📄 Download This Paper (Delivery.cfm/SSRN_ID1147591_code337309.pdf?abstractid=1111796&mirid=1)

Open PDF in Browser (Delivery.cfm/SSRN_ID1147591_code337309.pdf?abstractid=1111796&mirid=1&type=2)

☆ Add Paper to My Library

Share: f 𝕏 ✉ 🔗

The Hazards of Using IRR to Measure Performance: The Case of Private Equity

23 Pages
Posted: 27 Mar 2008
Last revised: 23 Sep 2009

Ludovic Phalippou (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=337309)
University of Oxford - Said Business School

Abstract

Most of the investments in asset classes such as real estate and private equity (include buyout, mezzanine and venture capital) are made via private partnerships. Measuring performance in these partnerships is important for investment allocation decision as well as for compensation. The main performance measure that is used in practice is the Internal Rate of Return (IRR). However, it is known that the effective Rate of Return (RoR) experienced by investors differs from IRR. This difference means that the incentives of the asset managers partly differ from the objective of the investors.

This article makes two main contributions to the literature on performance evaluation. First, it shows the problems that arise when IRR is used as a performance measure in the context of private partnership investments. It shows that in addition to the well-known pitfalls, IRR leads to a number of issues. First, it provides severely distorted incentives for the timing of cash flows and grouping of funds. Second, it biases upward volatility estimates. Third, at least for venture capital and buyout investments, simple average performance measures are significantly upward biased. Fourth, in a situation where "kick-backs" can happen, the use of IRR provides incentives to alter significantly cash flow amounts. The second contribution is that it describes in details a solution. While it is known that using Modified IRR (labeled MIRR), or, equivalently, Net Present Value, (labeled NPV) largely tackles the well-known pitfalls of IRR, its practical implementation in a private partnership context is not obvious. I show how MIRR can be implemented at the investment level and at the fund level in order to not only tackle the well-known pitfalls of IRR but also provide the right incentives to the fund managers.

Suggested Citation >

Show Contact Information ⌐

11 References

1. Z Bodie , A Kane , A Marcus
   Investments Posted: 2005

2. R Brealey , S Myers
   Principles of Corporate Finance, Sixth Edition Posted: 2001

3. J Cochrane
   The Risk and Return of Venture Capital
   Journal of Financial Economics , volume 75 , p. 3 - 52 Posted: 2005
   Crossref (https://doi.org/10.1016/j.jfineco.2004.03.006)

4. A Damodaran
   Corporate Finance
   Theory and Practice Posted: 2001

Citations

Fetch Citations

Paper statistics

DOWNLOADS	10,116
ABSTRACT VIEWS	27,820
RANK	1,065

41	Citations
11	References

PlumX Metrics

(https://plu.mx/ssrn/a/?
ssrn_id=1111796)

Related eJournals

Social Sciences Education eJournal (https://papers.ssrn.com/sol3/JELJOUR_Results.cfm?form_name=journalBrowse&journal_id=3128507)

Follow ⓘ

Finance Education eJournal (https://papers.ssrn.com/sol3/JELJOUR_Results.cfm?form_name=journalBrowse&journal_id=282)

Follow ⓘ

Recommended Papers

Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=218175&rec=1&srcabs=1111796&pos=1)
By Steven N. Kaplan (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=16313) and Per Strömberg (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1286984)

Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=228134&rec=1&srcabs=1111796&pos=2)
By Steven N. Kaplan (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=16313) and Per Strömberg (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1286984)

Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=46909&rec=1&srcabs=1111796&pos=3)
By Ronald J. Gilson (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=17982) and Bernard S. Black (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=16042)

View more >

Feedback 💬

Submit a Paper > (https://hq.ssrn.com/submission.cfm)

f (https://www.facebook.com/SSRNcommunity/)
in (https://www.linkedin.com/company/493409?
trk=tyah&trkInfo=clickedVertical%3Acompany%2CentityType%3AentityHistoryName%2CclickedEntityId%3Acompany_493409%2Cidx%3
🐦 (https://twitter.com/SSRN)

(http://www.elsevier.com/)

We use cookies to help provide and enhance our service and tailor content.

To learn more, visit Cookie Settings.   ⚡

(http://www.relx.com/)

(https://papers.ssrn.com/sol3/updateInformationLog.cfm?process=true)