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Interpretive Guidance for Private Equity

Introduction and Scope

Private equity has become an increasingly mainstream asset for sophisticated investors. Private equity entails investment in nonpublic companies at various stages of development and encompasses venture, buyout and mezzanine investing. Investors typically invest in private equity assets either through individual funds, usually limited partnerships with a specified investment stage and geographic focus, or via a fund-of-funds, through which commitments are made to multiple underlying funds. Some investors may also invest directly into unquoted companies, often on a co-investment basis alongside individual funds. Secondary investment – the acquisition of an interest in a private equity fund from the original investor before the end of the fund's fixed life—is also embraced within the broad definition of private equity.

When investing in private equity through funds or funds of funds, an investor makes an initial commitment of capital that is then "called" or drawn down as the investment managers of the underlying funds find investment opportunities. Capital is chiefly returned to the investor via distributions on the sale or recapitalization of individual unquoted companies by the underlying funds, although in some cases investors may also receive earnings-derived distributions.

Private equity investment vehicles typically have a limited life (i.e., they are not open-ended) and are generally illiquid. The ultimate return of the investment is not known until the fund or partnership is finally liquidated. Because of the unique characteristics of this asset class, additional performance reporting requirements are needed. The GIPS standards, which are based on the principles of fair representation and full disclosure, seek to provide prospective clients with the critical pieces of information needed to evaluate the firm's performance.

The concept of fair value used in the GIPS standards private equity provisions mirrors the fair value principles used in international accounting standards. In order for any performance-reporting requirements to be meaningful, the return calculations must be based on fair value of the underlying securities. Unlike investments in publicly traded securities where there are well-defined prices, it is difficult to find an objective valuation of private equity investments. This difficulty has led to harmonized guidelines (developed by the British Venture Capital Association (BVCA), European Venture Capital Association (EVCA), and the U.S. Private Equity Industry Guidelines Group (PEIGG)), developed in an attempt to standardize the methods used for valuing these assets. *The GIPS Private Equity Valuation Principles outline high-level guidelines for valuation, whereas the various regional guidelines provide the supporting methodology.*

Recognizing that firms may not be able to gather historical valuations and/or records for transactions of private equity assets in order to create a five-year performance history, firms may link non-compliant performance for these assets for periods prior to 1 January 2006 to compliant performance with appropriate disclosure as to why the performance is not in compliance with the Standards.

Investment Structures

Limited Partnerships (GIPS private equity provisions are applicable)

The predominant vehicle in the global private equity industry is the independent, private, fixed-life, closed-end fund, usually organized as a limited partnership. These funds typically have a fixed life of 10 years that

can be extended by a pre-set number of defined periods (e.g., two one-year periods) upon agreement of the investors. It is termed a Closed-End Fund in that the number of investors/shares is fixed for the life of the fund and closed to new investors.

The limited partnership is a fund of pooled interests managed by a general partner who raises capital (i.e., committed capital or commitments) from outside investors (limited partners). The general partner charges an investment management fee, typically from one to three percent per annum on the total commitments raised. Most funds require at least a nominal one percent investment by the general partner. In addition, the general partner will take a profit split (known as the carried interest or simply the "carry") of usually 20 percent of profits.

The general partner will "call" the capital from its investors in tranches as needed for investment into underlying companies. These capital calls are also termed "drawdowns." Another unique feature of these types of vehicles is that any proceeds from investments must be distributed to investors; reinvestment is only acceptable if predefined terms appear in the contract between the general partner and the limited partners.

In this type of structure the cash flows are fairly easy to enumerate as the performance is calculated on the basis of the cash flows between the limited partner and the partnership. The investment management fee is typically charged on the total assets committed to the fund rather than on the value of the invested capital of the portfolio.

