

Private Equity's Diversification Illusion: Economic Comovement and Fair Value Reporting*

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Abstract

This study examines how diversification claims and demand for private equity investments have been shaped by accounting practices. Despite research showing that private equity lacks economic diversification, demand for private equity investments has surged. I show that private equity returns based on prior fair value reporting standards understate the economic comovement with the market, creating a diversification illusion. As fair value has changed for private equity, I show increased market beta and increased correlations; furthermore, abnormal returns disappear after the adoption of redefined fair value. Private equity firms also encounter higher—not lower—costs when accessing capital, a finding at odds with public-market research.

JEL Classifications: G11, G12, G14, G15, G23, M41, M48

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1 Introduction

Academic researchers have noted an unusual paradox in (private equity)¹ investing: though demand for private equity investments has increased steadily since the early 1990s, reaching \$3 trillion under management by 2013 (Prequin, 2013), private equity provides inadequate diversification to portfolios.² I hypothesize that this paradox is due, at least in part, to financial reporting that provides an illusion of diversification. Meanwhile industry proponents assert that portfolio diversification is one of the primary benefits of private equity.

Prior to recent changes in fair value reporting, best practice in private equity financial reporting dictated conservative estimates of fair value. The illiquidity of private equity assets was invoked to legitimize the use of extreme discounts in reported valuations, a maneuver similar to a blockage factor discount.³ “Often there was no writedown unless a bankruptcy or down round [of equity financing] occurred” (Valuation Research Corporation, 2007).⁴ This mismatch between accounting and economics falsely inflated the diversification benefits of private equity by understating the comovement between private equity portfolios and the market, a diversification illusion.

David Swensen, chief investment officer of Yale University’s endowment, elaborates on the implications of using accounting information for risk assessment of illiquid private equity assets (Swensen, 2009):

Illiquidity masks the relationship between fundamental drivers of company values and change in market price, causing private equity’s diversifying power to appear artificially high. . . . Private compan[ies] gain spurious diversifying characteristics based solely on lack of co-movement with the more frequently valued public company.

Financial reporting by private equity firms changed with the advent of *International Accounting*

¹I classify private equity as buyout investments in mature companies. This does not include venture capital investments

²Most research notes that limited partner investors lose money or break even on a risk adjusted basis. Risk-adjusted returns are difficult to fully determine as commitment and illiquidity risk is high for these investments and difficult to include in analysis. An extensive literature documents risk-adjusted returns (see Axelson et al., 2013; Harris et al., 2012; Higson and Stucke, 2012; Kaplan and Schoar, 2005; Phalippou and Gottschalg, 2009; Phalippou and Zollo, 2005; Gottschalg et al., 2003; Axelson et al., 2010; Ljungqvist et al., 2008; Franzoni et al., 2012; Robinson and Sensoy, 2011; Korteweg and Nagel, 2013)

³A blockage factor discount is used in measuring the value of a security to reflect the impact of selling a large block of the security all at once to an illiquid market.

⁴see also Seery (2012) and Partners (2012)

Standard 39—Financial Instruments: Recognition and Measurement (IAS 39) effective in 2005⁵ and *Statement of Financial Accounting Standards No. 157—fair value Measurements* (FAS 157) went into effect in 2008.⁶ IAS 39 and FAS 157 provided a clearer definition of fair value that eliminated industry specific “best practice” accounting. Under prior accounting, fair value had an imprecise definition across industries amenable to various interpretations; new fair value standards explicitly define fair value in a way that assumes an orderly transaction between a willing buyer and a willing seller. The new standards also explicitly prohibit using similar blockage factor discounts in reporting fair value. While in other settings the change in fair value reporting would mechanically increase the comovement of Level 1 and Level 2 assets (both use market prices), in private equity firms only have Level 3 assets of which use unobserved inputs in valuation models. Moreover these private equity firms were reporting “fair value” to their investors in prior periods under industry best practices, making this setting not a shift to fair value but causing fair value to be redefined for an industry.

To explore whether the new accounting standards have modified diversification claims, this study exploits the adoption of IAS 39 in a difference-in-difference design to examine the impact of fair value accounting on (1) private equity market beta, excess returns, and quarterly correlations with equity markets, and (2) private equity firms access to capital. The tests focus on private equity firms reporting under International Accounting Standards for two reasons. First, the mandated U.S. adoption of FAS 157 by private firms occurred during the financial crisis, confounding the identification of empirical tests. Second, IAS 39 was implemented before FAS 157, and possibly and could have informed investors in both markets about previously unreported economic comovement.

Using a modified capital asset pricing model (CAPM), tests show that under IAS 39 the overall market beta shifted from 0.22 to 0.91. Moreover, the tests show that the beta increased 0.47 as a direct result of the new definitions of fair value under IAS 39. When the sample excludes the first year of implementation—a period characterized by accumulated unrecognized markups that would seem uncorrelated with public markets—excess returns for private equity firms adopting fair value disappear. This shift in systematic risk and investment alpha is consistent with the so-called private equity “Beta Puzzle” in private equity (Axelson et al., 2013).⁷ By examining private equity deal level

⁵The most relevant standard as of the date of this paper is *IFRS 13 Fair Value Measurement*. Prior to the introduction of *IFRS 13*, *IAS 39* was the standard that shifted best practices for private equity firms. In anticipation of the new international accounting standard, the *International Private Equity and Venture Capital Association* issued accounting valuation guidelines for private equity firms in December 2004.

⁶FAS No. 157 has also been known as ASC 820 since the FASB updated codification.

⁷Axelson et al. (2013) identify the Beta Puzzle from research that finds private equity firms seem to increase leverage up to six fold in portfolio companies without changing systematic risk.

returns Axelson et al. (2013) show that private equity indeed follows standard Modigliani and Miller (1958) calculations, and that systematic risk (beta) is indeed higher, offering a solution to the Beta Puzzle. The lower alpha and higher beta findings mirror results from Sorensen et al. (2012) indicating that, after fees, investors probably break even on private equity investments. This paper differs from that of Axelson and colleagues in that I explore the impact of redefining fair value on revealing the economic beta and alpha.

An examination of three-year correlations shows that market comovement increased across international firms subject to the new standard. Figure 1 shows the impact on European private equity funds of implementing IAS 39. Correlations with the MSCI World Index are small and positive prior to implementation of fair value standards. After implementation of IAS 39 in 2006, we observe an increase in accounting correlations. The upward trend in correlation after Q4 2005 and the eventual plateau is a result of including redefined fair value estimates in each additional quarter. Typically, a chart showing differencing event has a sharp shock within the first few periods of implementation. The nature of calculating rolling correlations, which will include prior quarters under the old standard, causes Figure 1 to look like a trend.

[Insert Figure 1 near here]

In assessing the economic impact of redefining fair value, I use a number of measures of private equity firms' access to capital, including dollars raised per day, dollars raised per investor, and propensity to raise capital. After implementation of IAS 39, private equity firms are less likely to attract new capital; they also raise less capital overall and less capital per investor, and spend more days soliciting capital for lower amounts invested. As a result of redefining fair value, private equity firms implementing the new standards raise roughly 50% less capital than their counterparts.

Overall, this evidence is consistent with the notion that fair value reporting improves the information environment for evaluating portfolio diversification and optimizing private equity investment. Survey data and interviews corroborate these findings. Investors' assumptions about private equity appear to have shifted after implementation of the new standard. The large sample and field data are consistent with institutional investors' use of accounting information to inform correlation assumptions used in asset allocation models. Following the change in fair value accounting, many institutional investors and investment consultants appear to have revised their correlation estimates upward based on new accounting information.

It is noteworthy that fair value improves reporting, given the private equity industrys strong opposition to redefining fair value. Because private-equity compensation is based on realized returns rather than accruals (thus matching investors time horizon), this setting offers a unique perspective on existing research in accounting. Short-term reporting has less impact on incentives and agency issues at private equity firms than at public companies, but the incentives around long term reporting and smoothing returns are the same as those that CEOs at public companies face. Private equity managers have incentives to their funds as low-risk diversifying investments by obfuscating systematic risk (that is, by smoothing returns). Moreover, institutional investors who rely on accounting information, such as investment managers at endowments and pensions, also have incentives to obfuscate systematic risk and to choose investments that appear low-risk to demonstrate prudent portfolio management to their institutions trustees and benefactors. Fair value, in this setting, actually helps mitigate agency conflicts and reduces potential agency concerns (attributes not historically associated with fair value standards), not only between private equity firms and institutional investors but also between institutional investors and portfolio benefactors.

The balance of the paper proceeds as follows. Section 2 describes institutional investing in private equity. Section 3 reviews the literature on fair value accounting and implementation of IAS 39 and FAS 157. Section 4 motivates a set of hypotheses on the consequences of the new fair value standard. Section 5 outlines the data and research design, including a discussion of the cost-of-capital proxy measure. Section 6 presents the main empirical results, Section 8 discusses how well the diversification illusion has been resolved by fair value reporting, and Section 9 discusses the contributions of this study and its implications for research and practice.

2 Background

Private equity firms' incentives and governance structures differ from those of public firms. Compensation at private equity firms is based on realized returns, not accruals or estimates as at public firms; as a result, a firm's managers and its investors are compensated simultaneously. Even if managers of public companies are paid entirely with restricted equity, they will exit holdings at different times than their will investors, causing a timing and incentive mismatch. Moreover, limited partner investors in private equity funds have little recourse to their capital, which is usually locked up for ten years or more. These unique governance structures do not eliminate principal-agent problems, but they do create a different dynamic within which both the principal and the agent operate. This section

outlines the unique attributes of private equity governance and compensation. It then discusses the underlying economic drivers of private equity returns as they relate to financial reporting and portfolio management.

2.1 Private Equity: A Corporate Governance Nirvana?

The governance structure of private equity firms has been called a “corporate governance nirvana” (Cendrowski et al., 2012). As result of greater information asymmetry, private equity compensation incentives are aligned strongly with limited partner investors, in comparison with public firms. As one scholar has asserted: “More than any other factor, [private equity firms] resolution of the owner manager conflict explains how they can motivate the same people, managing the same resources, to perform so much more effectively under private ownership than in the publicly held corporate form” (Jensen, 1997).

For their part, institutional investors in private equity funds face considerable information asymmetry and limited control over how and when their investment commitments are invested (Lerner et al., 2007). Figure 2 illustrates the typical fund structure of private equity investing. Once capital is committed, private equity managers enjoy discretion over which investments are made, when committed capital is called, and when in the course of the funds investment life (up to ten years) invested capital is returned. Since managers enjoy more control and investors face higher information asymmetry, private equity governance structures seek high incentive alignment between principals (limited partner investors) and agents (private equity firms).

[Insert Figure 2 near here]

To achieve this alignment, private equity managers are compensated primarily through carried interest, a percentage of investors’ realized returns, not accruals or estimates. Thus, the timing of private equity compensation matches the time horizons of the limited partners (Cendrowski et al., 2012). Both this high incentive alignment and the long term commitment of capital make the impact of accounting standards less clear in the private equity setting.

The nature of compensation based on realized returns rather than accruals enables private equity to offer a unique perspective to research. At public firms, for example, earnings management largely deals with accruals and estimates of the future as managers try to increase their stock prices (that is, to beat analysts’ estimates) via earnings management. The impact of generally accepted accounting

principles (GAAP) regulation might seem less relevant in private equity, but investors still use financial reporting information to make decisions and incentives are still imperfectly aligned.

One exception to incentive alignment occurs when fundraising begins for a new private equity fund. Private equity managers may manage valuations prior to fundraising to promote follow-on funds (Jenkinson et al., 2013). But fundraising is a repeated activity, and institutional investors seem to be keenly aware of the potential for this type of earnings management (Seery, 2012). For example, Jenkinson et al. (2013) find that private equity firms sometimes inflate valuations but that investors seem to see through such manipulation. The same work suggests that institutional investors assign significant weight to the realized returns of liquidated funds and tend to discount the new investment portfolios estimated returns. In other words, unrealized returns are viewed with skepticism during fundraising. Jenkinson et al. (2013) also find that the firms with the strongest track records actually underreport their performance to avoid looking like valuation manipulators.

