

Discussion: Gatchev, Ivanov, Pirinsky

“Asset Sorting in Private Equity”

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Stanford GSB & NBER & CEPR

Summary: what the paper does

► Idea:

⇒ GPs sort assets across funds strategically to increase carried interest

► Mechanism:

⇒ Agency *GP allocates deals to max carry* vs
productive sorting *GP sort assets b/c of skills/expertise*

► Setting:

⇒ VC funds, VentureExpert, 1980–2022, 78K investments; focus on
firms running ≥ 2 funds

► Main asset sorting test:

⇒ For each new investment, compare the firm's *estimated* carried interest when the deal goes to the actual fund vs. to another fund of the same firm open at the same time (averaged over those funds)

Summary: findings

- ▶ **Table 3:** carry under the actual vs. counterfactual allocation
⇒ $\approx 1\text{pp}$ higher carry under actual (“asset sorting” estimate)
- ▶ **Table 4:** good follow-on investments are placed in *better-performing* funds
⇒ presumably increasing carried interest
- ▶ **Table 5:** asset sorting vs. future IPO/acquisition
⇒ not (significantly) related
- ▶ **Table 6:** asset sorting vs. *reputation* (VC market share $\times$ VC age)
⇒ uncorrelated
- ▶ **Conclusion:** evidence for *agency-based* asset sorting

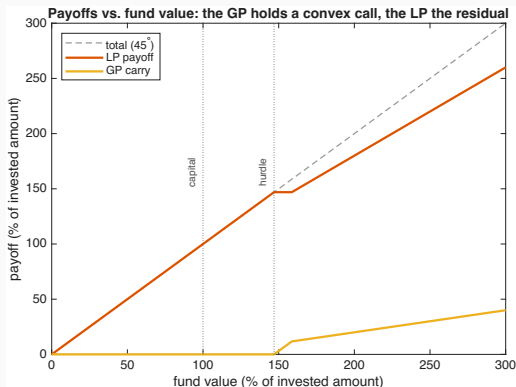
Mechanism: convex fund-level carry rewards correlated risks

Distribution waterfall: return of capital $\rightarrow$ preferred (hurdle) to LPs $\rightarrow$ 100% GP catch-up $\rightarrow$ 80/20 split

$\Rightarrow$ GP carry per fund is a **call option**: $\text{carry}_f = c \max(V_f - H, 0)$

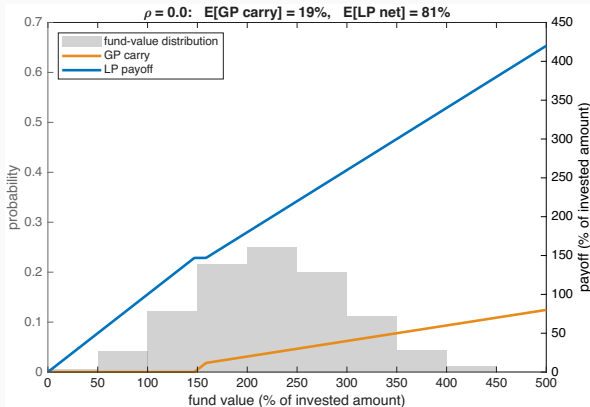
$\Rightarrow$ Grouping *correlated* payoffs raises within-fund variance

$\Rightarrow$ by Jensen, $\mathbb{E}[\text{carry}]$ rises in ρ



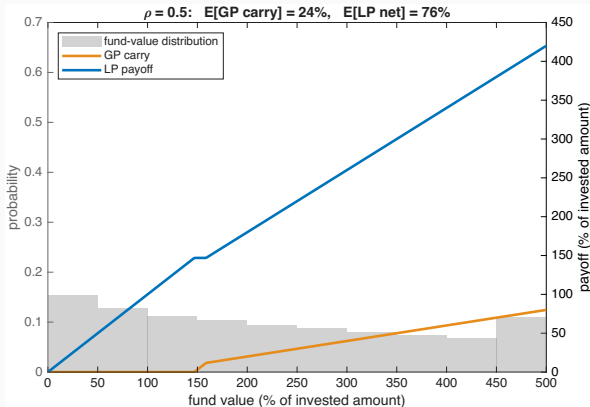
Higher within-fund correlation: GP carry up, LP down