Direct Investments (GIPS private equity provisions are applicable)
Investments can be made in private equity assets directly, rather than via a fund or partnership. Direct investments are made both by institutions and by high-net-worth individuals. Many institutions making direct investments into unquoted companies do so on a co-investment basis alongside private equity funds in which they are limited partners, in line with a formal pre-set co-investment agreement.

Captive and Semi-Captive Funds (GIPS private equity provisions are not applicable)
The private limited partnership is not the only investment vehicle that makes private equity investments. Some vehicles are organized as captive vehicles or semi-captive vehicles. Captive refers to a fund that only invests for the interest of its owner organization. This parent may be a regular corporation, a financial corporation, insurance company, university, and so on. The salient feature is that the fund only invests its parent's capital—there are no outside investors. Corporate venture groups of technology companies are examples of this type of vehicle, although several insurance companies and investment banks also have similar vehicles.

The notable feature of this type of vehicle is that typically the vehicle is not a fixed-life investment pool—it is "evergreen" (i.e., a fund with no fixed cost basis as the parent can contribute additional capital or withdraw capital from the vehicle whenever it chooses). This lack of a fixed cost basis complicates the cash flow calculations because the cost basis fluctuates as the capital managed increases and decreases. The other problem is that a fund of this type charges no management fee to its owner and does not really have a "carried interest" profit split, although a few creative groups have compensation schemes for the investment officers that work in a similar manner to carried interest.

Another type of hybrid vehicle, called a semi-captive fund, mixes capital from both outside investors and the parent organization. These funds typically charge a management fee and carried interest to the outside investors and are usually closed-ended, as the number of investors is fixed, but a number of evergreen semi-captives also exist.

As such, captive and semi-captive structures are not comparable to private fixed-life limited partnerships on a net-of-fees basis. Therefore, the scope of the GIPS private equity provisions is in no way directed toward captive or evergreen funds within this industry. These structures must follow the general provisions of the GIPS standards.

Open-End Funds (GIPS private equity provisions are not applicable)

Another investment structure is an open-end public entity that acts much like a publicly-quoted mutual fund. The fund is a public investment vehicle traded on an exchange and priced daily. These vehicles typically operate much like a mutual fund or publicly-traded company and are not required to follow the GIPS private equity provisions, but must follow the general provisions of the GIPS standards.

Funds/Partnerships vs. Composite

Although most private equity investment vehicles are structured as limited partnerships or closed-end pooled funds, the GIPS standards are structured around the concept of composites. A composite is an aggregation of portfolios with a similar investment style or strategy. In relation to private equity, the composite is an aggregation of funds/partnerships with the same strategy and "vintage year" (year of first capital drawdown). In most cases, a composite will contain only one fund/partnership. If a firm has multiple funds/partnerships with the same vintage year and strategy, they must be combined into a single composite. A co-investment fund will most likely be placed in a separate composite from the underlying linked fund. Accordingly, firms should realize that all provisions and guidance related to composites apply to funds and partnerships. For example, when the Standards state that the cumulative annualized SI-IRR (since inception—internal rate of return) must be presented for the composite, because each composite will typically contain only one fund or partnership, this will be the same as the annualized SI-IRR for the fund or partnership. It is important to remember that the GIPS standards are primarily designed for presenting the firm's performance to prospective clients rather than reporting performance to an existing client.

It is also important for firms to realize that provision 3.A.1 states in part that, "All actual fee-paying discretionary portfolios must be included in at least one composite." Firms must understand that the GIPS standards are aimed at a firm-wide level of compliance and not just selected composites/funds.

Within the private equity asset class, the GIPS concept of "carve-outs" is not applicable. A carve-out is a subset of a portfolio's assets used to create a track record that reflects a narrow segment of a broader mandate. In particular, it could be argued that a fund-of-funds composite is invested across many separate strategies. Breaking out and showing the substrategies as stand-alone composites would be misleading because a prospective investor could not solely invest in the substrategies. Furthermore, the value added of a fund-of-funds manager is to aggregate across various fund strategies. If a manager would like to separately disclose the substrategies for comparison purposes, this information must be presented as Supplemental Information (See the Guidance Statement on the Use of Supplemental Information).