The unique governance structures of private firms offer a new setting in which to explore how well accounting standards mitigate principal/agent issues. Since compensation is based only on realized returns (that is, it matches investors' time horizon), private equity firms face lower incentives and agency concerns with short term reporting. However, private equity firms face the same incentives around the long term reporting and smoothing returns that CEOs at public companies face. Managers at public firms face incentives to smooth earnings to create an illusion of detachment from market movements. In the same way that smoothing returns creates a diversification illusion for public firms, motivating CEOs to maintain cookie-jar reserves or big baths, private equity firms have an incentive to provide an appearance of unique economic returns.

2.2 Private Equity's Unclear Portfolio Value

Private equity assets are frequently promoted as "alternative assets" that provide diversification benefits for institutional investors (Franzoni et al., 2012).⁸ Figure 3 is an example of marketing materials from a private equity firm demonstrating the perceived diversification provided by including private equity in a portfolio; the illustration suggests that portfolios without private equity are dramatically inferior. But empirical research suggests that no material diversification exists (Franzoni et al., 2012). Thus, if fair value standards improve the information environment, and investors use the resulting ac-

⁸Diversification is an appealing attribute for institutional investors' portfolios, since assets characterized by low covariance with public equity markets can generate enhanced returns via rebalancing and portfolio risk reduction (Fama, 1972)

counting information in their evaluations, implementing fair value standards should improve investors' assessments of private equity investments.

[Insert Figure 3 near here]

Private equity firms generate returns by three methods: (1) interim paydown of debt using firm cash flows, (2) improvements in operational performance and (3) multiple expansion (market timing). When a private equity firm adds leverage to a portfolio company, it increases its own expected returns and risk levels but does nothing to enhance diversification. Prior research suggests that operational improvements in portfolio companies are private equity's main means of diversifying its risk exposure from that of public markets (Kaplan and Schoar, 2005; Franzoni et al., 2012).

One important question is why institutions continue to invest so much capital in private equity. Research on private equity's risk-adjusted performance indicates that some of the \$3 trillion invested in private equity assets might be misdirected. Lerner et al. (2007) assert that many institutional investors lack sufficient understanding of private equity economics to effectively evaluate such investments, noting that the "progress of the funds' portfolios is very difficult to assess from traditional accounting data" (p.733). This problem is compounded by the inherent complexity of developing meaningful economic correlation assumptions to determine appropriate portfolio allocation and appropriate rebalancing of economic exposure to private equity investments.

Our knowledge of the risk-adjusted performance of private equity returns has improved with research from Harris et al. (2012). Harris et al. (2012) use data from the Burgiss Group, a back office software management tool for private equity information for large institutional investors, and find that private equity firms outperform public markets. Other evidence of relative out performance by private equity can be found in the work of Higson and Stucke (2012) and Ljungqvist et al. (2008). This outperformance however does not factor in illiquidity and commitment risk, the most salient attribute to investors considering private equity assets. Franzoni et al. (2012) find that private equity suffers from significant exposure to the same liquidity risk factors as public equity and other alternative asset classes. Consistent with this assertion, Robinson and Sensoy (2011) find that the cash flows of private equity are procyclical with the market, a finding confirmed by Kaplan and Schoar (2005). Finally, Phalippou and Zollo (2005) find that private equity performance covaries positively with both business cycles and stock market cycles and is exposed to tail risk. In all, the research on risk-adjusted performance of private equity returns has been informed but not concluded (Harris et al., 2012; Sorensen et al., 2012; Higson and Stucke, 2012).

2.3 Portfolio Diversification via Private Equity: A Free Lunch?

Understanding how private equity’s economic returns move with the public market is critical for investors intent on determining the appropriate magnitude of their private equity investments and rebalancing appropriately. Though economists often warn that there’s no such thing as a free lunch, [Campbell \(2000\)](#) notes that finance theory does offer a free lunch: the reduction in risk achievable via diversification. [Sharpe \(1992\)](#) also observes that asset allocation across asset classes with different exposures to economic risk is a key driver of portfolio returns, and that understanding the underlying economics of an asset class is critical to asset allocation decisions. Since the emergence of private equity as an asset class in the 1990s, even the most respected institutional investors have had to contend with the challenge of managing a portfolio that contains illiquid assets. This state of affairs led [Lerner et al. \(2007\)](#) to remark that institutional investors are widely viewed as sophisticated appear to make foolish choices when investing in private equity firms.

It is difficult for investors to determine the true comovement of private equity with equity markets and other asset classes. Consider the three inputs to mean variance optimization analysis of a portfolio: estimating expected returns, estimating expected volatility, and estimating expected portfolio asset correlation. Of these three measures for evaluating the value of portfolio assets, determining expected portfolio covariance is arguably the most complex.⁹ To the extent that accounting information contributes to investors’ understanding of private equity economics, assumptions about expected variance and correlation may be affected by changes in accounting. Again, Yale’s CIO aptly described the possible impact of accounting information on investment allocation decisions ([Swensen, 2009](#)).

If two otherwise identical companies differ only in the form of organization—one private, the other public—the infrequently and less aggressively valued private company appears much more stable than the frequently valued publicly traded company, particularly in a world where securities markets exhibit excess volatility. Even though both companies react in identical fashion to fundamental drivers of corporate value, the less volatile private entity boasts superior risk characteristics, based solely on mismeasurement of the company’s true underlying volatility. Not only does lack of day-to-day valuation information reduce reported risk levels, the private company gains spurious diversifying characteristics based solely on lack of co-movement with the more frequently valued public company.

⁹As Swensen points out, “The correlation matrix is the most difficult set of mean–variance optimization variables to specify. Less intuitive than either means of variance, correlations indicate the degree to which asset class returns tend to move with one another” ([Swensen, 2009](#)).

In other words, the nature of reporting and accounting leads to a diversification illusion for institutional investors. Before fair value was explicitly defined by the new standards, private equity assets were typically not marked up or down over time. In letters to the FASB, private equity managers have argued that including the historical best practice for fair value is a conservative approach as it does not overstate performance.¹⁰ The consequence of including discounts under the old method is that private equity assets look more attractive to investors seeking equity–market diversification.

All else being equal, the lower the co–movement of an asset within a portfolio, the more important it becomes to the portfolio to allocate to the asset. By making private equity assets seem minimally correlated with public–market alternatives, prior accounting practices helped private equity firms market portfolio diversification as a benefit of the asset class, creating a diversification illusion for institutional investors who rely on accounting information to make portfolio allocation and investment decisions (Franzoni et al., 2012).

2.4 Are Institutional Investment Managers “Foolish?”

Recent research argues that some institutional investors—typically characterized as informed investors—make foolish choices when investing in private equity funds. In “Smart Institutions, Foolish Choices,” for example, Lerner et al. (2007) document that institutional investors tend to suffer from a lower–quality information environment or inferior selection ability when making private equity investment decisions. Two explanations can motivate these choices: (1) investment managers are responding to incentives from their trustees, and/or (2) accounting information has a greater impact in markets that have a lower quality information environment, such as private equity which has few participants, no information intermediaries, and inconsistent benchmarks.

Portfolio managers have incentives to invest in assets that generate superior returns. However, such incentives could instead have the unintended consequence of encouraging managers to pursue the *appearance* of being astute investors. If looking like a good investor is important to a manager, private equity’s diversification illusion and its lower volatility would be appealing. Pre–adoption private equity accounting makes investments seem low–risk not only to the portfolio manager but also to the trustees whom the portfolio manager represents. Thus a pension–fund manager who is already locked in to a ten year private equity investment might have stronger incentive alignment with a private equity fund manager to smooth returns, even if this incentive is out of sync with the interests of pension

¹⁰See National Association of College and University Business Officers (2009b,a); Private Equity Growth Capital Council (2009, 2010); National Venture Capital Association (2010, 2011); Cambridge Associates (2009)

recipients. The same point applies to college–endowment managers and endowment beneficiaries. Letters to the FASB from both private equity firms and limited partners argue against new fair value accounting standards citing the strong incentive alignment between the two groups, but these letters did not address the potential over alignment of incentives at the expense of retirement or endowment beneficiaries. The reporting practices of private equity could offer an attractive means for a pension or endowment manager to appear to be reducing risk in a portfolio. With such investments, managers are not foolish; they are simply responding to incentives.¹¹

An alternative explanation is that, as a result of market institutional voids, accounting information matters more in private equity investing because it represents an unusually large fraction of available information. Typically, between 20 and 30 investors each commit \$2 to \$200 million to a given private equity fund, in the absence of information from intermediaries or analysts. Public markets, by contrast, have information intermediaries and a greater number of peer investors to analyze and digest information. Stocks can be shorted in public markets; in private equity the only option is to abstain from investment. Moreover, unlike public market risk and return benchmarks (such as the S&P 500 or the Russell 2000), the benchmarks for private equity investing assets (e.g., Cambridge Associates Private Equity Index) suffer from the same accounting shortcoming studied here and include funds with varying life cycles. As a result, it is difficult to measure how well a manager is performing until the fund is liquidated. This is the primary reason why the finance literature, such as [Axelson et al. \(2013\)](#), focuses on liquidated investments. [Swensen \(2009\)](#) explains the basic mechanism that causes confusion:

The lack of widely accepted benchmarks for the private equity asset class prevents investors from understanding the risk, return, and correlation characteristics of private equity, and hence, the role of private equity in a diversified portfolio. The few private equity indices that exist face the standard problem of how to measure the performance of private assets. The inability to determine a true market price for private assets forces one to use appraisal-based prices that typically lead to artificial smoothing of the returns. Smoothed returns result in lower estimates of volatility, lower correlations with most other asset classes, and artificially high risk and return relationships, all of which can lead to a dramatic over-allocation in a traditional mean-variance optimization setting that attempts to maximize

¹¹Institutional investors could face incentives to invest in these new asset classes in order to maintain prestige among their peers. Private equity and venture capital are new asset classes that hold out the promise of producing the most compelling asset–management returns of the last century. Their governance structure might also bias an investor toward the appearance of stable returns from a lower–volatility investment.

return per unit of risk.

In the face of so many information voids, investors are at a disadvantage and face limited choices when determining the expected comovement of their private equity portfolio. Asset-allocation models for the purpose of motivating portfolio’s mean-variance optimization could be based on (1) assumptions supported by theory but not by empirical return data from portfolio or indices (e.g. Cambridge Associates Private Equity Index), or on (2) accounting data from portfolios or indices in motivating portfolio mean variance optimization. Similar to a methodology noted in Swensen (2009), discussions with practitioners suggest that the best practice for portfolio optimization is to use the available flawed data and to set limits manually on specific asset classes based on management preference. Portfolios are never perfectly optimized; however, with the diversification illusion in play, mean–variance asset–allocation models will always allocate fully 100% of a portfolio to private equity using private equity index returns. In practice, portfolio managers set allocation constraints to limit the amount of private equity the optimizer specifies, typically based on the managers preference.

2.5 Fair Value Accounting

Both IAS 39 and FAS 157 define fair value to exclude the illiquidity estimates that were previously used to justify “best practice” accounting for private equity. Both the IASB and the FASB replaced illiquidity assumptions by defining fair value as assuming an orderly transaction with a willing buyer. The prior estimates for illiquidity were replaced with a liquidity classification hierarchy (Level 1, Level 2, and Level 3). Level 3 has the lowest liquidity, with valuations based on models, and Level 1 assets have quoted market prices. Previously, private equity firms typically reported fair values which reported marginal economic movement until there was a “milestone event” (e.g., a liquidity event, including new rounds of financing or an asset sale), with no writedown unless a bankruptcy or down round of equity financing occurred. While this seems is not how fair value is currently defined, at the time this was the best practice for reporting assets at fair value.

