Fascinating Exchange Among PE Managers About Lying to Investors

- Published on June 22, 2020

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Two years ago I published a short article about how private equity investment managers can manipulate their preferred "performance" metric--internal rate of return (IRR)--to make themselves appear much more successful than they really are. The original article is no longer available, but you can still read a version of it at https://www.reit.com/news/blog/market-commentary/irr-easily-manipulated-performance-metric. I didn't actually accuse GPs of using manipulated IRRs to lie to investors, but the other day I saw a fascinating online exchange, among people who appear to be GPs, who sure do seem to be confirming that they regularly do exactly that: manipulate IRR to lie to investors.

Person 1 starts by summarizing my article. "The gist of it is that IRR calculations are heavily manipulated by PE funds to artificially inflate their performance and take more incentive bonuses. Even Yale had to retract their statement that their annual return from PE funds exceed 93% per annum because it is just not true. Obviously, the manipulation of IRR calculations are pretty robust and well hidden and complicated enough that most investors just say mmmm kay good enough. So, I went to our controller and asked about this whole thing…He looked at me blankly and said yeah so what do you want to know…Now I am not saying or implying that my fund utilizes such IRR calculation methods…just saying don't trust those numbers you see on online or even investor briefings…"

Person 2 responds, "yes, I'd assume most PE funds that are incentivized on those numbers game the numbers."

Person 3 chimes in, "Yeah, I do these calcs, and they are all BS. We flat out lie and make up new rules of math. It's complicated enough that micro-thinker Americans can't figure out the scam. But when presenting to East Asia people see thru the lies, they see the whole picture and are like 'yeah, this stinks, we do not believe.' Then the arguments start 'but that's crazy, look at our made up numbers, see the fictitious returns, you would be stupid not to invest!' This is part of what Eric Weinstein has pointed out, that ALL the numbers in America are lies, it's a giant Ponzi, and the moment they stop lying, the whole thing collapses."

Person 4: "Outright fraud is very rare (as in deliberately misstating figures). But IRR can be manipulated for sure. ... Another way to game the process is with credit facilities." (Note: the use of credit facilities was the explicit subject of my article.)

Person 3 again: "Back in subprime 2002 I went to mgmt, as a naive noob…'look at this trend, seems like this could get out of control fairly easily.' Was told to never answer the phone when the credit risk dept called, and never to share any of our risk analytics without mgmt approval. So yeah, they know they are lying. Never did that again."

Person 5: "Agreed as well… see tons of deals where the IRR's are essentially backed into by virtue of the structure of financing and building in when you want to pay for fees associated with the deals. Then, seeing as how your exit is the bulk of the IRR anyway, you justify a way not to take a hit on revaluation & hold onto it until the fund is winding down & the cash flows mean less anyway so your fund IRR is fine."

Person 6, who objects only to the idea that Asian investors see through it: "If you think US PE returns are manipulated (which I don't disagree with), I can't even imagine how bad they are for countries that lack serious controls (hint: China)."

Now back to Person 1: "This whole thing made me realize that back office ain't as far 'back' as I thought. This whole performance manipulation is fattened up and cooked up by the BO team which makes them a crucial asset in revenue generating activity."

Several years ago, at a panel discussion among three PE investment managers, I asked how important it is to lock in a high IRR early so it would stay high no matter how badly the investments performed over the remaining life of the fund. I didn't use the word "manipulate," and I didn't ask specifically about subscription lines, but I don't think any of the panelists misunderstood what my question was about. One of them looked at the other two, seemingly to make sure they wouldn't hang him out to dry, before answering "oh, it's absolutely crucial" as the other two nodded their agreement.

I'm very interested in this question: when are investors going to stop being fooled by GPs? And, when it's obvious to everybody that GPs have been lying, how are they going to explain their actions?