Input Data

As mentioned above, performance reporting is of little value unless the underlying valuations are based on sound valuation principles. The GIPS Private Equity Valuation Principles establish a broad foundation for valuing private equity assets. These broad principles can be supplemented with more detailed valuation guidelines such as the harmonized European guidelines. One of the goals of the GIPS standards is to improve comparability between firms. The GIPS Private Equity Valuation Principles help to achieve that goal by requiring that firms use the same fundamental principles as the core of their valuation methodology. The concept of fair value used in the GIPS Private Equity Valuation Principles is the amount at which an asset could be acquired or sold in a current transaction between willing parties in which parties each acted knowledgeably, prudently, and without compulsion. Fair value does not assume an intention or ability to sell at the date of valuation but is an estimate of the likely exchange price involving subjective judgments, which must be based on reasonable estimates of the company's current and future performance.

The GIPS standards require that portfolios be valued monthly beginning 1 January 2001, and beginning 1 January 2010, portfolios will be required to be valued at the time of any large external cash flow. Because the Standards require a SI-IRR for private equity assets, however, increased frequency in valuations will not result in increased accuracy of the return calculation. The Standards only require that annual returns be presented and therefore the only valuation that is needed is at the year-end. More frequent valuations are generally required for client reporting purposes and are considered good business practice. The GIPS private equity provisions recommend quarterly valuations because this will allow firms to report performance on a more frequent basis. Firms that do not value on at least a quarterly basis can only present performance through the prior year-end.

Calculation Methodology
An internal rate of return (IRR) reflects the effects of the timing of cash flows in a portfolio. The IRR is required for private equity assets because the firm controls the cash flows into and out of the portfolio. A time-weighted rate of return (TWRR) will not offer the best measure for an investor to compare returns between private equity funds because the TWRR will not capture the critical effects of cash flow management within the control of the private equity manager. Although the GIPS private equity provisions advocate that the IRR is the most accurate measure of performance for an individual private equity manager, it may not be so at higher levels of aggregation. In the case where an investor (e.g., a limited partner) is trying to calculate the return at a wider portfolio level, including a number of private equity funds, that investor has no control over the timing of any cash flows. In this situation of a wider portfolio, a TWRR is more applicable and will provide a comparability measure at a portfolio level with other private equity portfolios as well as other asset classes. It is inappropriate to directly compare IRR and TWRR figures to each other. This clarification is provided in recognition that the main purpose for the GIPS private equity provisions is to provide comparability between private equity firms and not necessarily to standardize the performance presentation of the investors.

The IRR is the annualized implied discount rate (effective compounded rate) that equates the present value of all of the appropriate cash inflows (paid-in capital such as draw downs for net investments) associated with an investment with the sum of the present value of all the appropriate cash outflows (such as distributions) accruing from it and the present value of the unrealized residual portfolio (unliquidated holdings). For interim cumulative return measurement, any IRR depends upon the valuation of the residual assets. The subperiod IRR, r, is calculated as follows:

$$0 = \sum_{i=0}^{n} CF_i \left(1 + \frac{r}{c}\right)^{-(ic)},$$

where CF is the cash flow for period i, n is the total number of cash flows, i is the period of the cash flow, c is number of annual cash flow subperiods (e.g., $c = 365$ for daily cash flows), and r is the subperiod IRR. The subperiod IRR is converted to the annualized IRR, R, as follows:

$$R = (1 + r)^{(1/c)} - 1 .$$

As discussed in the section on investment structures, the predominant private equity investment vehicle is the independent private fixed-life fund. The cash flows are easily identified and enumerated as the fund has a fixed-cost basis of investment. It is reasonable to assume that because this type of fund has a fixed life, the return on investment is fairly easy to calculate. Because of the straightforward nature of the cash flows and closed-end basis of the fund, there are rarely any intractable or mathematical problems, such as multiple IRR's or unbounded solutions that often arise from complicated cash flow streams.