Private equity offers a more direct empirical context in which to test the impact of fair value accounting standards than has previously been possible. Prior research on fair value largely examined firms whose assets were only minimally impacted by the new definition of fair value. For example, Level 3 assets constitute only 4–6 percent of financial institutions’ balance sheets in the United States and Europe (Fitch Ratings, 2008). Thus fair value reporting research has focused primarily on firms

whose balance sheets were only modestly impacted by the fair value accounting standard; the literature is devoid of empirical studies in which Level 3 assets represent the majority of balance sheet assets. By definition, mandated liquidity assumptions should have the greatest impact on the most illiquid assets; thus, implementing fair value accounting of private equity assets impacts the entire balance sheet.

Research examining the shift to market based fair value measures has produced mixed outcomes. Song et al. (2010) find that the value relevance of fair values decreases with each increment in liquidity levels; highly illiquid Level 3 asset reporting is most value-relevant for firms with strong corporate governance. Riedl and Serafeim (2011) find that, under the new standard, the information risk embodied in a financial instruments fair values leads to higher cost of capital in illiquid assets. Altamuro and Zhang (2012) find that Level 3 mortgage-servicing rights measurements better reflect the persistence of mortgage-servicing fees than Level 2 mortgageservicing rights measurements. With the exception of Lawrence et al. (2013) who study closedend mutual funds whose underlying fair value assets are directly related to performance measures, the fair value reporting literature has focused on firms where only one aspect of balance sheet value is impacted by fair value accounting; the literature is devoid of empirical studies in which Level 3 assets represent the majority of firm assets across the sample. Because such assets require extensive assumptions to determine their fair value, Level 3 assets are likely to be impacted most profoundly by regulation that guides fair value assumptions, like IAS 39 and FAS 157.

Standard-setters assert that fair values provide the most relevant information to financial statement users, a position supported by some research (Barth et al., 1996). However, fair valuations are also subjective, particularly for unique illiquid assets with few comparable firms (categorized as Level 3 assets by both the IASB and the FASB). The fair value debate centers on whether improvements in the relevance of reported information outweigh the potential for management manipulation and estimation error.

2.5.1 Improved Information Environment

For private equity reporting, volatility is precisely the information that should enhance understanding of the underlying asset risk (Barth, 2004; Barth and Clinch, 1998; Muller III, 1999; Aboody et al., 1999; Richard Dietrich et al., 2000; Muller III and Riedl, 2002; Cotter and Richardson, 2002; Kallapur and Kwan, 2004). Cost-based reporting is perceived as less volatile, but it is a mechanical construct

founded on restricting information; the true economics of the asset are not apparent in a measurement that excludes the stream of changes in expected future cash flows that is incorporated in fair value.

2.5.2 Managerial manipulation

Agency theory predicts that managers will use unverifiable discretion opportunistically (Jensen and Meckling, 1976). Furthermore, research has shown that fair value reporting can actually help managers postpone or manipulate earnings (Beaver and Venkatachalam, 2003; Ramanna and Watts, 2009; Aboody et al., 2006; Bartov et al., 2007). Private equity managers do not face strong short-term reporting incentives to manipulate returns; however, they do face long term incentives to manipulate earnings (e.g., earnings smoothing).

2.5.3 Estimation error

Management's perceptions of the future could legitimately entail an estimation bias that differs from a market valuation. If a valuation deviates too much from the true economics, the inaccurate reporting volatility could mislead investors. Estimation error volatility should be a focus of concern because a high level of volatility error corrodes the information environment (Barth, 2004). For private equity firms we would expect the impact of estimation error to be small. Moreover, the private equity business model focuses on identifying and measuring value.

At private equity firms, long-term incentive contracts and investors limited exit opportunities make the short-term agency concerns that prevail at public companies (i.e., short-term earnings targets) less pressing. Instead, questions about communicating risk exposure are more pressing for institutional investors who are locked into the investment but anxious to consider portfolio rebalancing and future asset allocations in light of accounting information. Thus, in this setting, the test shifts from short-term incentives for managing fair value estimates to long-term incentives for smoothing earnings to make assets seem less closely correlated with public markets. Lambert et al. (2007) show that disclosure directly impacts investors' assessed covariance with other firms' cash flows, which is non-diversifiable. To the extent that disclosure reveals increased covariance with other firms' cash flows (the assets correlation/risk exposure common to the market), a firm's cost of capital increases. This is likely to be the most important direct effect of the new standard in the private equity setting where there is much less information; yet if the market is fully informed about private equity economics, new accounting disclosures should not have an economic impact on the market. But if the new

definition of fair value prompts firms to eliminate the liquidity concerns that help reduce the accounting co-movement discussed in the prior section (Swensen, 2009), private equity managers will not favor new fair value reporting. In that case, fair value reporting will be more costly and will reduce apparent diversification.

3 Hypothesis Development

Theory suggests that managers can increase a firm's value by reducing information asymmetries between insiders and investors. More complete disclosure reduces these asymmetries; theory suggests and empirical research has shown that, once investors are at less of an informational disadvantage, they will be willing to provide capital at a lower cost. A great deal of research studies this phenomenon. However, disclosures and regulations provide investors the most insight when the disclosures do not merely reduce uncertainty about outcomes but also promote understanding of the underlying economic uncertainty.

I argue that fair value reporting has indeed increased the financial reporting co-movement of private equity assets with public markets. One might think that the shift to redefined fair value would mechanically increase the comovement of private equity assets. However, unlike Level 1 and Level 2 assets which both use quoted market prices); in this setting, private equity firm balance sheets are entirely made up of Level 3 assets which use unobserved (typically internal) inputs. Moreover because these assets are based on internal valuation models and not market assumptions they are also more likely to have estimation error. Theory suggests that, as long as managers are able to report the fair value of assets accurately, the comovement of such assets with equity markets should increase with the shift in accounting standard. Therefore:

Hypothesis 1 *The comovement of private equity with public equity markets is higher under fair value reporting redefined by IAS 39 than under the prior reporting regime.*

As a result of greater disclosure, despite theory and empirical research in other settings to the contrary, I expect access to capital to decrease and the cost of capital to increase as a result of greater disclosure. A decrease in access to capital implies that investors use accounting information to understand private equity economics, and that it has informed them of the economic comovement of this asset class with public markets. I argue that investors will become more informed about the volatility comovement of the assets and will adjust their discounts. In other words, they will identify

previously unrecognized correlated systematic risk in their portfolios and reduce their demand for the asset. Hence the second hypothesis:

Hypothesis 2 *Private equity's access to capital is lower under redefined fair value than under the prior reporting regime.*

According to semi-efficient market theory, if the market of investors in private equity funds were fully informed of the diversification illusion, changes in accounting standards would have no significant economic consequence for private equity. However, if investors rely heavily on available accounting information to determine correlations with other portfolio asset classes, implementation of the new standard could be expected to affect private equity firms access to capital. In particular, if the correlation between accounting returns and market returns increases, I expect access to capital to decrease because private equity will subsequently exhibit greater comovement with other portfolio assets. Lambert et al. (2007) provide a model that illustrates the motivation for this hypothesis. In their model, disclosures that reveal the economic comovement of firm cash flows also reveal economic comovement with other investments, increasing the cost of capital. Inasmuch as private equity investors face uncertainty about the timing of cash flows, the Lambert et al. (2007) model for disclosure and capital investment motivates this hypothesis.

4 Research Design

Private equity firms represent a useful laboratory for exploring how private firms more generally are affected by accounting regulation. Though the governance structures of private firms vary widely, the governance, incentives, and investment structure of private equity firms are quite consistent. Moreover, institutional investors mandate that private equity firms adhere to GAAP in order to comply with their own portfolio mandates, whereas other private firms might not face this requirement. Finally, neither the creation nor the adoption of IAS 39 in 2005 and FAS 157 in 2008 has been linked to influence from the private firm investment market.

Though Watts and Zimmerman (1978) note that accounting regulation is not entirely exogenous, the impact of private equity firms on implementation of the standard is likely to be close to zero. In fact, responses to the FASB regulation were unanimously negative: in letters, both private equity firms and institutional investors opposed it. Those letters characterized the regulation as costly, since it generates information that might be useful in a liquid market but is of little value to firms

“locked into investment” with a private equity fund. In interviews at firms that invest in private equity funds, managers responsible for such firms’ internal reporting processes expressed the strongest opposition to the standard. As one said, “It wouldn’t be a problem if we didn’t also have to verify [the private equity firms’] valuations.” Indeed, it is not just private equity firms that are impacted by the fair value standard; institutional investors must also report their assets to pension recipients, university students/alumni, or foundation contributors. Since most institutional investors actively lobbied against the standard, including institutional investors in private equity, this setting is unlikely to have had an endogenous effect on adoption of the new accounting standards.

The empirical tests in this paper focus on IAS 39 instead of FAS 157, for two reasons. First, the mandated adoption of FAS 157 occurred in the middle of the financial crisis making the empirical identification muddled by major global events during the period. A reasonable argument can be made that a test in the United States would pick up some other paradigm shift in the market and not fair value reporting. Second, IAS 39 was implemented before FAS 157. I primarily examine implementation of IAS 39 after 2005, and use U.S. implementation of fair value standards only as a suggestive confirmation in untabulated findings.

The main empirical specification in this study is a difference-in-difference approach across funds subject to different standard-setting bodies in order to draw causal inferences about increased co-movement of private equity returns with equity markets. The first approach, however, uses a modified capital asset pricing model (CAPM) over the pre-and post-periods to examine the impact of the new fair value standards. The regression is specified as follows:

$$R - rf = \alpha_1 EUFund + \alpha_2 USFund + \beta_1 mktrf + \beta_2 EUFund \times mktrf + \beta_3 Post + \beta_4 EUFund \times Post + \beta_5 Post \times mktrf + \beta_6 EUFund \times Post \times mktrf + \epsilon \quad (4.1)$$

Where:

$R - rf$ = Quarterly private equity fund return less risk-free rate.

$mktrf$ = Quarterly return on value-weighted market portfolio of global common stocks minus the one month U.S. T-bill rate (source Fama/French data library).

$[EU/US] Fund$ = Indicator variable equal to 1 if the firm follows US or EU accounting standards and 0 otherwise.

$Post$ = Indicator variable equal to 1 if the observation is drawn from the post-adoption-period earnings distribution and 0 otherwise.

The data cover periods prior to and following implementation of IAS 39, from Q1 2000 to Q4 2005 for the pre period, and from Q4 2005 to Q4 2008 for the post-period. The constant is suppressed as indicator variables for each region are included in the regression, specifying the alpha attributable

investment managers in the region. Standard errors are clustered by fund. The two main coefficients of interest are the EU specific market beta (β_2) and unique EU investment alpha (α_1). H1 predicts the market beta (β_2) attributable to implementing IAS 39 will be higher. The investment alpha provided by managers that is unique to market movements is indicated by α_1 . Decreasing α_1 with implementing of IAS 39 would be an additional result consistent with H1. Equation (4.2), is similar to equation (4.1), but it combines the dataset across the time periods before and after implementation. Equation (4.2) uses the full time period and a difference-in-difference coefficient to measure the impact of the change on the market beta.

The second regression specification determines the shift in correlations associated with implementing IAS 39. While market betas and correlations are similar and should provide similar intuition, correlations provide a lower bound for the changing assumptions used in practice with portfolio mean variance optimization models. The panel data regression is specified as follows:

$$Corr = \alpha + \beta_1 Post + \beta_2 EUFund + \beta_3 Post \times EUFund + Controls + \epsilon \quad (4.2)$$

Where:

Corr = Three-year rolling correlation of private equity firm's returns with the MSCI World Index.

