ChatGPT's View of Private Equity in TDFs

By Chris Tobe *Fri, Aug 1, 2025*

'Private equity appears safer and more diversifying than it really is because it controls its own marks. This undermines the integrity of asset allocation models and can lead to over-allocation, particularly in pensions, endowments, and TDFs,' the A.I. companion opines.

"Because private equity is clearly an ERISA prohibited transaction, it can create the false illusion that it adds value to a portfolio like a target date fund (TDF) by overstating performance and understating risks," **wrote** Chris Tobe, a Chartered Financial Analyst (CFA), at the CommonSense 401k Project **blog**, which is co-authored by attorney James W. Watkins III and CFA Rick Ferri.

"As I testified to the ERISA advisory committee last year, SEC-registered mutual funds will not allow this ruse, but weak state-regulated collective investment trusts (CIT's) would," he wrote. Tobe recently asked ChatGPT "how private equity cheats on performance and risk"? ChatGP responded:

Core Concern:

Private equity (PE) self-reports inflated returns and artificially smooths volatility, which distorts inputs used in mean-variance optimization (MVO), risk-parity models, and target-date glidepaths.

How the Distortion Happens:

1. Self-Reported, Marked-to-Model Valuations

- Unlike publicly traded equities, PE funds are not marked to market.
- General Partners (GPs) have **wide latitude** in determining "fair value" using Level 3 inputs under GAAP/IFRS.
- There's **no external price discovery** like in public markets—creating upward bias in reported IRRs and TVPIs.

Example: GPs may hold a portfolio company at $2.3B valuation for 12 months—until a sale occurs at $1.8B, but all the prior return models assumed $2.3B.

2. Return Smoothing Reduces Apparent Risk

- PE firms **smooth returns** by reporting only quarterly, and avoiding mark-downs in

downturns unless forced (e.g., in LP secondaries).
- This **lowers measured standard deviation**, making PE appear less risky than it truly is.

Ludovic Phalippou, in multiple SSRN papers, shows that **real economic volatility of PE is closer to or greater than public equities**, but accounting practices **mask this**.

3. Low Correlation Is Largely an Illusion

- PE is often shown to have low correlation with the S&P 500 or public equity indices.
- This is not because the underlying assets are fundamentally different—but because **quarterly smoothed valuations** fail to reflect the real-time economic correlation.

Empirical studies (e.g., Ang, Chen, Goetzmann 2013) show that **lagged public-equity returns** can explain much of PE fund performance.

Implications for Asset Allocation Models:

1. Misleading Inputs into MVO and Risk Budgeting

- MVO and Black-Litterman-type optimizations **overweight PE** due to inflated Sharpe ratios (high returns / low volatility).
- Allocators wrongly assume PE offers high return with diversifying low risk.

2. Target-Date Funds and Pension Glides Paths Are Over-Allocating

- Plan sponsors may use PE-heavy CITs or TDFs based on **deceptively low risk** and **attractive correlation stats**.
- This is especially problematic in **state-regulated CITs**, where oversight of inputs is weak.

3. Stress Testing Fails to Capture Liquidity & Downside Risk

- Smoothing hides **tail risk** and **liquidity gaps** during downturns (e.g., GFC, COVID).
- PE dry powder and capital calls may spike just when public markets are down.

Supporting Academic and Regulatory Sources

- **Ludovic Phalippou**, *"An Inconvenient Fact: Private Equity Returns & the Billionaire Factory"*
  → Calls out manipulated IRRs, opaque fees, and correlation illusions.

- **Andrew Ang (Columbia/BlackRock)**
  → PE appears low beta only due to infrequent marking; in reality, it is **leveraged equity**.
- **U.S. SEC** under Gensler has warned of **valuation opacity** and **risk-model distortions** in private funds.
- **CFA Institute (2021 paper)**:
  "Asset Allocation to Alternative Investments" (CFA Institute, 2025):
  Highlights that illiquid assets often have *stale and artificially smoothed returns*, recommends testing for serial correlation, and states clearly that analysts **"need to unsmooth the returns to get a more accurate representation of the risk and return characteristics of the asset class."** blogs.cfainstitute.org+13cfainstitute.org+13
- 2019 SSRN paper **"Unsmoothing Returns of Illiquid Assets"** by Couts, Gonçalves, and Rossi, which critiques existing methods and proposes a novel three-step unsmoothing technique—highly relevant for private equity modeling. papers.ssrn.com+2

Bottom Line:

Private equity appears safer and more diversifying than it really is because it controls its own marks.
This undermines the integrity of asset allocation models and can lead to **over-allocation**, particularly in **pensions, endowments, and TDFs**.

This misrepresentation may expose fiduciaries to legal risks under **ERISA's Impartial Conduct Standards** or **trust law's duty of prudence**—especially if they've failed to adjust for these distortions.

These distortions also apply to private debt, hedge funds, real estate, and other ERISA prohibited transactions like **crypto** and **annuities**. Target date funds that use any inputs that are prohibited transactions are at a high risk of making the entire TDF a Prohibited Transaction.

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