One of the reasons IRR is preferred is that this type of partnership generally has a fixed number of investors and a fixed commitment basis and proceeds cannot be reinvested so the cost basis of investment does not increase and decrease as it would with an evergreen or open-end fund. An open-end fund can find its investment pool increased (decreased) as investors invest (withdraw) more capital or by the addition (withdrawal) of investors.

One of the basic tenets of performance attribution is that the manager not be rewarded or penalized by decisions outside of their control. In an open-end fund as mentioned previously, the timing of cash flows in and out of the fund is totally at the discretion of the investors. As a result, a time-weighted return will (paradoxically) remove timing of the cash flows out of the performance calculation. Accordingly, open-end funds must follow the provisions of the general GIPS standards and report a time-weighted rate of return.

In a private equity independent, fixed-life fund, the decisions to raise money, take money in the form of capital calls, and distribute proceeds are totally at the discretion of the private equity fund manager. Therefore, timing is part of the investment decision process and thus the manager should be rewarded or

penalized by those timing decisions—thus the need for a time-value of money measurement such as the IRR.

Firms are required to deduct carried interest, the investment management fee and any transaction expenses when calculating net-of-fees returns. As noted above, the carried interest can often have a greater impact than the actual investment management fees. In the case of investment advisors that have discretion over the selection of venture capital or private equity funds or partnerships for their clients, the investment advisor must calculate all returns net of all the fund or partnership investment management fees and carried interest. Investment advisor net-of-fees returns must, in addition, be net of all the investment advisor's fees, expenses, and carried interest.

Composite Construction

It is only appropriate to create composites that show a firm's capabilities or past performance with regard to a particular investment strategy. Firms must also separate funds with different vintage years into different composites. The following hierarchy may be helpful as firms consider how to define private equity composites:

Vintage Year
- *Strategy* (venture, buyout, generalist, mezzanine, fund-of-funds, other private equity)
  - *Substrategy* (size of fund, stage, etc.)
    - *Geography*

Firms must remember that the GIPS standards have formal requirements in place regarding composite construction, which can be found in Section 3 of the Standards. (In order to fully understand composite construction topics one should also read the *Guidance Statement on Composite Definition*). Of most importance, "firms are required to include *all* discretionary fee-paying portfolios (funds/partnerships) in at least one composite that is managed according to a particular strategy or style." Creating meaningful composites is critical to the fair representation, consistency, and comparability of performance results over time and among firms.

Disclosures

Firms are required to disclose the vintage year of each composite. The vintage year is the year in which the private equity fund or partnership first draws down or calls capital from its investors. The disclosure of the vintage year increases comparability by allowing prospective clients to understand the time frame when the fund was initiated. In addition, firms are required to disclose the final realization date of a composite for all closed (discontinued) private equity composites. Similar to the vintage year statistic, the final realization date also aids in determining the time frame that the partnership was in existence in order to determine the appropriate comparability of one investment to another. Firms are also required to disclose the investment strategy of the composite.

Firms are required to disclose the composite's unrealized appreciation or depreciation. This disclosure helps prospective clients determine the potential for returns to change in the future based on the potential changes in the valuation of the investments within the composite. Firms must also disclose the total committed capital (or capitalization). Total committed capital is the total value of capital that investors have agreed to invest.

In addition to requiring the use of the GIPS Private Equity Valuation Principles, the Standards require the firm to disclose if it complies with any other valuation guidelines (e.g., BVCA or EVCA). The valuation methodology disclosure is important to determine the comparability of different returns and other important statistical information. If valuation methodologies are substantially different, certain investments may not be able to be compared to one another without very precise and appropriate valuation adjustments. Firms are required to document their procedures for reviewing valuations and must disclose that those procedures are available upon request.