Post = Indicator variable equal to 1 if the observation is drawn from the post-adoption-period earnings distribution and 0 otherwise.

EUFund = Indicator variable equal to 1 if the firm follows IASB accounting standards and 0 otherwise.

Controls = Quarter-year fixed effects, firm fixed effects, domestic economic correlation with the MSCI World Index.

Using the difference-in-differences approach, I model the economic impact of IAS 39 on private equity firms comparing European Union firms and firms located in the United States. The unit of observation is fund quarters, and standard errors are clustered by fund. This regression specification probably includes serial correlation as I use rolling correlation; this is primarily an issue with standard errors and t-statistics. The bias on coefficients is likely down. A separate test is also performed that uses only two periods of correlations, the three year correlation prior to fair value adoption as of the last quarter and the first three year correlation that includes only valuations from the new fair value accounting.

In the second group of tests, I examine the impact of the new standard on private equity firms' access to capital following panel data regression of a firm's cash flow correlation as presented in equation (4.3). Equation (4.3) presents the cross-sectional regression using each fundraising as the unit of observation.

$$Access\ to\ Capital = \alpha + \beta_1 Post + \beta_2 EUFund + \beta_3 Post \times EUFund + Controls + \epsilon \quad (4.3)$$

Where:

Access to Capital = Log dollars committed divided by days spent soliciting capital; log dollars committed divided by number of institutional investors; or an indicator variable equal to 1 if the observation was soliciting capital during the period and 0 otherwise.

Post = Indicator variable equal to 1 if the observation is drawn from the post-adoption-period earnings distribution and 0 otherwise.

EUFund = Indicator variable equal to 1 if the firm follows IASB accounting standards and 0 otherwise.

Controls = Fund sequence, first fund indicator, year time trend, Year FE, and private equity investment demand.

Standard asset-pricing models in finance define cost of capital as expected return $E(\tilde{R}_j)$, and the value of the firm's implied covariance with the market $Cov(\tilde{R}_j, \tilde{R}_m)/(\tilde{R}_m)$ which determines the firm's risk class (Fama, 1972). Unfortunately, an industrywide dearth of data necessitates creative solutions to understand how a firm's ex-ante cost of capital changes with implementation of new accounting standards. Thus researchers are left with few ways to measure how markets determine the future return prospects of a private equity firm, nor does the literature offer a standard measure. Internal hurdle rates, limited partner terms and secondary market transactions have all been considered as candidate measures, but these proxies suffer from determination by industry norms and exhibit little variation over time or between funds. Private equity firms' standard internal hurdle rate of 20 percent for investments does not vary and is not based on investors demand for capital market information. Given such small and infrequent changes, it is likely that such measures lack variation and fail to reflect investors' ex-ante expected returns accurately.

I propose using various measures of access to capital—specifically, measures of the duration and yield of fundraising—which I expect to be correlated with the cost of capital. As a firm's cost of capital increases in this market, it probably becomes more difficult for managers to go to the market to solicit investment capital. Thus managers contending with a high cost of capital should approach the institutional investment market less frequently and should need more time to find investors willing to commit capital. Consistent with this idea, practitioner periodicals regularly report on private equity firms' fundraising efforts, treating the amounts raised and the time elapsed before fund closings as benchmarks of fundraising success (Prequin, 2013; PitchBook, 2013).

As the time taken to close a private equity fund is frequently cited within the industry as a proxy for demand, the proxy is not without limitations. However, firms that take longer to close

new funds are widely agreed to encounter less demand for their investment services and are likely to incur increased costs with obtaining investment capital. As [Brav \(2009\)](#) points out, access to capital exhibits attributes similar to cost of capital from the point of view of managers, and access to capital is used not only for financial policy but also for real investment decisions in private firms.

A potential shortcoming of the proxy is that closure of a fund could be delayed by events uncorrelated to changes in access to capital, such as unexpectedly time consuming enhancements to a portfolio; it is unclear, however, how performance enhancements, on average, would cause investors to take longer to commit capital. Managers do have a number of competing responsibilities that could lengthen the time it takes to raise capital; however, these distractions would need to be unrelated to positive or negative shifts in their portfolio for this concern to be valid.

5 Data and Summary Statistics

5.1 Data and Sample Selection

This section discusses the sample selection used to test the hypotheses. My primary data sources are Preqin and Capital IQ, both frequently used in prior private equity research ([Lerner et al., 2011](#); [Harris et al., 2012](#)). Index data and Fama/French factors are obtained through from Bloomberg and Wharton Research Data Services (WRDS). Supplemental analysis relies on data from Cambridge Associates and hand collected data from institutional investors and actuaries.

Preqin has an extensive database of private equity quarterly cash flows and fund level valuations obtained through the Freedom of Information Act's mandated disclosure for certain investors (e.g. public pensions) to disclose investments. A possible bias in the Preqin sample is that the cash flow data from Preqin may not be representative of the larger universe of private equity LPs. For example, the set of firms obligated under the Freedom of Information Act to disclose cash flow data (the main method used to obtain Preqin data) might, as a group, invest in private equity firms whose financial reporting is of unusually high quality. Preqin could be missing funds with lower quality reporting whose investors are not subject to the Freedom of Information Act. If this bias is indeed present in the sample, it would probably bias the data against the key test of the paper. Moreover, this bias is inherent in alternative databases. According to [Harris et al. \(2012\)](#), the Preqin database is consistent with both the Burgess and Cambridge Associates Private Equity Index databases, two leading alternative databases, and represents a reliable measure of private equity performance.

The Preqin database provides quarterly cash flows and valuations, which include capital calls, capital distributions, and end-of-quarter fund fair values. Each of these data points is used to calculate fund quarterly returns, as presented in Equation 5.1.¹²

$$r_t = \frac{Nav_t + Dist_t - Calls_t - Nav_{t-1}}{Calls_t + Nav_{t-1}} \quad (5.1)$$

Where:

r_t = Return in quarter (t).

Nav_t = The end-of-quarter (t) fund net asset value

Nav_{t-1} = The end-of-prior-quarter (t-1) fund net asset value

$Dist_t$ = Distributions from a private equity fund to investors

$Calls_t$ = Capital calls from a private equity fund to investors

To illustrate, assume that a fund has a net asset value (NAV) of \$100 million at the start of Q1. During the quarter \$30 million in additional capital is called for new investments and \$10 million is returned to investors in cash distributions. If the ending NAV for the quarter is \$125 million, the fund would produce a 3.8% return for the quarter (\$5 million gain divided by \$130 base). Occasionally a fund will have a missing end-of-quarter net asset value (capital account balance) valuation in a series of reported fair values. When a fund is missing a single period valuation and it reports identical fair values before and after the missing period; the prior period valuation is assumed to have been reported in the missing period, this impacts a total of 59 fund quarters. Figure 4 presents a histogram of the sample's winsorized returns.

[Insert Figure 4 near here]

After calculating fund's quarterly returns, my starting point with the Preqin data, presented in Table 1, Panel A, is the universe of 2,245 funds reporting quarterly cash flow data. This database, according to Preqin, covers about 92% of all capital ever raised by private equity firms. I eliminate 1,535 private equity funds that are not that are not identified as "buyout" funds because such funds (which include venture capital and real estate funds) are less likely to exhibit the diversification illusion. I then drop reporting periods prior to January 2000. Consistent with prior work (Kaplan and Schoar, 2005), I drop fund quarters with less than \$5 million in deployed capital to reduce the influence on results of small funds' potentially extreme growth rates. When a given firm manages European and

¹²Capital calls are requests on the part of private equity firms for previously committed capital to be deployed. Capital distributions return capital to investors.

U.S. funds of the same type, I treat the European and U.S. buyout funds as separate partnerships. Finally, I exclude funds without vintage year data and without end-of-quarter valuations and winsorize quarterly returns at the 1% level. From the remaining funds, I construct my sample of private equity fund returns from the set of funds presented in [Table 1](#).

I obtain fundraising data from the Capital IQ database, which offers broader coverage than Preqin of private equity fundraising activity including start dates, fund sizes, and fund closings since 1999. Fundraising start dates serve as a key attribute of access to capital in this paper.

[Table 1](#), Panel B presents the sample selection from the Capital IQ data database which includes transactions that closed between January 1980 and December 2012. Information about investments prior to 1999 is back filled, because most private equity databases were not established until the late 1990s. Thus, my starting point is to drop reporting periods in Capital IQ prior to January 2000. As before, I eliminate private- equity funds that are not identified as buyout or turnaround funds. I drop funds whose size or fundraising start and end dates are missing.¹³ From the remaining funds, I construct my sample, presented in [Table 1](#), Panel B. To classify the firms that implement FAS 157 and IAS 39 in both Preqin and Capital IQ, I identify firms that are based in the United States and abroad from their firm office address and fund focus. I drop international firms that are headquartered in the United States.

[Insert [Table 1](#) near here]

5.2 Descriptive Statistics

[Table 1](#), Panel C, presents the number of funds that report returns and fundraising over the sample period. The most notable change in this period is the growth of the private equity industry between 2003 and the end of 2008. In this period, characterized by relatively low-cost debt capital and high growth rates in equity markets, we observe a dramatic increase in the number of funds initiated and incapital under management. The number of funds with deployed capital that report quarterly returns doubles from 155 to 309 in Europe and from 503 to 1,219 in the United States. The number of new funds follows a similar pattern: from a total of 64 in both regions in 2003 to 121 in 2008. Following the financial crisis, Europe and the United States exhibit similar changes in the number of funds reporting

¹³Capital IQ fundraising date information varies: some specifies start and end dates; some merely identifies the year . I drop funds that dont specify at least the month and year. I assume that all dates that specify only a month and year (e.g., June 2003) begin fundraising on the first day of the month (e.g., June 1, 2003) and end fundraising at the end of the month (e.g. June 30, 2003).

and in the number of funds initiated from 2008 to 2009. In 2010 U.S. private-equity firms closed 33 more funds than did European private-equity firms, probably due to uncertainty about Euro-zone government debt and a banking crisis that began in 2009 and intensified in 2010.

Table 2 presents information on returns from Preqin and market data across regional focus for the period 2000–2008. Column (1) presents funds’ average quarterly returns by region. EU funds represent a little under 20% of the sample of quarterly returns and have a lower mean than U.S. funds, yet mean reported returns for both groups over the period are relatively similar. After adoption of IAS 39 in 2005, we see the average returns of EU firms exceed those of US firms. One factor contributing to the outperformance of these funds is earlier recognition of gains from as a result of implementing fair value reporting. This finding suggests potential for increased investor demand for EU private equity investments if managers indeed chase returns, in direct opposition to Hypothesis 2. Columns (2) and (3) show mean quarterly excess returns over the period, calculated as the quarterly return minus the market return and the quarterly return minus the risk-free rate respectively. For pre- and post-implementation, the mean return for both EU and US private equity outperforms the market average. Column (4) shows the excess return on the market, calculated as the market return minus the risk-free rate.

[Insert Table 2 near here]

In Column (4) of Table 2, the post-adoption period average market return is below the risk-free rate. It is important to compare Columns (2), (3) and (4). Since beta measures how an investment comoves with the market and alpha measures additional excess performance, columns (2) through (4) indicate that firms in the sample seem not to have had a market to “ride” for the beta component of returns. The fact that the market was down during this period and that private equity firms show higher returns superficially suggest that private equity returns have become less economically connected to the market in the post-adoption period. If this overly simplified approach (e.g. without statistical models) were used to attribute private equity alpha, private equity would look like an economically unique asset class with low correlation to equity markets. Thus it will be important to observe what happens to investment alpha when I calculate market beta in later stages of the analysis.

