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Michael B. Imerman, Editor



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Michael B. Imerman, Editor

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Michael B. Imerman: You have made the point that private markets benefit from valuation practices that suppress volatility—what is referred to as "volatility laundering." From a risk-management standpoint, why is suppressed volatility potentially more dangerous than explicitly recognized drawdowns?

Cliff Asness: Volatility laundering is what allows many investors to use private equity to increase their overall equity exposure while sidestepping the occasional short-term excruciating pain that comes with public markets.

Granted, it's *possible* that some of these investors have coincidentally increased their actual capacity to bear market risk, and if so, fine. But that's rarely what's going on. More often, investors' move into privates rests on a convenient belief: that private equity is meaningfully lower-volatility than public equity.

Understating risk is not a free lunch; it's a tail event waiting to happen. To be clear, this risk won't emerge in every equity market drawdown. Private equity's volatility laundering tends to work out fine in short selloffs like the kinds we've mostly experienced over the past decade (or even in a sudden crash like early 2020). In those cases, PE can rely on its patented ostrich technique of waiting it out.

But say we get an ugly 5- to 10-year bear market, something that's unlikely but hardly unprecedented, and certainly within the realm of possibility. (And if risk management isn't about preparing for low-probability, high-severity, long-horizon wealth destruction, what is it for?) In this scenario, comforting assumptions about high-single-digit volatility and low correlations for a (usually) leveraged equity portfolio will not come to investors' rescue. Rather, they're likely to see losses beyond what their stress tests prepared them for, potentially making them forced sellers at exactly the wrong time. This is a big risk for most investors—and it's abetted by volatility laundering.

Most generally, not reporting market fluctuations doesn't reduce risk—it just masks it.

Imerman: Some allocators argue that smoother return streams reduce behavioral errors and improve long-term discipline. Do you see any credible risk-management justification for that view?

Asness: I think most investors recognize they can take on more risk if they don't have to look at it every day. And, yes, infrequently and inaccurately (understating price movements) priced investments are certainly one way to make sticking with something a little easier.

But this raises a question. Once you explicitly acknowledge "We know prices move, but it helps not to see them," shouldn't this behavioral trick stop working? Once you say out loud, "We know the prices move, but it's useful to fool ourselves," doesn't the fooling yourself part stop working? Apparently not!

You asked about risk-management justification. I think this behavioral "trick" goes in the opposite direction. If people are allocating to a risky asset with a conveniently smoothed return stream with their eyes wide shut, then they aren't managing portfolio risk, they're probably increasing it without admitting it.

Imerman: If private equity portfolios were marked to market daily, how do you think historical drawdowns would compare with what investors experienced during crisis periods such as 2008–2009 or 2020?

Asness: During the GFC the maximum drawdown of PE indices was about –28% versus small-cap value stocks (unlevered!) of about –55%. Does anyone actually think this reflects private companies' actual comparative performance if one accurately marked them to market?

If private equity portfolios were marked daily and marked accurately, I'd expect drawdowns at least as severe as public equities—particularly for diversified private portfolios where idiosyncratic effects stemming from a few companies is less of a factor.

If anything, given the leverage typical in private equity, one could rationally expect the average PE fund to look even worse than public equities in crisis periods. Though I'm just speculating here.

Imerman: A common justification for private market allocations is diversification. How reliable are correlation estimates when return series are smoothed by construction? What are some ways that evidence-based research could potentially remedy this?

Asness: I've been arguing about falsely-low correlations for almost three decades, starting in fact with my hedge fund brethren, where the culprit was also illiquidity (though private equity says "hold my beer" to hedge funds over illiquidity). In an old article, "Do Hedge Funds Hedge?," my coauthors and I showed that most hedge fund categories' equity betas were understated by standard "regression" techniques as they owned some less-liquid securities that didn't always trade (Asness et al. 2001). When you calculate hedge fund betas using not only the current month's equity return but also a few lagged months, the measured betas go up—particularly for strategies that tend to hold relatively illiquid securities. This is not happening because prior months actually matter but because a fall last month only partially showed up that month in the hedge fund, but eventually does manifest.

The same analysis can be done for private assets, and the effect is generally stronger, often pushing correlations very close to 1. Many researchers have come up with sophisticated ways to unsmooth private asset returns, but even simple methods of adding lagged market terms (or using two- or three-year holding periods instead of quarters) get you a lot of the way there.

Imerman: Should institutional investors be explicitly stress testing private market allocations for correlation convergence during downturns?

Asness: Yes. Very, very explicitly.

Imerman: What type of a systemic event could you envision impacting private equity or private credit? How should allocators prepare their portfolios for these types of events?

Asness: I think the most obvious and least avoidable event is a bear market that's long enough and/or deep enough that private assets are unable to keep playing make-believe with prices. An environment that causes pain for public equity or credit for several years is likely to do the same for their private equivalents.

What I think won't work in terms of preparing for such a scenario is hedging strategies, such as "black swan" type funds. Options-based hedging strategies often seem intuitively appealing but don't hold up to scrutiny empirically or theoretically—and practically, there are real challenges getting an investment committee to hold on to an investment that can lose money quite consistently for long stretches of time.