Presentation and Reporting

Firms are required to present the annualized Since Inception IRR (SI-IRR) for private equity composites. The firm is required to present an annualized SI-IRR for each year since the vintage year. Unless disclosed, calendar year period-ends are assumed. For example, assume a composite has a vintage-year date of 1 January 1999. As shown in the table below, the firm would present the SI-IRR for 1999, the annualized SI-IRR (covering 1999 and 2000) for 2000, the annualized SI-IRR (covering 1999–2001) for 2001, and the annualized SI-IRR (covering 1999–2002) for 2002. Periods less than one year must not be annualized.

Year	Annualized Gross-of-Fees SI-IRR (%)	Annualized Net-of-Fees SI-IRR (%)
1999	–5.2	–8.2
2000	10.3	7.3
2001	29.6	25.6
2002	22.4	18.3

When presenting private equity performance, firms are required to present both gross-of-fees and net-of-fees returns. Net-of-fees returns must be net of the investment management fee, carried interest (the management firm's portion of any realized gains as well as the implied carried interest component of any unrealized gains in the portfolio), transaction expenses, and any other fees. In general, in cases where an investor is not able to negotiate the investment management and/or administrative fees, it may be most appropriate to present performance returns net of the nonnegotiable fees. In addition, if any fees are paid outside of the fund vehicle, they still must be incorporated in the net-of-fees return. Firms must disclose when fees are paid outside of the fund vehicle.

For each year presented, firms are required to report paid-in capital to date, total current invested capital, and cumulative distributions to date. The paid-in capital to date is the amount of the total committed capital that the firm has drawn down (called) from investors. The total current invested capital is the amount of the paid-in capital that is actually invested in private equity assets. The total distribution equals the total amount of capital or income that has been returned to investors. This measure gives prospective clients an understanding of the amount of initial invested capital returned to investors relative to other composites with similar vintage years and strategies.

The internal rate of return is not the only useful metric used to gauge performance. It assumes, for example, that the residual value of a composite is totally liquid, whereas in reality, the residual value is the unrealized (and often illiquid) portion of the composite. For performance calculation there are one non-cash-flow item—residual value (net of investment management fees and carried interest)—and two cash flow items—drawdowns from limited partners (also referred to as capital calls or paid-in capital) and distributions (cash and/or stock) to limited partners.

These three components can be used to calculate the internal rate of return assuming the residual value is taken as a terminal cash flow value. Only part of the return, however, is actually realized (i.e., the distributions). Accordingly, realization multiples (such as the Distributions to Paid-In Capital or DPI) provide additional information as to how much of the return has actually been realized and how much is still unrealized.

The Standards require firms to report the investment multiple (Total Value to Paid-In capital or TVPI) and the realization multiple (DPI) for each year presented. The investment multiple is calculated by dividing the residual value plus distributed capital by the paid-in capital. The investment multiple gives prospective clients information regarding the value of the composite relative to its cost basis. The realization multiple (DPI) is calculated by dividing the cumulative distributions by the paid-in capital. The DPI is a measure of how much of the return has actually been returned to investors. In the early life of an independent fixed-life fund, the DPI will be zero until distributions are made. As the fund matures, the DPI will increase. Once the DPI is greater than one, the fund has broken even. A DPI of greater than one means that the fund has generated capital gains. In addition, firms must present the ratio of Paid-In Capital to committed capital (or

PIC multiple). This ratio gives prospective clients information regarding how much of the total commitments have been drawn down.

The private equity provisions also require the presentation of the Residual Value to Paid-In capital (RVPI). The RVPI is calculated as the residual value divided by paid-in capital. RVPI is a measure of how much of the return is unrealized. As a fund matures, the RVPI will increase to a peak and then decrease as the fund matures and eventually liquidates to a residual market value of zero. At that point, the entire return of the fund has been distributed.

