

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 Coutts, 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.