- ▶ Same payoffs; raising the within-fund correlation ρ spreads the fund-value distribution (mean-preserving)
- ▶ Convex GP carry integrates to more, concave LP to less



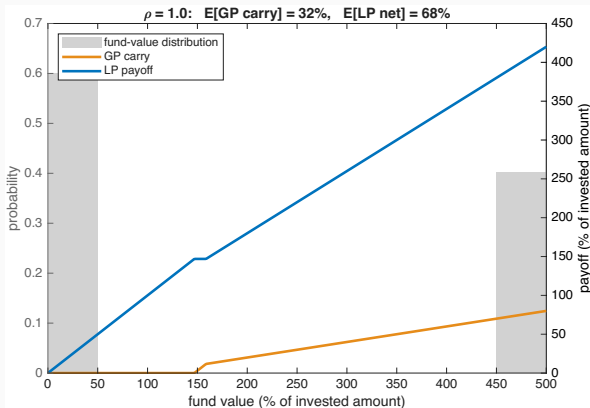
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Contribution and Discussion

- ▶ **Contribution:** new, plausible agency channel: fund-level convex carry rewards concentrating correlated assets
- ▶ Begenau-Siriwardane (2024) documents fee variation *across* investors within a fund, less in VC b/c standardized LPAs
- ⇒ sorting may substitute for fee dispersion as even less visible form of extraction (Gabaix & Laibson 2006)
- ▶ **Main comment: agency interpretation versus value creation?**
 - ⇒ GP carry rises whether sorting transfers value or creates it, and the paper measures the GP's carry, not the LP's payoff

Three sub-points:

- ▶ **(a)** total fund value size matters
- ▶ **(b)** the evidence against value creation is indirect
- ▶ **(c)** performance and specialization are measured coarsely

How they build fund value & carry variable

Data: imputed invested amount per round, IPO / acquisition / neither
no valuations, fees or realized carry

Each fund's value uses a binary success x_i :

$$V_f = \sum_i a_i x_i M, \quad \text{carry}_f = c \max(V_f - H_f, 0)$$

Baseline $M = 5$, $r = 8\%$, $T = 5$, fee 2%, $c = 20\%$, 100% catch-up.

- ▶ Asset sorting = imputed firm carry (actual) – (sibling) > 0
- ▶ Carry measure based on observed exits
- ▶ every winner counts as 5×: ignores home-run skew driving carry
- ▶ x_i is the *eventual* exit: built with hindsight, not ex ante

Set-up with fixed investment size

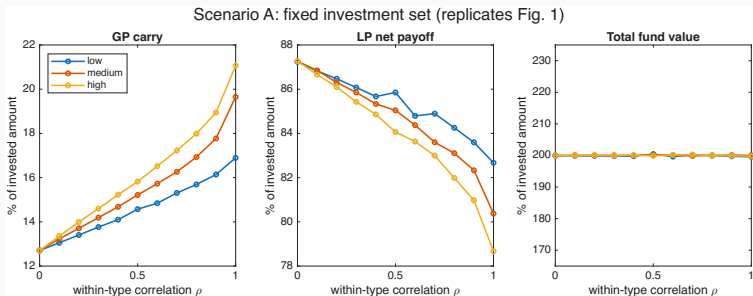
- ▶ One firm, 2 funds; 4 investments of $a_i = 1$, 2 per fund
 - ▶ Each pays $M = 5$ w.p. probability $p = .4$, else 0
 - ▶ Two types: **within-type** $\rho = 1$, across-type independent
 - ▶ $\mathbb{E}[V_f] = 8$; GP carry = $c \max(V_f - K, 0)$; $c = .2$
 - ▶ Sorting = how the correlated assets are grouped:
 - ▶ *Diversified*: fund value $\in \{0, M, 2M\}$
 - ▶ *Sorted* (the correlated pair together): $\in \{0, 2M\}$
- $\Rightarrow$ **mean-preserving spread**

	Diversified	Sorted
$\mathbb{E}[\text{GP carry}]$	1.088	1.280
$\mathbb{E}[\text{LP net}]$	2.912	2.720
$\mathbb{E}[\text{LP net}] + \mathbb{E}[\text{GP carry}]$	4	4