If a benchmark is used, the private equity provisions require the presentation of a cumulative annualized SI-IRR for that benchmark that reflects the same strategy and vintage year as the composite. Firms must disclose the calculation methodology of the benchmark (e.g., monthly cash flows) and if a custom benchmark is used, how that benchmark is constructed. If no benchmark is presented, then the firm must disclose why no benchmark is appropriate. If a custom benchmark is used, then the firm must describe the benchmark creation and rebalancing process.

Application:

1. *What was the process for developing the GIPS private equity provisions and who was consulted?*

The GIPS Private Equity Subcommittee was drawn from professionals around the world with private equity experience in a range of industry roles. The provisions have circulated for public comment amongst investors, private equity firms and organizations, as well as other professionals with a private equity interest.

2. *How do the GIPS private equity valuation provisions relate to those of regional private equity organizations such as the EVCA, BVCA, PEIGG, etc.?*

The GIPS standards seek to encourage convergence of performance standards globally and find common ground in the difficult and subjective area of private equity valuations. The GIPS private equity provisions include a commitment to the fair value approach and provide guidance on a number of issues but do not seek to develop independently a full set of guidelines on valuation methodology.

3. *If my firm only manages private equity must I comply with the GIPS standards in its entirety to claim compliance?*

The claim of compliance with the GIPS standards is voluntary. However, claiming compliance requires adherence to all aspects of the Standards. Firms managing private equity assets will want to pay particular attention to provisions contained in the Fundamentals of Compliance section of the GIPS standards.

4. *Will the GIPS private equity provisions provide assurance of comparability between funds?*

The provisions should ensure consistency in the presentation of the most important performance measures. Interim valuations will remain subjective and precise comparability cannot be assured. Marking to Fair Value is, however, designed to give a much more consistent approach to valuation and thereby improve comparability.

5. *Will the GIPS Standards private equity provisions be endorsed by trade associations?*

Trade associations were consulted during the development of the private equity provisions and they are expected to support the new provisions.

6. *Do the GIPS private equity provisions override accounting requirements and standards?*

The GIPS private equity provisions are a minimum level of reporting to investors. They do not override any statutory obligation or accounting standard that may arise in any particular jurisdiction.

7. *How should tax payable be treated?*

In general, any taxes payable by the investors should be ignored in calculating the returns both net- and gross-of-fees. Some small withholding tax or income tax deducted prior to receipt by the fund or payable by the fund may arise and the net- and gross-of-fees cash flows should be reduced by these amounts.

8. *How is fair value defined and how does this compare with accounting standards?*

The concept of fair value used in the GIPS private equity provisions mirrors the fair value principles used in international accounting standards. Fair value is the amount at which an asset could be acquired or sold in a current transaction between willing parties in which parties each acted knowledgeably, prudently, and without compulsion. Fair value does not assume an intention or ability to sell at the date of valuation but is an estimate of the likely exchange price involving subjective judgments, which must be based on reasonable estimates of the company's current and future performance. In sales of private company holdings, a buyer is likely to reflect in the price any restrictions applying to the asset, including the extent to which liquidity can be achieved in any subsequent resale.

9. *Can managers value investments on a cost basis and still be compliant with the fair value approach?*

A general policy of holding investments at cost is not compliant with the GIPS standards. In some circumstances, cost is the best estimate of fair value, for example, where it reflects a recent arm's length transaction with no subsequent events or information affecting its validity. There may also be circumstances where a fair value estimate is not reasonably ascertainable and in these circumstances cost less a reduction for any value impairment is the only practical option.

10. *Should early-stage venture investments be treated differently than more mature investments?*

More mature investments with established profit, growth, and cash flow characteristics are in practice easier to benchmark against quoted market multiples for valuation purposes than are early-stage investments. In principle, early-stage investments should also be valued at fair value, although it is recognized that there will be instances where fair value cannot be estimated with any reasonable accuracy. In these instances, cost less estimated impairment needs to be used. Where early stage investments have raised material amounts of further funding on an arm's length basis, this practice does provide a market-based value.

