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THE INVESTMENT INDUSTRY has discovered a new frontier: your clients. Private equity (PE), once exclusive to sovereign wealth funds, pension funds, and endowments, is now being packaged for retail consumption. Advisors are told this is the "democratization" of alternatives. Democratization of alternatives sounds like a noble cause. Why shouldn't every investor have access to the wealth-creating machinery of private equity?

But access is not empowerment. Giving individual investors exposure to a high-fee, opaque, conflict-ridden asset class—marketed using gameable metrics and de facto fictional track records—is not governance for the people. It's governance at their expense. As I've warned before: You can't call it democratization if the system is designed to benefit the insiders while leaving the public exposed to risks that they may not understand.

People cannot be prevented from investing in PE, especially because they are allowed to invest in some extremely dubious things (yes, crypto, I'm looking at you). But the same protective rules that govern other financial products must apply here. You cannot have thousands of pages of regulation when individuals buy mutual funds and suddenly a Wild West when it comes to private equity. Advisors will play a critical role in mediating their clients' interactions with private market strategies. Here are some of the things they might stay alert to.

YOU CANNOT HAVE THOUSANDS OF PAGES OF REGULATION WHEN INDIVIDUALS BUY MUTUAL FUNDS AND SUDDENLY A WILD WEST WHEN IT COMES TO PRIVATE EQUITY.

The Siren Song of Returns

A decade ago, Steven Davidoff Solomon, a corporate law professor at University of California, Berkeley, published in the *New York Times* an article entitled: "Private Equity Fees Are Sky-High, Yes, but Look at Those Returns."[1] This was back when some people were begging for democratization. This article was a clear and typical plea. The message was simple. Retail investors were understandably eager to invest in private equity funds given the incredible money they were generating:

> *Critics love to complain about private equity and its exorbitant fees. But imagine if retail investors–people like you and me–were suddenly allowed to invest in the funds managed by private equity giants … If all the barriers and regulations came down, you could probably guess what would happen. Hordes would flood the offices of these firms, racing to invest … The reason is obvious. As an asset class and with the right fund, private equity is nigh unbeatable, well worth the fees paid … Over the last 20 years, Yale has had a 36.1 percent return from its private equity portfolio. … Super achievers in the top quartile include Kohlberg Kravis [sic], which has had a 26 percent net return for its long-term funds since inception in 1976, and Apollo, with a 25 percent net return since inception.*

During such a long timeframe, these performance statistics are truly remarkable and obviously exciting to retail investors. In fact, the returns are so high that they surpass Warren Buffett's track record by a wide margin over any of these timeframes.

Even more remarkable, these return figures have remained the same a decade on. In its latest form 10-K filing,[2] KKR said:

> *From our inception in 1976 through December 31, 2024, our Private Equity and Real Assets investment funds with at least 24 months of investment activity generated a cumulative gross IRR of 25.5%, compared to the 12.2% and 9.5% gross IRR achieved by the S&P 500 Index and MSCI World Index, respectively, over the same period, despite the cyclical and sometimes challenging environments in which we have operated.*[3]

Similarly, Apollo asserts in its form 10-K about the 39-percent gross internal rate of return (IRR) (or 24-percent net) generated by its private equity funds from inception through the end of 2024.[4]

Apparently, these private equity firms have managed to defy the laws of mathematics, economics, and reality.

Because most people typically don't have a good grasp of compounding, it might be helpful to express these numbers in dollars to show how fantastical they really are.

If KKR's first $31-million fund from 1976 had compounded at 26 percent a year it would be worth $2.6 trillion today. Add in its second fund ($350 million) and you get $13 trillion—more than the global PE market.

Apollo's first fund would now be worth $74 trillion, just shy of global gross domestic product (GDP). And Yale's endowment? At a 36-percent annual net return since 1990, its PE portfolio alone would be worth $5 trillion (the whole endowment is worth $41 billion).

What's going on? The widespread abuse of IRR, the private equity industry's favorite but most hopelessly flawed measure of returns.