Column (5) presents average 3-year correlations with the MSCI World Index. Before fair value was redefined, EU private equity firm returns indicated a 0.3% correlation with the MSCI World Index; US firms reported a 16.6% correlation. Both EU and US correlations are surprisingly low given the economic nature of leveraged buyouts (e.g. adding leverage) yet they reflect the nature of

the accounting and prior research (Axelson et al., 2013). It is also important to note the 20% jump in correlations in the post-adoption period for firms implementing new definitions of fair value. By contrast, US firm correlations increase by less than 1%.

Table 3 presents information from Capital IQ on private equity's access to capital between 2000 and 2008. Column (1) presents the average total new commitment a fund obtains before closing. Though the average commitment increases over time for both EU and US firms, a dramatic shift is evident in the average amount of capital that US firms are able to secure from investors. The absolute number of funds raising capital in each period (in parentheses below the commitment amount in column 1) does not dramatically shift; however, the amount of money they are able to raise does shift. This summary statistic suggests that observed results are not due solely to "quality" of firms' ability to access capital. Column (2) shows the average time taken to close a fund, which does not materially change between the periods. Column (3) shows the average dollars raised per day, revealing a decline in average EU capital raised. Finally, column (4) shows average dollars committed per investor, or the size of the average bet that an investor is willing to make on a private equity investment manager. The amount increases slightly for EU firms, from \$37.0 million per commitment to \$52.5 million; US firms average commitment size increases from \$56.3 million to \$90.2 million.

[Insert Table 3 near here]

Table 4 presents the summary statistics from both Preqin and Capital IQ for the period 2000–2008. Within private equity research, vintage year indicates the year in which a firm began deploying committed capital.

Fund sequence indicates an individual fund's position in a series of funds. For example, Bain Capital Fund IV is Bain's fourth investment vehicle with a particular investment strategy. Funds with higher series numbers have a longer track record and are thus more likely to raise capital more easily and to have stronger industry networks and more experience, boosting performance. A fund's vintage year is frequently used to benchmark its performance relative to that of other funds of the same vintage; it has been shown to be a strong determinant of fully liquidated fund returns. Table 4, Panel A, presents the Preqin data for my sample. The average reported vintage year is 1999, which is expected given that I limit the reporting period, not the vintage year of funds reporting. Table 4, Panel B, also presents a first fund variable, which indicates whether a given fund is the first in a series. First time funds are likely to encounter intense scrutiny and to have difficulty accessing capital

because they lack a liquidated–investment track record to benchmark. This measure is thus important to include in any access–to–capital analysis of private equity firms.

[Insert Table 4 near here]

6 Empirical Results

6.1 Private Equity’s Economic Comovement with Public Equity Markets

This section and the next examine the comovement of private equity returns with global capital markets and the corresponding change in access to capital. Table 5 presents results from a modified CAPM model using private equity returns less the risk–free rate as a dependent variable. The columns (1), (2), and (3) unpack the results of the difference–in–difference model in column (4) to make the impact of fair value standards easier to calibrate. Results from the pre–implementation of IAS 39 is presented in Column (1); results from the post–implementation of IAS 39 is presented in Columns (2) and (3). The model also includes two measures of alpha, corresponding to firms that implement redefined fair value (EU funds) and those that do not (US funds). Because both indicator variables cover the sample, the intercept is removed from the regression. This setup enables us to observe the change in market beta and alpha attributable to the event.

[Insert Table 5 near here]

Column (1) in Table 5 presents the beta and alpha prior to implementing new definitions of fair value. The market beta (mkrf) in the pre–implementation period is significant and positive, suggesting market comovement of private equity prior to adopting fair value standards. We know from prior research that this beta is probably low due to the beta puzzle (Axelson et al., 2013). The alpha of EU funds and US funds is also significant and positive, suggesting that private equity investment managers in the EU and the United States provided diversifying alpha and unique exposure to portfolios prior to new fair value definitions, a narrative that shifts when we observe the implementation of new standards.

Columns (2) and (3) in Table 5 illustrate the impact of IAS 39 in the post–adoption. In column (2), the main experimental variable (EU Funds*mkrf) is significant and positive. By comparing the pre and post periods in columns (1) and (2), I observe the equivalent of a difference–in–difference estimator (EU Fund*mkrf), which shows a large and significant increase as a result of the event. As a

result of new fair value definitions, the EU fund returns have nondiversifiable risk (beta) that is 0.47 higher. This means that EU funds have a post-adoption beta of 0.916 (0.446+0.470) compared to US funds beta of 0.446. This is not trivial: a beta twice that of US funds suggests that redefining fair value revealed twice the comovement of private equity returns with equity markets. The magnitude is also significant when we consider that prior to the new standards private equity firms were reporting a beta of 0.223.

A second important result is evident in [Table 5](#), column 3, which uses a longer period than column 2. When adopting the new fair value standards, private equity firms will have accumulated unrecognized value that will be disclosed in the first year after implementing the new standard. This is economic value created in prior periods that went undisclosed as a result of the industry best practice of keeping valuations low. In the first period after adoption, therefore, private equity firms shifting to a new definition of fair value will have a higher alpha simply due to the accounting change. Column 3 eliminates the first period after the accounting change and reports an interesting effect on the alpha of EU funds: as fair value standards are adopted, it appears that private equity investment managers abnormal return disappears for EU funds. In [Table 5](#), column 3, where the first year after adopting fair value standards is excluded from the sample, alpha from European firms is indistinguishable from zero. Excess returns in the pre-adoption period seem to be due more to accounting than to management ability.

[Table 5](#), column (4), presents a traditional difference-in-difference estimator (EU Fund*Post*mkrf) using the full sample period. The key test variable indicates an increase of beta of 0.503 as a result of implementing the redefined fair value reporting. There also seems to be an increase in beta of 0.222 across both fund types in the post period.

Beta is an effective tool to examine market comovement, but practitioners who are determining asset allocations typically use correlations in mean variance optimizer assumptions. Though the results in [Table 5](#) indicate that correlations used by investors had a downward bias, [Table 6](#) provides a conservative base line estimate of how far off these correlation estimates might be. [Table 6](#) presents the results of regressing the 3-year correlation of private equity accounting returns with the MSCI World Index on design variables. My design variables indicate firms that adopted fair-value accounting standards (EU funds) and whether the reporting period followed the adoption (Post-2005). The panel regression results in [Table 6](#) include regression results with and without fund fixed effects. The panel data is used for the period 2000-2008.

[Insert Table 6 near here]

The significant and positive coefficient on the interaction of EU Fund and Post 2005 variables in Table 6 is evidence that accounting correlations track more closely with the broader economy when fair value accounting is employed; in general, accounting correlations are at least 20% higher. As a result of using correlations as a left-hand variable, the model exhibits autocorrelation concerns. Because rolling correlations over time is the dependent variable, it is influenced by prior dates of measurement. This is likely to work against the main finding, suggesting that the 20% change is a conservative estimate. To test the impact of this effect, I select only the last periods when all valuations embodied prior accounting practices and the first three consecutive years of fair values under the new standard. With data only from these two periods, these correlations are regressed on all specifications included in equation (4.2). The experimental variable indicates a 57% jump in accounting correlations which is significant at the 1% level (untabulated). The fund size control variable loads and is significant in the expected direction.

The implementation of fair value standards resulted in a 20% percent increase in accounting correlations with broader equity markets. This shift in correlations is robust to various specifications of the model. When dates are restricted to exclude the implementation of fair-value standards after 2008, the results remain significant. Changing specifications on standard errors produces results and significance similar to those presented in Table 6. These findings pinpoint the diversification illusion caused by financial reporting. Overall, they are consistent with Hypothesis 1: the comovement of private equity with public equity markets is higher under fair-value reporting redefined by IAS 39 than under the prior reporting regime.

6.2 The Impact of Fair Value Accounting on Access to Capital

In the prior section, I provide evidence of the impact of fair value reporting on the reported private equity comovement with public markets. Table 7 reports the cross-sectional regression results of the change in access to capital as a consequence of new fair value definitions. Columns (1), (2), and (3) present the results of regressing the natural log of dollars committed to funds divided by days on the market on my experimental variables. Column (4) presents regressions using the log of dollars committed divided by the number of limited partners. This dependent variable indicates the magnitude of the investment that limited partners are willing to make in new funds or “the size of the bet.” Column (3) indicates the ability of funds without a prior fund track record (“first-time fund”)

to raise new capital. Fund sequence is included as a control indicating the number of similar funds launched by the firm in the past.

[Insert Table 7 near here]

The difference in difference estimator (Post 2005*EUFund) for each regression is positive and significant at the 1% level; moreover, the magnitude of the interaction coefficient is material. As the dependent variable is transformed using the natural log, the interpretation of the coefficients in columns (1)–(4) indicates that implementation of fair value reporting caused roughly 50% less capital to be raised by private equity firms across each measure of access to capital. This result is consistent with the direct effect of disclosure noted in Lambert et al. (2007); that disclosure impacts investors' assessed covariance with other firms' cash flows, which is non-diversifiable. The finding that fair value increases market beta and potentially removes alpha from reported returns and the corresponding downward effect on access to capital suggests empirical results unique to the fair value literature. Typically better disclosure leads to lower costs of capital in public markets and a likely lower cost of accessing capital. This result is unique to the literature on fair value reporting and seems to confirm the findings of Lambert et al. (2007) on the direct effect of disclosure, revealing how cash flows move with the market.

Size, sequence, year, and first-time fund status are significant determinants of fund inflows and are well specified (coefficients load in the expected direction). EU Funds in general raise less capital than US firms, as noted in Table 7. Funds late in a sequence are likely to raise capital with greater ease, given their track record. As expected, first-time funds have more difficulty accessing capital because they are unproven.

In untabulated results, I use a probit regression to capture the likelihood that a firm will go to market to fundraise. Results indicate a negative coefficient on the experimental variable, revealing that firms implementing the new accounting standard are 60% less likely to solicit capital in the post-adoption period. In each regression, results are consistent with Hypothesis 2: Private equity's access to capital is lower under redefined fair-value reporting than under the prior method of reporting.

7 Additional Tests

7.1 Field Survey and Interviews

For supplementary analysis of the change in correlations, I use three data sources: Bloomberg for public private equity index returns, Cambridge Associates, and survey data from institutional investors. Bloomberg provides S&P Index returns for 19 public private equity firms, which serve as a proxy for economic correlations. For my sample of private equity quarterly index returns, I obtain data from Cambridge Associates benchmarking database. This database is frequently cited in industry publications and is used by private equity industry associations and institutional investors to assess industry performance (Harris et al., 2012). The Cambridge Associates database also provides information on industry-wide private-equity returns since 1986. The benchmarks include private equity funds in Cambridge Associates' client portfolios and private equity funds who participate voluntarily.

I also explore changes in correlations with industry benchmarks over time. Under a simple approach, correlation is calculated using Cambridge Associates quarterly private equity benchmark returns to a public equity market index. I compare the correlation of the same benchmark in the periods before and after the shift to fair-value accounting and observe an average period correlation increase of 21.4%. I then calculate the correlation of 16 public private equity firms with the S&P 500 representing the economic correlation (available after 2007). The prior accounting approach has a much lower correlation than do the periods of new fair value reporting. Moreover, index correlations are much closer to public private equity firms, suggesting that economic correlations are higher under prior accounting regimes.

Finally, I survey 30 institutional investors and consultants about historical mean variance optimization assumptions. Every year, limited partners and investment consultants generate assumptions about portfolio assets expected return, variance, and correlation. These capital market expectations serve as the motivation for long-term portfolio holdings and rebalancing. From these assumptions, I gain insight into how the shift in accounting standards has impacted institutional investors' view of private equity assets. Specifically, I examine whether fair value reporting has indeed changed the expected comovement of assets with public markets. From these discussions, it is clear that any significant changes in assumptions driven primarily by changes in the analysts making the calculations of at each firm. Moreover, at the firms in question, the average expected correlation of private equity to equity markets in 2004 is 50%, steadily increasing to an average of 80% by 2012. This finding

suggests that managers' understanding of private equity diversification is indeed attributable in part to accounting.