11. *Please clarify the recognition of management fees and carried interest accrual.*

In constructing cash flows for calculating performance, management fees should be recognized as dated cash flows accrued at the quarterly, annual, or other periodic date when such management fees are payable. This method is in contrast to the occasional practice or treatment in which management fees are simply subtracted from the ending net asset value used in calculating performance. This latter treatment delays recognition of the management fee and thus artificially increases the rate of return calculated by an IRR calculation.

Carried interest accrual creates another problematic treatment. The net asset value used at the end of the period for which performance will be made up of largely unrealized and some realized investments yet to be distributed. The net asset value should have subtracted actual carried interest for realized investments that have not been distributed and should have fair value estimates of accrued carried interest subtracted for any investments that have yet to be realized. The intent is to provide an estimate

of what the limited partner would receive if the unrealized portfolio were liquidated and distributed at the date of performance calculation.

12. Must all private equity funds be included in at least one composite?

Yes. Firms are required to include all discretionary, fee-paying portfolios (funds/partnerships) in at least one composite that is managed according to a particular strategy or style. Firms must also separate funds with different vintage years into different composites.

13. What are composites and how do they relate to private equity?

The GIPS private equity provisions follow the terminology of the broader GIPS standards in using the concept of a composite. In practice, for most private equity investment firms, secondary firms, and fund of funds, individual funds are raised from time to time with a specific investment strategy and a vintage year defined by reference to the date of the first investment drawdown of cash for either investment of fee. Thus, each fund is a composite, and the terms are interchangeable. More complex situations may arise where managed accounts exist, if these have the same mandate and vintage year, they should be aggregated.

14. How should side-by-side funds be handled?

For funds that may have an auxiliary parallel or "side-by-side" fund vehicle, that vehicle should be included in the performance calculation for the entire fund. An acid test for deciding whether to include such a vehicle in the performance calculation is:

> If a parallel or side-by-side vehicle's capital is included to determine the entire fund's capitalization (so called "capital under management") then that parallel or side-by-side vehicle should be included in the performance calculations of the entire parent fund. Performance can be calculated separately for the fund vehicle as additional information but is required to be included in the calculation for the parent.

15. What disclosures at the asset level are required by GIPS private equity provisions?

None.

16. Why show both gross-of-fees and net-of-fees returns?

The gross-of-fees return is designed to show how well the invested capital performed, with the net-of-fees return reflecting the impact of management fees, performance fees (carried interest), and certain other costs. The investor needs an appreciation of both to understand the dynamics of the asset class.

17. What is a proper benchmark?

Investors in private equity are generally looking to outperform comparable quoted indices. Examples of relevant benchmarks would be a small-capitalization index (covering the same countries as the fund) for funds investing in comparably sized companies or a quoted technology index for those investing in venture funds. The index chosen will need to be a total return index (e.g., including dividends reinvested). The preferred calculation methodology involves notionally investing/divesting the fund cash flows into/out of the appropriate index and using the index cash flows to calculate an IRR.

In addition, many private equity associations and some specialist performance measurement firms provide data on median-and top-quartile performance for different classes of private equity. These returns for the same vintage year can be useful benchmarks. Although benchmarks are quite individual, the best benchmark for the composite should reflect the overall composite strategy, not necessarily individual clients' benchmark preferences.

18. Which fees are not deducted from the gross-of-fees and net-of-fees returns?

All fees associated with making, managing, and divesting an asset (defined as transaction expenses in the GIPS glossary) must be deducted from the gross-of-fees return. management fees, carried interest and transaction expenses must be deducted from the net-of-fees return. In line with the general GIPS provisions, fees relating to the expenses incurred in running the fund itself, defined as administrative fees, and including custody fees and fund legal and accounting fees, do not have to be deducted in calculating the gross- or net-of-fees returns.