsized effect on the output because distributions are such a critical component of the calculation. This is particularly pertinent in the newer vintages that are showing better relative performance, as these vehicles are often holding two-thirds to three-quarters of their value in unrealized gains.

Additionally, while Direct Alpha addresses many of the shortcomings of other metrics, it does not account for illiquidity or leverage. Still, Direct Alpha is a useful tool for assessing performance of private markets, particularly for an analysis of individual funds, as well as comparing performance to other alternative investment strategies, namely hedge funds.

Direct Alpha is improving for the top tier of funds in newer vintages

PE Direct Alpha percentiles by vintage



Source: PitchBook | **Geography:** Global
*As of September 30, 2018

Alpha is harder to find

Alpha is a familiar concept in hedge fund investing, where it can be precisely measured by decomposing returns and attributing performance to specific factors. As investors have developed a penchant for passive strategies over the last decade, hedge funds have come under fire for failing to deliver alpha. Top-performing hedge funds certainly continue to beat the broader market, with most of the criticism coming through the lens of aggregate hedge fund performance. Perhaps the most high-profile example is the decade-long wager between Warren Buffet and Protégé Partners, with the Oracle of Omaha betting that a plain vanilla index fund would outperform a basket of hedge funds. With the wager initiated in 2007, the equity index returned an annually compounded 7.1%, compared to a paltry 2.2% for the hedge funds.

Admittedly, the last decade experienced one of the longest bull runs in history (the initial market crash notwithstanding), and as such, it has been a particularly favorable environment for equity-oriented portfolios. Despite this headwind, many investors believe the recent inability for hedge funds to produce alpha en masse is a categorical shift that will persist. The common rationale for the relative performance struggles of hedge funds mirrors recent critiques of actively managed strategies: new tools and an influx of managers have evaporated arbitrage opportunities; a deluge of data has minimized information asymmetries; and fewer publicly traded companies has limited scalable investment options.

As the merit of active public market strategies has been called into question, PE investors have claimed they can produce alpha that is irreplaceable in public markets. One reason commonly asserted is that private market managers wield a high degree of influence and control that allows them to dictate the course of a business. Another purported driver of alpha in private markets is the idiosyncratic nature of the underlying investments; while investors have a multitude of options for accessing asset classes such as public equities, fixed income, currencies and other liquid securities, a private company is inherently unique. But these seeming advantages have been called into question, as the return profiles of some private market strategies have been replicated through relatively basic levered public equity strategies.

Deconstructing returns and conducting performance attribution is fairly straightforward for many hedge funds, which tend to invest in relatively liquid securities that enable returns to be deconstructed on a granular level. While the term “alpha” is often used colloquially in private markets to discuss manager skill or a general ability to “outperform,” it tends to not be quantified, which is one reason why Direct Alpha is valuable.