8 Resolving Private Equity's Diversification Illusion

To summarize the empirical results up to this point, private equity firms implementation of redefined fair-value measures increases the reported economic comovement of private equity assets with public markets. Redefining fair value also seems to identify and address private equity's diversification illusion. Fair value accounting in this setting improves disclosure in that it impacts investors' assessed covariance with other firms' cash flows (Lambert et al., 2007). However, it is difficult to determine to what degree fair value reporting represents a solution to private equity's diversification illusion. Many analysts have pointed out that private equity groups in both the United States and Europe did relatively modest write-downs in the immediate aftermath of the financial crisis but then did a long series of write-downs in the subsequent quarters, even as public equity markets returned to health. This pattern suggests that, despite the best efforts of financial regulators, private equity groups continue to engage in the smoothing of returns, leading to depressed correlations and incorrect investment decisions. The results of this study indicate that fair value reduces these effects, but the question remains: how much of the diversification illusion is resolved by redefining fair value? Accounting information perfectly reflecting the economic comovement is likely to be prohibitively costly and not optimal for financial reporting. The improvement that this paper identifies is probably a second best solution: accounting information gets closer to reporting the economics of the business, but remains slightly off.

One firm provides anecdotal evidence. 3i Group is the only publicly traded buyout firm for which we can observe both the stock's economic returns and reported returns reflecting the shift in accounting between 2000 and 2012. It is important to note that though the firm's operations are similar to those of firms in the sample, it operates in an entirely different information environment. The information voids that plague private equity reporting do not characterize 3i Group's process; it is a public company, and its investors benefit from having analysts, thousands of investors, and liquidity to price securities daily. By contrast, non-public private equity investors have access to a sliver of the information that public firm investors enjoy. Private equity's information environment will typically consist of a 5–10 page quarterly audited financial statement with updated accounting information and possibly a telephone conversation with firm management.

Figure 5 and Figure 6 illustrate the difference between accounting and economic correlations using

3i Group as an example. Figure 5 presents the quarterly indexed returns for 3i Group’s fund accounting return, stock return, and MSCI World return. At first glance, the volatile stock return in Figure 5, which exhibits a sharp spike and decline around Q2 2000, might appear to exhibit the lowest correlation with market returns. By contrast accounting returns seem to remain close to the market index. However, because correlation entails the comovement (direction) of returns in a given period, the Q2 2000 stock spike and decline is actually quite correlated with equity markets in Figure 6, at about 80%. In contrast the accounting return, which seems to track closely with the index, actually moves in opposite directions in several quarters, causing the accounting return correlation in Figure 6 to dip down to negative 80%. If we assume that the publicly traded stock return is a proxy for true economic movement, there is a persistent, significant difference between accounting and economic correlations in Figure 6. The portion of Figure 6 that shows a negative correlation up to 80% represents a period when 3i Group’s stock and equity markets both posted gains and losses in returns while accounting correlations maintained “conservative” reporting, not moving in sync with markets.

[Insert Figure 5 & Figure 6 near here]

In 2006, 3i Group implemented IAS 39, which caused accounting returns during the financial crisis to comove more with public markets. While the difference between the stock and accounting correlations of 3i Group in Figure 6 after 2006 is still significant, the difference between its accounting correlations during the 2000–2002 market swings and at the end of 2008 and during the first half of the 2009 financial crisis is dramatic. This anecdotal evidence supports the thesis that fair value improves the reported comovement of private equity returns.

Global financial regulators’ insistence that private equity groups implement fair value reporting seems to be helping phase out private equity’s diversification illusion. Fair value will not eliminate private equity firms’ practice of return smoothing, but fair value reporting seems to be bringing accounting returns more in line with the economics of investment.

9 Conclusion

My empirical results are consistent with the main hypothesis of this paper: that financial reporting has created a diversification illusion for private equity assets, and that fair value helps to mitigate this illusion. First, I found firms that implemented fair value standards to be reporting twice the market beta as a result of the standard. Excess return alpha also disappears. Not only do assets move

more in sync with the market than previously reported, but managers also benefit from transferring beta returns to alpha returns. Additionally, I find correlations dramatically increased after fair value adoption. When I examine access to capital, those firms adopting redefined fair value standards exhibit a lower propensity to raise capital, raise less capital overall, raise less capital each day they are in the market, and raise less capital per investor.

My analysis and results make several contributions. First, my results provide insight into the private equity diversification illusion. Prior to the advent of fair value standards, best practice fair value estimates provided a diversification illusion to limited partner investors by not updating asset values, causing returns to look more diversified than the underlying economics. After implementation of the new standard, correlations increased and private equity firms' propensity and ability to attract new capital commitments decreased. The presumed diversification benefits of private equity for institutional investors effectively shrank with implementation of fair value. For the private equity literature more broadly, my study also contributes a set of measures of access to capital previously unexplored by the literature.

Second, the results inform fair value research on FAS 157. Prior research on fair value accounting has primarily examined firms only a small portion of whose balance sheets were impacted by the standard. In the private equity setting, a firm's entire balance sheet is impacted by the standard; also, the majority of assets are highly illiquid Level 3 assets, which require more significant mandated assumptions by new fair value standards. My results are largely consistent with the notion that fair value standards improve the reporting environment.

Third, my analysis and results have normative implications for the impact of public accounting standards on private firms. Specifically, this study serves as a laboratory in which to examine how public accounting standards impact private firms. For private equity firms, where incentive alignment might seem to justify an exception to fair value GAAP, it is not clear that such an exemption is warranted. The results address an important topic facing the IASB and FASB: providing private firms potential exemptions from public GAAP. Despite scant research on the topic, the FASB formed the Private Company Council (PCC) in 2012 to explore GAAP exemptions for private firms. Though a number of private firms influenced the FASB, the move was motivated in part by private equity firms' objections to implementing FAS 157.¹⁴ While incentive alignment is probably high between pension fund managers and private equity managers as noted in the lobbying for private GAAP, it is not

¹⁴One of the nine PCC board members is a private equity manager. None of the letters from private equity firms to the FASB supported the FAS No. 157 fair value standard.

clear that pension fund retirees incentives are fully aligned with a pension fund manager's incentive to smooth returns through private equity investments. Accounting standard setting bodies should weigh private firm exemptions from public GAAP with care. Even in a setting like private equity, in which there appears to be strong incentive alignment, opportunities still exist to inform investors via accounting. Moreover, given that institutional investment managers face additional incentives to report diversification derived from holding illiquid assets, accounting can help inform trustees and beneficiaries of those portfolios about the true extent of diversification.

Finally, practitioners unaware of the diversification illusion will be more aware of the shortcomings of using private equity's reported returns to create correlation assumptions for allocating capital and rebalancing their portfolios. Though fair value accounting seems to improve the information environment, private equity investments still exhibit smoothing effects by management caused by the diversification illusion. Overall results indicate several important considerations for academics, practitioners, and regulators involving the evaluation of private equity as an asset class and attributes of fair value reporting.

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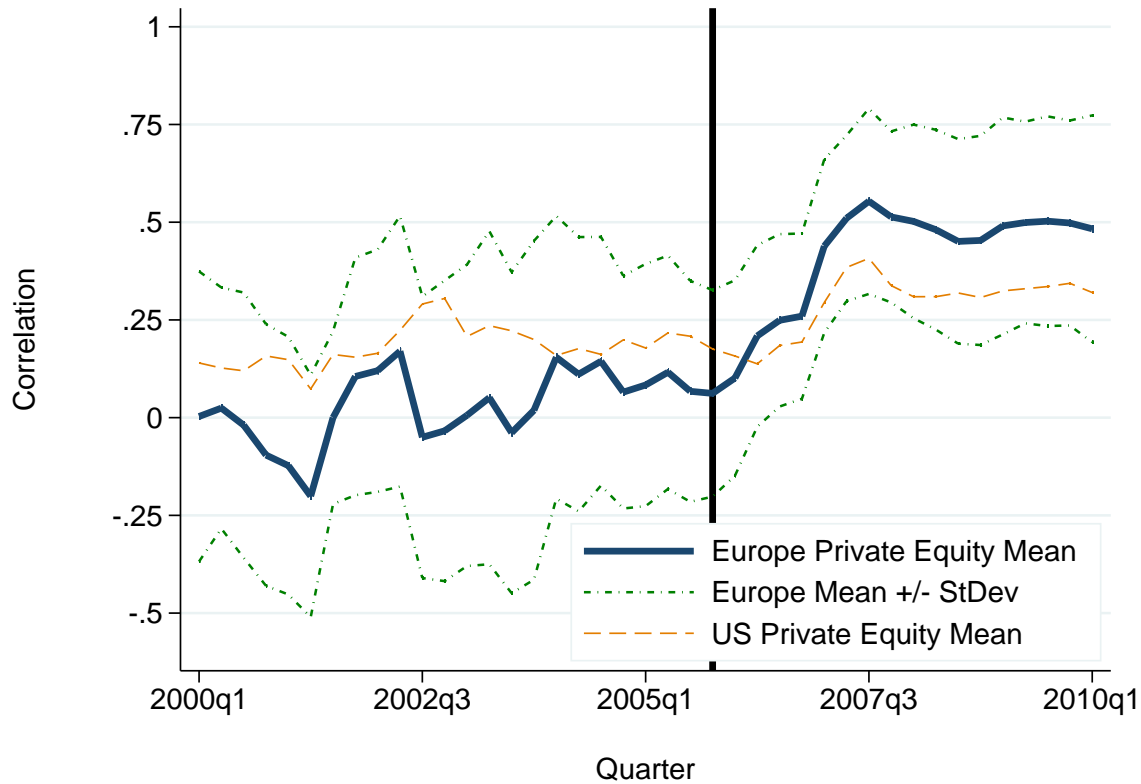
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Appendix A Variable Definitions

Dependent Variables	Definition
<i>r</i>	Return for a quarter calculated by summing end of quarter net asset value (NAV) plus distributions less capital called less prior period NAV. The resulting amount is divided by the sum of capital called and prior period NAV. Winsorized at 1%
<i>Corr</i>	The 3-year rolling quarterly correlation of returns with the MSCI World Index
<i>ln(Commit)</i>	Total dollars committed to invest with a private equity fund
<i>ln(Time)</i>	Time taken to close fundraising in days.
<i>ln (Commit / Time)</i>	Natural log of dollars committed to a fund divided by the number of days spent fundraising.
<i>ln (Commit /# LP's)</i>	Natural log of dollars committed to a fund divided by the number of Limited Partner investors in the fund.
Control Variables	
<i>rf</i>	Risk-free rate of return
<i>mkrf</i>	Market return less the risk-free rate of return.
<i>EU PE Firm</i>	Indicator variable equal to one if the private equity firm is located in Europe following IFRS standards.
<i>Post 2005</i>	Indicator variable equal to one if the fundraising time is after the deadline to implement IAS 39, December 2005 for international accounting standards.
<i>3 Year Return</i>	The quarterly rolling 3 year return across funds of a fund manager
<i>Fund Sequence</i>	Then number of similar investment funds the manager has brought to market
<i>First Fund</i>	Indicator variable equal to one if this is the first fund type invested by private equity firm
<i>Fund Size</i>	The current period net asset value of a fund
<i>Commit > \$5MM</i>	Indicates regressions exclude funds smaller than \$5MM USD
<i>Fund Vintage</i>	The year a private equity fund begins investing
<i>Launch Year</i>	The year a private equity fund begins fundraising
<i>Close Year</i>	The year a private equity fund closes fund
<i>VIX Index</i>	Measure of the implied volatility of S&P 500 index options. The VIX index is quoted in percentage points and translates to the expected movement in the S&P 500 index over the upcoming 30-day period, which is then annualized.
<i>Quarter Year FE</i>	Indicator variable equal to 1 if reporting in specific firm year quarter.

