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How Much for a Haircut? Illiquidity, Secondary Markets, and the Value of Private Equity

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Abstract


Limited partners (LPs) of private equity funds commit to invest with extreme levels of illiquidity and significant uncertainty regarding the timing of capital flows. Secondary markets have emerged which alleviate some of the associated cost. This paper develops a subjective valuation model incorporating these institutional features. Model-implied breakeven returns are close to empirically observed average fund returns for moderately risk tolerant LPs with private equity allocations up to 40%. Likewise, optimal portfolio allocations for these LPs are similar to those observed in practice. More risk averse LPs optimally place little, but not zero, weight on private equity.

Keywords: private equity, performance, secondary market, liquidity, value, risk

JEL Classification: G11, G12 , G23, G24

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