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## Private equity's basic math problem

***Investor Daily:* A balancing problem is causing a selloff in private equity - and providing opportunity for a little-known subset of investors.**

By [Michael V. Copeland](#), senior writer  
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(Fortune Magazine) -- Not since fourth grade have so many sophisticated investors been so troubled by a basic math equation. An asset-allocation problem called the "denominator effect" is forcing the selloff of billions in private equity and alternative investments.

The problem is straightforward. Portfolio managers have strict guidelines for asset allocation (Harvard's endowment, for instance, is offloading \$1.5 billion in private equity to get back to its 13% target.) As the public markets have collapsed and the prices of liquid assets have plummeted, the value of the overall portfolio, or the denominator, has shrunk.

But allocations to venture funds, buyouts, and real estate, which aren't priced often, have held - at least in theory. So a slice that once accounted for 10% of a portfolio now might suddenly account for 15%.

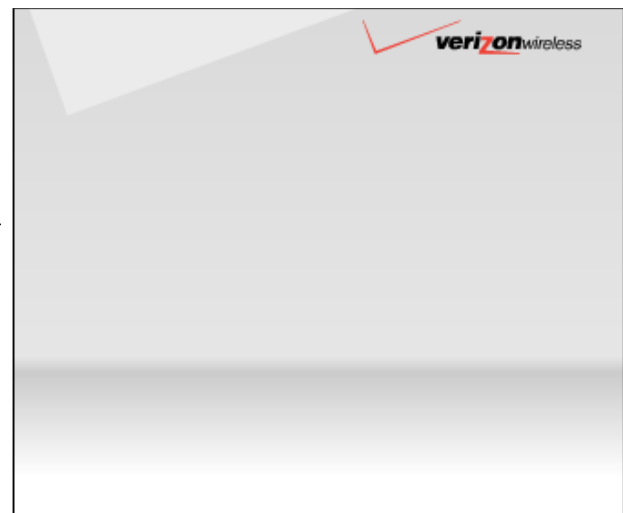
There are two things that fix the problem: a rising market for stocks or portfolio managers rebalancing by selling off the private-money investments.

The latter is starting to happen, with Harvard, Duke, and others unloading alternative-asset portfolios or portions of them. If they aren't already, say industry insiders, practically every big endowment or pension fund soon will be putting something up for sale.

The Great Unwinding of 2008 is providing opportunity for investors in the so-called private equity secondary market, an obscure corner of the private-money universe that trades preexisting commitments to alternative-asset funds.

By buying these castoff units, secondary-market investors hope to capture the higher returns of alternative assets, and because they can pick and choose among funds or even individual companies, they do it with slightly less risk.

Because the shares provide liquidity, they are typically discounted; in bad times, when everyone is scrambling for



cash, they can get dirt cheap. Bids for shares in the top buyout funds have already fallen by almost 14% this year, according to NYPPEX, a Greenwich, Conn., secondary-markets advisor.

Secondary buyers are anticipating further write-downs and lower prices in coming months, especially for the sale of shares in firms like Blackstone ([BX](#)), Bain Capital, and others that from 2005 to 2007 paid huge multiples and used massive leverage for companies now in their portfolios.

Some buyers are bidding as little as 50 cents on the dollar; earlier this month, according to industry sources, Lehman Brothers sold part of its \$3 billion private equity portfolio at a 50% discount.

As prices fall, the volume of these transactions is soaring. Larry Allen, managing member of NYPPEX, estimates that there will be some \$27 billion in private equity secondary deals this year, up from \$18 billion in 2007.

"We expect the volume to accelerate into 2009 for all kinds of alternative assets," he says. "The buyers smell blood in the water."

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