Fixed fund value $\Rightarrow$ carry $\uparrow$ (Jensen), LP $\downarrow$ one-for-one

Replicate paper simulation, matches the GP-carry in Fig. 1

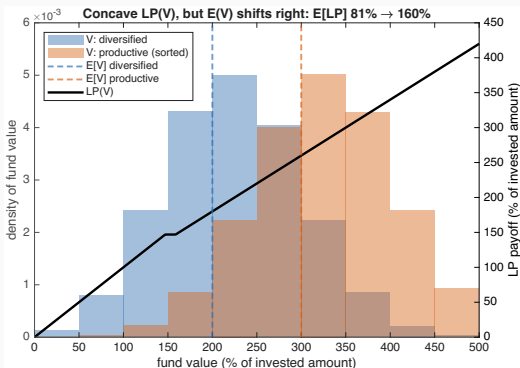
- ▶ Paper's calibration: 3 funds, 10 invs., 3 types;
 $p = .4$, $M = 5$, $c = .2$, $r = 8\%$
- ▶ GP carry per fund is 13–21% of invested amount (authors Fig. 1)
- + LP and total value



- ▶ GP carry rises, the total fund value is flat, the LP falls one-for-one
- ▶ Adding a 100% catch-up shrinks transfer, does not flip its sign

(a) Total fund value matters: intensive margin

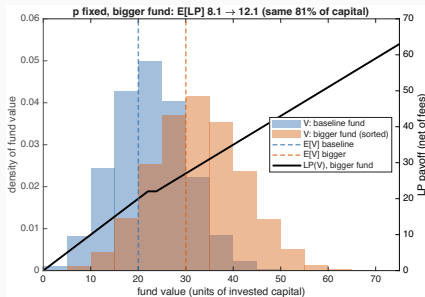
- ▶ Carry up $\neq$ transfer: LP gain if sorting raises *net* value (NPV)
- ▶ **Intensive:** specialization raises exit rates ($p \uparrow$) $\Rightarrow$ fund value shifts right, so $\mathbb{E}[LP]$ (NPV) rises even though $LP(V)$ is concave



(a) Total fund value matters: extensive margin

- Extensive margin: extra funding unlocks positive-NPV deals needing a *minimum size* – a bigger fund, p fixed

Chung, Sensoy, Stern & Weisbach 2012; Gompers 1996



Suggestion:

- values unobserved here – use PitchBook/Prequin for *valuations*
- valuations would separate transfer from value creation

(b) Paper's evidence: agency, possibly – needn't be risk

- ▶ T3 (carry gap) and T4 (winners $\rightarrow$ better funds) are *related*: both reflect routing winners to *in-the-money* (above-hurdle) funds
 - ▶ Carry is a per-fund call: move a marginal winner w from a below-hurdle to an above-hurdle fund $\Rightarrow$ GP books cw , LP loses it, *total value unchanged* – a pure LP $\rightarrow$ GP transfer
- $\Rightarrow$ consistent with agency, but it would be *moral hazard* (exploit the call's *moneyiness*), not *risk-taking* (the model's correlation/variance, Jensen)
- $\Rightarrow$ without documenting increased correlation we cannot tell

Suggestion:

- ▶ test the correlation channel directly (are sorted funds more correlated?)

(c) Performance and specialization measures do not nail valuation question

- ▶ T5/T6 relate asset sorting to *exit outcomes*/reputation, not to whether the LP got less
- ▶ IPO/acq (T3/5/6) vs. avg. # prior rounds (T4); # rounds proxies fund age, and older vintages exit more, exit counts don't separate b/w "barely made it" and "home-runs"
- ▶ Industry = broad (e.g., Medical/Health), geography = state; Sub-sector expertise is invisible (oncology vs. genomics tools)

Suggestion:

- ▶ use consistent performance measure and finer (sub-sector) specialization controls
- ▶ other data sources may help

Conclusion

- ▶ Interesting paper on a plausible mechanism
- ▶ But GP carry rises under *both* an agency & value motive
- data work does not yet separate b/w value and agency
- nor identify the proposed risk-bundling mechanism
- ▶ Main suggestion:
 - ▶ compute the LP's payoff in dollars to separate agency from value creation
 - ▶ clarify the agency mechanism
 - ▶ additional data on valuations/outcomes would help