IRR is a powerful tool, but it's not a rate of return. It is a mathematical artifact. It assumes every dollar distributed is reinvested at the same rate it was earned. It's not realistic, not additive, not comparable to market indexes—and not designed to be used the way the industry uses it. IRR's most bizarre feature is that it becomes fixed early and barely changes after that. That's because of how it is calculated (see sidebar).

This IRR stickiness is fertile ground for gaming. Fund managers know how to juice it. It's not fraud—it's strategy. But the consequences are real, because people often are presented these numbers as actual rates of return and frequently believe them. This distorts investment decisions.

For example, the fact that IRR is influenced by early distributions makes it possible for fund managers to manipulate the metric strategically by quickly exiting successful investments and retaining less profitable ones. They also can borrow to make their first investments rather than calling capital from investors (using subscription credit lines).

Even without manipulation, IRR tends to be inflated because of the survivorship factor. Firms that survived had good early exits (otherwise they wouldn't have been able to raise follow-up funds) and a high IRR is then set in stone. As a result, almost every firm that's been around long enough claims a 20–30 percent return. The IRR is the cornerstone of private market marketing and the Achilles' heel of investor understanding.

HOW IRR MISLEADS—AN EXAMPLE

Let's say you invest $30 million in 1976, get back $100 million in 1980, and then in 2024 the remaining assets in the fund are worth $100 million. The annualized rate of return is defined as what you have at the end (2024) over what you started with (1976). But what you have at the end depends on what you did with the $100 million you received in 1980.

You earned a return on it that we do not know, and thus label x. So, you have:

(100+100(1+x)^44).

You had invested $30 million, and so your annualized rate of return is:

y=((100+100(1+x)^44)/30)^(1/48)–1.

But this is an equation with two unknowns, which is a bit of an issue. We don't have a unique solution to this. And so, someone thought: "What if we set x=y? Then we have only one unknown and we're good to go!" And this is IRR—it assumes that future positive cash flows can be invested at the same rate of return. This is a simple mathematical hack that has become the dominant performance metric for a huge part of the global investment industry.

The mathematics mean that early cash flows dominate the calculation. You can invest for 40 years, make or lose billions—and your since-inception IRR still will reflect that nice exit in 1980 or whenever.

In this example, the IRR is 35.1 percent. If today the investment would be worth $1 billion instead of $100 million, the IRR would still be 35.1 percent. Make it $10 billion and it's still 35.1 percent. How about $100 billion? Well now it goes up to 35.2 percent! IRR is the most stubborn number in finance.

Why? Because if you treat IRR as a real return number, the $100 million of 1980 is supposed to be worth ... $56 trillion. So, nothing that can happen today will change the overall return. You could bankrupt hundreds of billions of dollars' worth of investments in the meantime, but it wouldn't matter to you, because your reinvested 1980 dividend is worth $56 trillion, circa half of global GDP.

Multiple on invested capital (MOIC), the second most popular metric, is marginally better. MOIC also is vulnerable to manipulation, in this case by recycling capital. Without clear standards on what counts toward MOIC, the number becomes just another figure on a slide with limited bearing on investor outcomes.

The NAV Trap and Legal Risk

Another commonly misunderstood, yet critically important, metric in private markets is the net asset value (NAV). In the traditional private equity model (closed-end funds with a quasi-fixed 10-year life) NAV was largely irrelevant, basically a placeholder. Investors committed capital, the general partner (GP) invested it, and everyone waited a decade to see what came back. No redemptions, no pricing based on NAV. Whether the GP said the portfolio was worth $100 million or $1 billion halfway through didn't matter much; it was all "paper money" until the exits happened.

That is no longer the case.

Today's semiliquid products (interval funds, tender-offer vehicles, evergreen structures) are built on NAV. Every single subscription and redemption is done with NAV. It is the heartbeat of these products. Only some NAVs are audited, and even when they are audited, the GP hires and pays the auditor.