Figure 1: Three-Year Correlation of European Private Equity Returns with MSCI World Index



3 Year Correlation of European private equity firms' returns with the MSCI World Index before and after adoption of fair value accounting. The figure shows centered correlations of European private equity fund returns with the MSCI World Index over three years. The solid lines display the centered mean and upper/lower standard deviation of quarterly three-year rolling correlations. The vertical line demarcates the mandated adoption of fair value accounting by European private equity firms beginning in 2006. The upward trend in correlation after Q4 2005 and eventual plateau is a result of including redefined fair value estimates in each additional quarter. To illustrate, in Q1 2006 European private equity firms would report their first quarter of returns using redefined fair values, yet the calculation of the three year correlation would include 11 periods of returns under old reporting standards and only one quarter under new standards. As more returns are reported in following quarters using redefined fair value estimates, correlations shift to their new levels as a result of the standard.

Figure 2: Typical Structure of Private Equity Fund

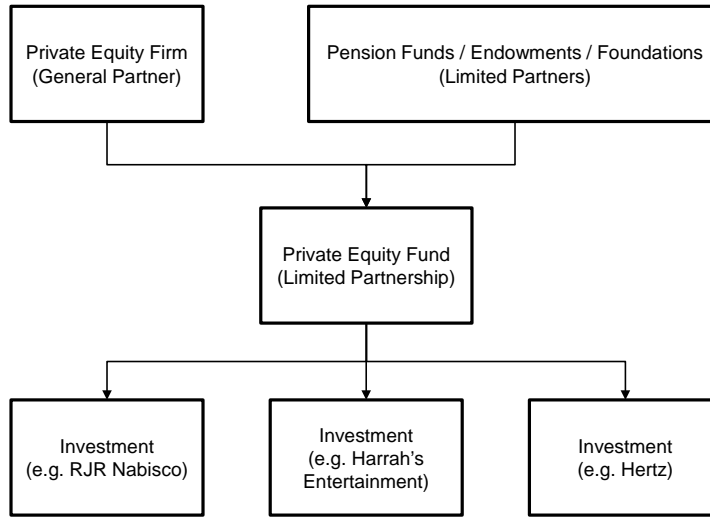
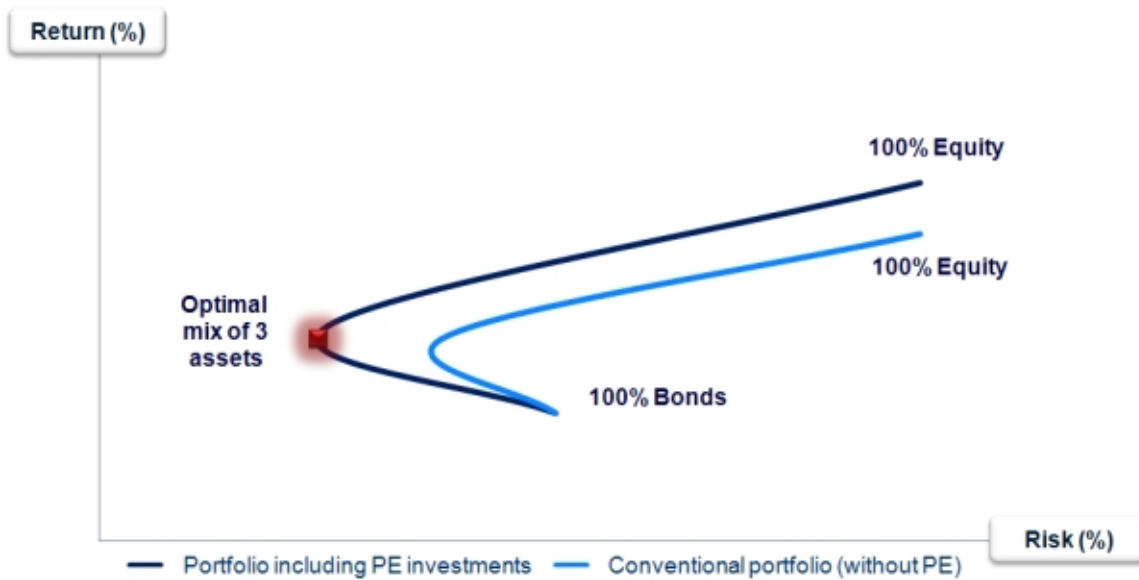


Figure 3: Illustration of Portfolio Diversification Using Private Equity to Shift the Efficient Frontier (from marketing materials)



Slide from Nexus Private Equity Partners marketing materials (Nexus Private Equity Partners, 2013) illustrating portfolio diversification with private equity by shifting efficient frontier

Figure 4: Private Equity Quarterly Returns

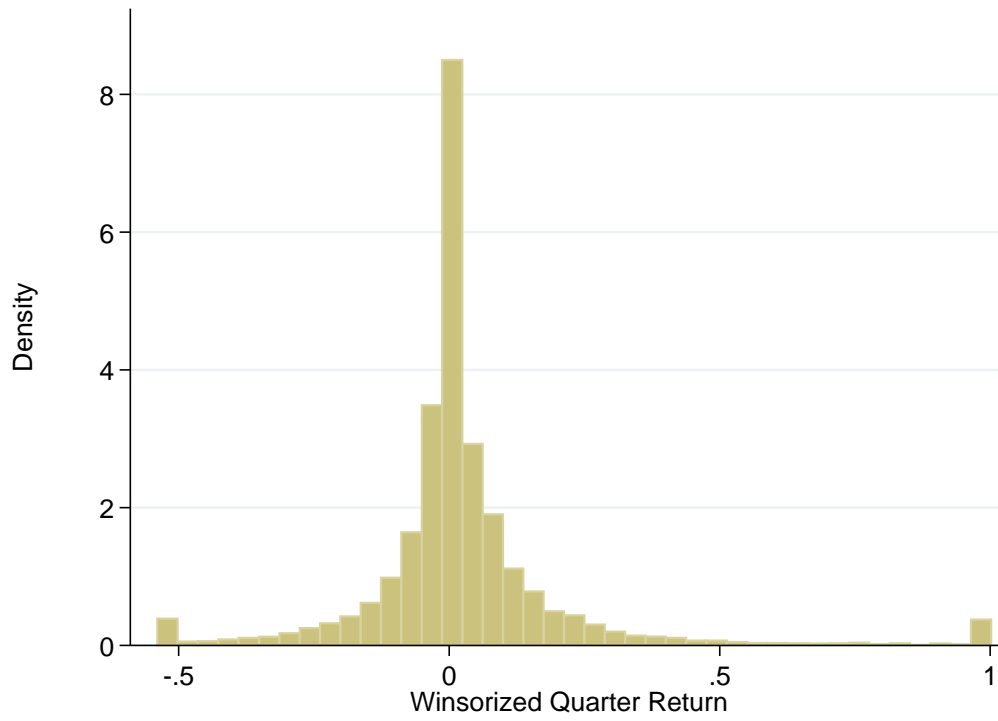


Table 1: Sample Selection and Frequency Statistics

Panel A: Private Equity Cash Flow Fund Selection			Funds	Firms
All Preqin Funds			2,245	1,022
Less: Non Buyout/Turnaround Private Equity Funds			1,535	651
Less: Funds closing before the year 2000			48	23
Less: Institutions not located within the US or Europe			46	25
Private Equity funds in the US			472	243
Private Equity funds in Europe			144	80
Total			616	323

Panel B: Private Equity Fundraising Selection			Funds	Firms
All Private Equity Firms in Capital IQ database			28,929	6,670
Less: Firms not identified as buyout or turnaround			15,197	3,907
Less: Firms missing fundraising start date			8,715	1,292
Less: Firms missing fundraising end date			3,708	668
Less: Firms Fundrasing before the year 2000			142	36
Less: Firms missing fund size			45	13
Less: Institutions not located within the US or Europe			110	80
Private Equity funds in the US			711	491
Private Equity funds in Europe			301	183
Total			1,012	674

Panel C: Annual Distribution						
Year	Preqin Fund Quarters			Capital IQ Fundrasing Closings		
	Europe	US	Total	Europe	US	Total
2000	74	385	459	14	28	42
2001	98	456	554	5	17	22
2002	119	465	584	14	28	42
2003	155	503	658	20	44	64
2004	148	646	794	30	66	96
2005	174	771	945	39	81	120
2006	223	926	1,149	33	94	127
2007	276	1,088	1,364	43	101	144
2008	309	1,219	1,528	36	85	121
2009	354	1,318	1,672	12	50	62
2010	370	1,328	1,698	22	55	77
2011	401	1,427	1,828	17	49	66
2012	408	1,364	1,772	5	24	29
Total	3,109	11,896	15,005	290	722	1,012

Table 2: Excess Quarterly Returns and Correlation

	(1)	(2)	(3)	(4)	(5)
	R	R-Rm	R-Rf	Rm-Rf	3-Year Correlation MSCI World Index
All Pre 2006	2.9%	1.2%	2.2%	1.0%	14.0%
	(3,994)	(3,994)	(3,994)	(3,994)	(1,516)
EU Funds Pre 2006	3.9%	1.8%	3.3%	1.5%	0.3%
	(768)	(768)	(768)	(768)	(245)
US Funds Pre 2006	2.6%	1.1%	2.0%	0.9%	16.6%
	(3,226)	(3,226)	(3,226)	(3,226)	(1,271)
All Post 2005	1.9%	4.2%	1.1%	-3.1%	18.0%
	(4,041)	(4,041)	(4,041)	(4,041)	(1,522)
EU Funds Post 2005	2.4%	4.8%	1.5%	-3.3%	21.1%
	(808)	(808)	(808)	(808)	(296)
US Funds Post 2005	1.8%	4.0%	1.0%	-3.1%	17.3%
	(3,233)	(3,233)	(3,233)	(3,233)	(1,226)
Average All	2.4%	2.7%	1.6%	-1.1%	16.0%
	(8,035)	(8,035)	(8,035)	(8,035)	(3,038)

The table includes absolute returns, excess returns and correlations for buyout funds from 2000 to 2008. Column (1) presents average quarterly returns of funds by region. Column (2) and (3) show the mean quarterly excess returns over the period calculated as the fund quarterly return minus the market return and the fund quarterly return minus the risk-free rate, respectively. Column (4) shows the excess return on the market, calculated as the market return minus the risk-free rate. Column (5) presents average 3-year correlation with the MSCI World Index. The number of fund observations are in parentheses below each mean.

Table 3: Private Equity Fundraising Access to Capital

	(1) Commit (\$MM)	(2) Time to Close (Days)	(3) Commit / Time to Close (\$MM/Days)	(4) Size of Bet (\$MM/#LP's)
All Pre 2006	755.9 (384)	420.6 (393)	7.0 (384)	50.3 (330)
EU Funds Pre 2006	482.2 (116)	396.8 (125)	5.9 (116)	37.0 (102)
US Funds Pre 2006	874.3 (268)	431.7 (268)	7.4 (268)	56.3 (228)
All Post 2005	1,171.1 (394)	413.3 (404)	12.1 (394)	80.0 (300)
EU Funds Post 2005	624.2 (110)	398.3 (118)	3.0 (110)	52.5 (81)
US Funds Post 2005	1,382.9 (284)	419.5 (286)	15.6 (284)	90.2 (219)
Average All	966.2 (778)	416.9 (797)	9.6 (778)	64.5 (630)

The table includes the fundraising data for individual buyout funds from 2000 to 2008. Column (1) presents the average new commitments to individual funds in millions of dollars. Column (2) and (3) show the average time taken to close a fund (in days) and the average dollars per day from fundraising, respectively. Column (4) shows the average dollars per day from fundraising. Column (6) shows the average dollars committed per investor. The number of fund observations are in parentheses below each mean.