So what might help? In general, diversification (real diversification, not fake illiquidity-driven reported diversification) should be an allocator's friend here, be it having more globally diversified exposures, more risk-balanced asset class exposures,

or holding truly diversifying alternatives (e.g., market-neutral equities). Even though diversification isn't a hedge—it won't automatically save you from every equity drawdown—over longer periods it can really help.

In particular, something AQR has written about in the past is among alternatives (ones that are actually diversifying), trend-following tends to have the most theory and evidence to support its efficacy for these "doom scenarios." Not only has trend shown evidence of long-term positive returns (we've tested these strategies using over 100 asset classes and with some tests going back for more than a century), but it's tended to do particularly well in the types of environments you'd expect to be most damaging to private allocations: protracted equity market declines. Of course, this makes sense, as mechanically these strategies would tend to position themselves short in such episodes.

Imerman: You have extended your critique to private credit, suggesting it is often "high-fee public credit." What risk characteristics do allocators most frequently misunderstand in private credit strategies?

Asness: Default rates in private credit often appear reassuringly low. This is not due to superior underwriting. To a large extent it's a reflection of how defaults in private credit are defined and delayed.

Private credit's payment-in-kind (PIK) features, "amend and extend" transactions, and other loan modifications mean reported default rates are not comparable to those in public credit markets, where covenant breaches, rating downgrades, and market prices force risk to be recognized. Instead, private credit allows interest to be capitalized, maturities extended, covenants loosened, or terms reset. On paper, the loan remains "performing." Economically, not so much—the lender gets to avoid a default today in exchange for a larger claim on a weaker borrower tomorrow.

Low observed default rates in private credit should be taken with a giant grain of salt. As with many things in private markets, the risk isn't always reduced—it's often just hidden from your quarterly statement. For investors, defaults may look low for a long time, followed by losses that look surprisingly high when they finally arrive. For instance, data we've looked at shows that private middle-market loans experienced more credit losses than high-yield bonds during the GFC (though private credit has really exploded in popularity in the last few years, so future experience might be different—we don't find that at all comforting!). That seems to me a reasonable base case for performance in the next crisis.

I should note, and this applies to private equity too, that nothing I'm discussing means there aren't great private investments and private investors out there. But the comparison should be apples to apples, and it's so often not.

Imerman: Once risk is properly measured, do you believe the traditional fee premium in private markets is economically justified?

Asness: Skillful managers definitely exist, even if it's hard to measure what part of private market "alpha" stems from manager skill versus accounting effects—this may be a reason fees have remained so high for so long. But today's private asset environment is very different from that of a decade ago. Large inflows and new entrants have made the space more competitive, and the reported performance advantage of privates seems to have weakened, and in some cases gone negative, once the cost of leverage rose significantly in 2022. These days, given the typical private manager's fees, we believe it's unlikely most clients are getting true alpha relative to a properly measured equity benchmark. (yes, including the "but I only invest in top-quartile managers" people! Please note, there are few asset classes that aren't attractive if you can consistently pick top-quartile managers).

Another headwind for justifying private asset fees today is what's conventionally called the illiquidity premium. Illiquidity used to be considered a "bug," which investors had to be compensated for bearing. In fact, this has historically been most of the justification for believing you get premium returns in private assets. This extra return is coming rationally (rationally, you have to be paid to bear with a bug like illiquidity).

But what we're seeing more and more is that illiquidity, pricing opacity, and volatility laundering have become a *feature*, not a bug. It's all flipped on its head. Institutions originally got paid extra for bearing the bug of illiquidity, and yet now it's entirely possible they are getting paid less (negative alpha) for the privilege of enjoying the feature of illiquidity.

In other words, the attractive smoothness, as fake as we think it is, of returns is something you pay for. If illiquidity is now, unlike the past, more of a positive than a negative to most investors, it could easily mean paying a higher price and accepting a somewhat lower return to obtain it. This further reduces the odds that the traditional fee premium is justified today.

Imerman: Should allocators be explicitly "unsmoothing" private asset returns when integrating them into total-portfolio risk models?

Asness: Yes, there's no perfect way, but when we work with investors, we tend to model risk as comparable to public equity risk, often a little higher to account for embedded leverage and small-cap tilts.

Imerman: In your long-term thought experiment, private markets fail to meet elevated expectations. What structural forces lead you to that conclusion?

Asness: I think three of the most likely ones today are (1) the illiquidity premium having changed to an illiquidity discount, (2) too much money chasing the same deals, and (3) cost of leverage these days versus a decade ago.

Imerman: Finally, for allocators who believe private markets have a role to play, what does a genuinely risk-managed approach to private markets investing look like in practice?

Asness: I should be clear here, that while I've become a private asset gadfly, I do believe private assets have a role to play in markets and in some investor portfolios (though private assets going after 401(k) and retail is a discussion for another day …).

If an allocator holds private assets, at minimum they should separately consider those assets' "fast beta" and "slow beta." The fast beta is the conventionally reported and economically understated measure; the slow beta uses longer horizon estimates to be a more risk-aware measure and tells you about the significant risks of a persistent bear market. In case you want to know if you're measuring it correctly, the slow beta should usually be at least 1.0.

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