The consequences of this setup are profound. If redeeming investors exit at an inflated NAV, they receive more than they should and the remaining investors bear the loss. If the NAV is understated, the exiting investors can claim they were shortchanged. In both cases, litigation is not just possible, it's probable.

Worse, NAVs often can be objectively challenged. There is now an active secondary market for private fund interests. The discounts

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seen in that market are real-world signals of what investors are willing to pay—not theoretical third-party marks or GP fantasies. If the secondary market prices some assets at 30–40 percent discounts, any lawyer can easily bring this as hard evidence to court.

Take venture capital (VC) funds today. These funds were marked up significantly during the tech euphoria of 2021–2022, when everything with the word "cloud," "platform," or "AI" received nose-bleed valuations. Then the world changed. Interest rates rose, liquidity dried up, and exit markets cooled. Yet many VC NAVs have not budged. If a semiliquid product has a lot of VC funds, new investors are buying into 2021-era valuations in a 2025 world. That's a lawsuit waiting to happen.

Or look at commercial real estate. Office buildings in major cities have declined in value since 2020. Transaction volumes are down, cap rates have moved, refinancing is harder. Yet many real estate portfolios continue to show NAVs that pretend none of this happened. If these NAVs are used for redemptions, early redeemers win, latecomers lose, and the lawyers sharpen their pencils.

In a highly litigious market such as the United States, this is not a theoretical concern. It is an inevitability. The question is not if lawsuits will emerge, but when and who gets sued first.

In short, we have taken an asset class known for opacity, subjectivity, and illiquidity, and layered on redemption rights and pricing mechanisms based on unverifiable marks. And we wonder why that might blow up.

Advisors Must Be the First Line of Defense

Advisors are the gatekeepers. If retail investors are going to enter private markets, they must do so with their eyes wide open. Before recommending any private market product, advisors should insist on the following:

- Fully detailed cash flows (all, not selected) and the ability to compute total value to paid-in capital (purged from recycling) and net present value measures with appropriate benchmarks that can be used to soberly explain any track record wizardry to their clients.
- Full transparency around fee layers and other fund expenses, including performance, administration, and distribution, monitoring, and transaction fees. Show the impact (gross to net), a sort of total expense ratio.
- A clear explanation of redemption mechanics, including gating provisions.
- A disclosure of valuation methodology and audit arrangements, an explanation for secondary markets, and a defense of the NAV.
- An explicit statement of fiduciary duties, or lack of (most GPs waive their fiduciary duties in their limited partnership agreements; your clients ought to know if that is the case and what it implies).

The list could go on, but you get the gist. Without these guardrails, advisors are exposing clients to products they cannot properly assess and open themselves up to liability.

Conclusion: Real Democratization Requires Governance

The push to "retailize" private markets has gained tremendous momentum. But calling something democratization does not make it democratic. True democratization requires oversight, transparency, and accountability.

Right now, we are offering semiliquid, high-fee, low-transparency products to individual investors based on metrics that are misleading at best and manipulative at worst. That is not empowering the people. It is exposing them.

As private markets grow, the burden is on all of us—academics, advisors, regulators, and allocators—to raise the bar on education and investor guidance. If we fail to do so, the backlash will be swift. Because one thing is certain: When the lawsuits come, no IRR will be high enough to protect the players.

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ENDNOTES

1. S. D. Solomon, "Private Equity Fees Are Sky-High, Yes, but Look at Those Returns," *New York Times* (December 9 , 2015), https://www.nytimes.com/2015/12/09/business/dealbook/does-private-equity-earn-those-exorbitant-fees.html.
2. See https://www.sec.gov/ix?doc=/Archives/edgar/data/0001404912/000140491225000015/kkr-20241231.htm.
3. In his article, Solomon seems to have mixed up KKR's net and gross IRR, as well as the firm's name. See endnote 1.
4. See https://ir.apollo.com/sec-filings/content/0001858681-24-000031/apo-20231231.htm.

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