Table 4: Descriptive Statistics on Private Equity Returns and Fundraising, 2000–2008

Panel A: Quarterly Valuation and Cash Flows (Preqin Fund Quarter)						
	Mean	Std Dev	Q1	Median	Q3	Skew
Dependent Variables						
Fund Return	0.02	0.22	-0.04	0.00	0.05	1.84
3-Year Correlation	0.16	0.35	-0.11	0.17	0.43	-0.11
Control Variables						
rf (Risk-free rate)	0.01	0.00	0.00	0.01	0.01	0.18
mkrf (Market less rf)	-0.01	0.09	-0.05	0.01	0.05	-0.60
EU PE Firm	0.20	0.40	0.00	0.00	0.00	1.53
Post 2005	0.50	0.50	0.00	1.00	1.00	-0.01
Fund Size (\$MM)	1306.21	2018.91	300.00	550.00	1500.00	4.47
Fund Sequence	2.85	2.16	2.00	3.00	4.00	0.62
Year	2005.01	2.48	2003.00	2006.00	2007.00	-0.51
Fund Vintage	1999.47	4.56	1997.00	1999.00	2003.00	-0.43
Panel B: Fundraising (Capital IQ Fund Level)						
	Mean	Std Dev	Q1	Median	Q3	Skew
Dependent Variables						
Commitment (\$MM)	966.54	2144.12	143.87	325.23	787.00	5.53
Time to Close (Days)	416.90	310.33	190.00	366.00	564.00	1.63
Commitment / Time to Close	9.56	66.11	0.35	1.05	3.75	17.26
Size of Bet (\$MM/#LP's)	64.47	101.36	15.38	30.23	69.19	4.00
Control Variables						
EU PE Firm	0.30	0.46	0.00	0.00	1.00	0.85
Post 2005	0.51	0.50	0.00	1.00	1.00	-0.03
Fund Sequence	2.55	2.05	1.00	2.00	3.00	1.71
First Fund	0.42	0.49	0.00	0.00	1.00	0.31
Launch Year	2005.19	2.23	2004.00	2006.00	2007.00	-0.68
Close Year	2006.24	2.41	2005.00	2007.00	2008.00	-0.52

The table presents the summary statistics from both the return (Preqin) and fundraising (Capital IQ) databases for years after 1999 and before 2009. Variable definitions are included in Appendix A.

Table 5: Modified Capital Asset Pricing Model

	Europe vs. US			
	Pre IAS 39	Post IAS 39	Post IAS 39	
	2000-2005	2006-2008	2007-2012	2000-2008
	(1)	(2)	(3)	(4)
EU Fund (<i>Alpha</i>)	0.030*** (0.007)	0.045*** (0.008)	0.008 (0.004)	0.030*** (0.007)
US Fund (<i>Alpha</i>)	0.018*** (0.003)	0.023*** (0.004)	0.016*** (0.002)	0.018*** (0.003)
mktrf (<i>Beta</i>)	0.223*** (0.044)	0.446*** (0.038)	0.202*** (0.019)	0.223*** (0.044)
EU Fund*mktrf (<i>IAS 39 Beta</i>)	-0.03 (0.107)	0.470*** (0.092)	0.277*** (0.052)	-0.03 (0.107)
Post				0.01 (0.005)
EU Fund*Post				0.01 (0.011)
Post*mktrf (<i>IAS 39 Beta</i>)				0.222*** (0.059)
EU Fund*Post*mktrf (<i>IAS 39 Beta</i>)				0.503*** (0.143)
N	3,994	4,041	9,862	8,035
adj. R ²	0.02	0.06	0.05	0.04

Standard errors in parentheses; ***, **, and * indicate significance at the 0.001, 0.01, and 0.05 levels, respectively.

$$R - rf = \alpha_1 EU Fund + \alpha_2 US Fund + \beta_1 mktrf + \beta_2 EU Fund \times mktrf + \beta_3 Post + \beta_4 EU Fund \times Post + \beta_5 Post \times mktrf + \beta_6 EU Fund \times Post \times mktrf + \epsilon$$

Where:

R - rf = Private equity fund quarterly return less risk-free rate.

mktrf = Quarterly return on value-weighted market portfolio of global common stocks minus the one month U.S. T-bill rate (source Fama/French data library).

[EU/US] Fund = Indicator variable equal to 1 if the firm follows accounting standards from US or EU and 0 otherwise.

Post = Indicator variable equal to 1 if the observation is drawn from the post-adoption-period earnings distribution and 0 otherwise.

The constant is suppressed as indicator variables for each fund region category is included indicating the alpha attributable investment managers. Standard errors are clustered by fund. Columns 1-4 display results for funds in Europe and United States. Columns 1 and 2 are from the first quarter of 2000 through the fourth quarter of 2005. Column 3 is from the first quarter of 2006 through the fourth quarter of 2008. Columns 4 include data from 2000 to 2008. The shift to redefined fair value for Level 1 and Level 2 assets (both use quoted market prices) would mechanically increase the comovement of an asset. However, in this setting, private equity firm balance sheets are entirely made up of Level 3 assets which use unobserved (typically internal) inputs. All variable definitions included in AppendixA.

Table 6: Shifting Correlation

	Europe vs. US	
	3-Year Correlation	3-Year Correlation
Post 2005 * EU Fund	0.190* (0.082)	0.194*** (0.074)
Post 2005	0.034 (0.105)	.179*** (0.047)
EU Fund		-.174* (0.051)
Fund Sequence		0.006 (0.010)
Fund Vintage		-0.003 (0.005)
Fund Size		0.000*** (0.000)
Fund FE	Yes	
Quarter Year FE	Yes	Yes
Quarter Time Trend	Yes	Yes
N	3,038	3,038
R ²	0.09	0.11

Standard errors in parentheses; ***, **, and * indicate significance at the 0.001, 0.01, and 0.05 levels, respectively.

$$Corr = \alpha + \beta_1 Post + \beta_2 EUFund + \beta_3 Post \times EUFund + Controls + \epsilon$$

Where:

Corr = Three-year rolling correlation of private equity firm returns with the MSCI World Index.

Post = Indicator variable equal to 1 if the observation is drawn from the post-adoption-period earnings distribution and 0 otherwise.

EUFund = Indicator variable equal to 1 if the firm follows IASB accounting standards and 0 otherwise.

Controls = Quarter-year fixed effects, firm fixed effects, domestic economic correlation with the MSCI World Index.

The table presents the panel regression with standard errors from 3 year rolling private equity fund quarterly correlations with the MSCI world index. The panel data is used for years after 1999 and before 2009. All variable definitions included in Appendix A.

Table 7: Access to Capital

	Predicted Sign	Europe vs. US			
				First Time	
		(1)	(2)	Fund (3)	Size of Bet (4)
Post 2005* EU Fund	-	-0.600** (0.23)	-0.677** (0.26)	-0.744* (0.38)	-0.620** (0.20)
EU Fund	-	-0.21** (0.18)	-0.19** (0.19)	-0.24** (0.26)	-0.19*** (0.14)
Fund Sequence	+	0.287*** (0.03)	0.323*** (0.04)		0.133*** (0.03)
First Fund	-	-0.278* (0.14)	-0.23** (0.16)		-0.363** (0.12)
VIX Index		Yes	Yes	Yes	Yes
Year FE		Yes	Yes	Yes	Yes
Commit>\$5MM		Yes	Yes	Yes	Yes
Close Year<2009			Yes	Yes	Yes
N		1,012	778	324	630
R ²		0.21	0.20	0.03	0.20

Standard errors in parentheses; ***, **, and * indicate significance at the 0.001, 0.01, and 0.05 levels, respectively.

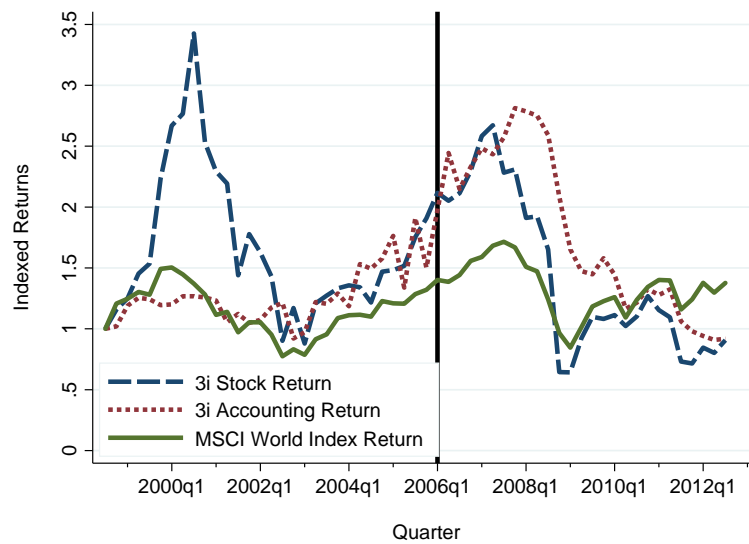
$$Access\ to\ Capital = \alpha + \beta_1 Post + \beta_2 EU\ Fund + \beta_3 Post \times EU\ Fund + Controls + \epsilon$$

Where:

- Access to Capital = Log dollars committed divided by days spent soliciting capital; log dollars committed divided by number of institutional investors; or an indicator variable equal to 1 if the observation was soliciting capital during the period and 0 otherwise.
- Post = Indicator variable equal to 1 if the observation is drawn from the post-adoption-period earnings distribution and 0 otherwise.
- EUFund = Indicator variable equal to 1 if the firm follows IASB accounting standards and 0 otherwise.
- Controls = Fund sequence, first fund indicator, year time trend, Year FE, and private equity investment demand.

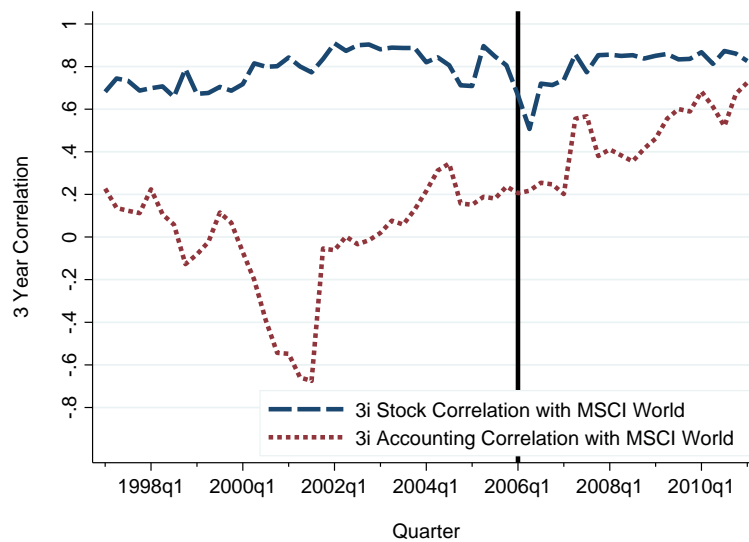
The table presents the cross-sectional regression of access to capital for private equity funds. All variable definitions included in Appendix A.

Figure 5: Indexed Returns for 3i Group’s Stock Return, 3i Group’s Fund Accounting Return and MSCI World Return



3i Group’s stock returns, accounting returns and the MSCI World Index return indexed at 1 in Q1 1999. The vertical line in 2006 identifies the start of the mandated adoption of fair value accounting for European Private equity firms.

Figure 6: 3i Group’s Stock Return Correlation vs. Fund Accounting Return Correlation with MSCI World Index



3i Group’s stock and accounting three year correlations with the MSCI World Index (centered). The 2006 vertical line identifies the start of the mandated adoption of fair value accounting for European Private equity firms. The significant negative swings in 3i Group’s accounting correlation reflect the smoothing caused by historical fair value accounting best practices in private equity. The lack of a similar negative swing in accounting correlations during the financial crisis suggests new fair value accounting definitions better reflect systematic risk.