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The Truth About Private Equity Performance

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Summary. Private equity fund performance is most often reported in a way that exaggerates the truth. A modified calculation gives a more accurate read of performance and can change a fund's relative rank. **close**

Rising credit costs have already taken the bloom off private equity's rose, but some funds (and some investors) are due for another shock. Our research shows that the way PE fund performance is most often reported overstates the truth.

Here's the problem: Private equity returns are often reported as the internal rate of return (IRR)—the annual yield on an investment—of the underlying cash flows. This implicitly assumes that cash proceeds have been reinvested at the IRR over the entire investment period—that if, for example, a PE fund reports a 50% IRR and has returned cash early in its life, the cash was put to work again at a 50% annual return. In reality, investors are unlikely to find such an investment opportunity every time cash is distributed.

Finance 101 teaches us a simple solution to this problem: the so-called modified IRR (M-IRR). This measure is similar to the regular IRR, but rather than assuming reinvestments at the IRR, it specifies a fixed rate of return for investing and borrowing. We looked at this measure in a study of 1,184 private equity funds raised from 1980 to 1995, considering all investments and corresponding cash flows through 2004. The highest IRR in our sample was an impressive 464% per year; when we applied the M-IRR measure to that fund and specified 12% per annum for borrowing and investing, we got an M-IRR of 31%: a far cry from 464%, and certainly a better representation of the fund's true return.

Doing the same for all funds in our sample, we found that the top 25% as ranked by IRR had an average net-of-fees IRR of 35.32%. However, the top 25% as ranked by M-IRR (assuming borrowing and investing at 12%) had an average M-IRR of only 18.56%—much more in line with other investment opportunities.

In addition to skewing the apparent performance of "star" funds, IRR calculations can mislead investors who are trying to compare the returns of different fund managers. We ranked the funds in our sample according to IRR and M-IRR and found immediately that the top two according to M-IRR don't even appear in the list of the top 10 according to IRR. As the table shows, the top 10 IRR funds in our sample shift dramatically when ranked by M-IRR. What's more, the astronomical returns suggested by IRR calculations plummet to earth when an M-IRR calculation is applied.

Radical Shift

Top 10 private equity performers

Fund	Fund IRR %	Fund rank	Fund M-IRR %	Fund rank
A	464	1	31	9
B	313	2	42	4
C	248	3	30	10
D	244	4	41	6
E	190	5	43	3
F	166	6	41	5
G	155	7	33	8
H	153	8	28	15
I	147	9	23	21
J	143	10	29	13

The returns and relative rankings of the top 10 private equity performers (among 1,184 funds studied) change ...

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Overstated private equity performance may partially explain why investors continue to allocate substantial capital to this asset class, despite our finding (forthcoming in the *Review of Financial Studies*) that PE funds have historically underperformed broad public market indexes by about 3% per year on average.

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