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Beyond volatility: Are there better ways to measure risk?

Too many LPs are focusing on volatility as a key indicator of risk – a measure that is unsuited to liquid markets, according to consultancy Wellershoff and Partners.

By **Rod James** - 4 hours ago

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Limited partners need a different set of tools to measure the risk of their private portfolios, a report by Wellershoff & Partners has concluded.

For many LPs, volatility has become the main metric for measuring the risk of their private portfolios. This is based on a misapprehension, argues the Zurich-headquartered consultancy in *Beyond volatility: Five practical ways to measure private markets risks.*

For volatility to tell you anything about risk, the asset in question has to be traded freely and frequently, which private equity assets are not, the report argues. Volatility also relies on the assumption that change is inherently bad or caused by something negative, which does not readily apply to the asset class.

"If an asset price regularly appreciates as a consequence of improving fundamentals, this change is positive. It is not a risk," the report argues. "[Conversely], the word 'stable' can just as well mean 'stale'. Indeed, price stability may hide the degradation of an asset, undermining the formation of an equilibrium price and preventing any trading."

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The misuse of volatility as a measure of risk is driven by investment advisors applying sophisticated tools designed for public markets to their private equivalents, said Wellershoff partner Cyril Demaria. The quality, quantity, frequency and granularity of private markets data is much patchier, particularly outside of US buyout and US venture capital.

"There is some pressure [from regulators] to come up with some form of highly sophisticated risk measurement because they are used to seeing it from other segments of the financial world," he said. "If you spend three years developing very efficient tools that work in the listed world, why spend all this time and money again for something which as yet represents a small portion of your portfolio?"

Wellershoff suggests a combination of five alternative measures of risk:

Investment strategy risk

- Looking by vintage year at how the pooled average multiple of the invested capital of funds in a given strategy has changed over time.
- The indicator of risk can be calculated as the spread between the highest and lowest points.
- Helps identify when strategies have generated losses and under which circumstances.

Fund investment risk

- Looking at individual funds in a strategy to see which have lost capital and how much they lost on average.
- The indicator of risk is calculated by placing each fund in a bracket defined by their performance, based on a measure such as internal rate of return.
- Can show if the frequency or size of a strategy's losses match the investor's risk appetite. For example, an analysis of 953 US venture capital funds shows that 31.7 percent have returned an IRR of less than zero.

Active funds risk

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- Focusing only on active funds.
- The indicator of risk comes from plotting the quarterly TVPI of your active funds and comparing it with the average of your realised funds on a quarter-by-quarter basis.
- This allows you to compare the evolving performance of active funds to their realised equivalents, allowing you to spot potentially underperforming assets early.

Fund selection risk

- Focusing on the skill of a fund investor.
- The indicator is the spread of the multiple of invested capital of two groups of funds, such as the bottom and top quartile.
- Gives an idea of the source of risks. For example, if the top and bottom quartiles move in the same direction, the cause could be due to market movements. If they diverge, it could be manager-related.

Liquidity horizon risk

- Measuring duration- or time-to-liquidity risk.
- The indicator is the spread between the shortest and longest average duration registered in a given vintage year.
- Gives an idea of when you can expect to get your money back, helping manage risk as it relates to the availability of cash reserves.

Having to make five calculations to manage your exposure might not be as simple as the current, single-figure measure for volatility, and Demaria concedes that changing the norm will be a challenge.

"It's very difficult to step back and say, 'My fancy tools are not usable anymore, I should go again from the start,'" he said. "Even from the academic literature, we see it's hard to give up the fancy tools and use the rough ones. The fact is, the fancy tools don't work."

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