

SALIENCE

A NOTE FOR GENERAL PARTNERS

# A Measured Quantity of Risk

*A risk model for private equity: measuring where a company's uncertainty originates, how it propagates to enterprise value and to cash flow, and what a dollar of risk reduction buys.*

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*“Risk-adjusted return — the language your limited partners already speak.”*

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## 1 The opportunity

A general partner creates alpha in two ways. The first is operational: making the business run better, so it earns more and earns it more reliably. The second is financial: capitalizing the business well, so the company can carry leverage with a desired level of comfort, and equity is not paying for excessive risk. Private equity managers work each lever skillfully, both on the strength of operating partners who have turned companies around before and deal teams who have priced a great deal of leverage.

Despite the success of the GP model, there is room for improvement. The largest opportunity comes in the form of risk management.<sup>1</sup> In large part, private equity risk measurement is limited to qualitative measures. GPs don't have the sophisticated statistical models of risk that public equity managers have. Public equity managers use these tools to estimate company (security) risk and portfolio-level risk. In private equity we have neither, because we don't have a lengthy time-series of returns that public equity risk models rely upon to form their estimates.

Enter Saliency: a risk model that estimates how risk originates, propagates, and concentrates within a company and a portfolio of companies. Instead of a returns-based approach, Saliency estimates risk using a compact set of operational data to which any GP or operator will have ready access. Due to its design, Saliency extends the capabilities of a returns-based risk model. These capabilities, described below, result in more responsive performance measurement, more reliable performance, and increased alignment within the firm and across stakeholders.

## 2 What a risk model is

A risk model is a way of expressing uncertainty in a small number of estimable quantities, so that uncertainty can be measured, compared across unlike things, broken into its sources, and acted on. A risk model does not forecast returns and does not replace the judgment of the people doing so. It does give that judgment a useful unit that can be expressed at the company level, or aggregated into a portfolio.

Over the past 40 years, risk models became prevalent in every field adjacent to private equity.<sup>2</sup> Public-equity investors got factor models and could suddenly say how much

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<sup>1</sup>Public equity managers estimate company (security) risk and portfolio-level risk from long return histories.

Private companies offer no such history, which is why the instrument has been missing despite the need.

<sup>2</sup>In each field, as soon as risk models became practical, they were adopted by innovators; as their benefit

risk a portfolio carried and where it came from. Insurers decomposed a book into how often claims arrive and how large they are. Options markets reduced to a trade around estimated volatility that any two desks could discuss. In each case the model turned a matter of seasoned intuition into a sharable quantity.

| DOMAIN                    | WHAT IT COUNTS            | SHARABLE UNIT        |
|---------------------------|---------------------------|----------------------|
| Public equity             | Factor exposures          | Factor risk          |
| Insurance                 | Claim frequency, severity | Expected loss        |
| Options                   | Underlying movement       | Implied volatility   |
| Private equity (Saliency) | Size-count accumulations  | Operational variance |

**TABLE 1.** Each adjacent field turned intuition into a quantity two desks could discuss. Saliency extends the same move to private equity, using operational data in place of a price history.

Over the same time frame, the language of investing came to almost entirely rest upon a discussion of risk-adjusted return. Asset managers forecast return; risk models forecast risk. Put them together and you get risk-adjusted return. If investing is fundamentally about bearing risk for the chance of return, then risk-adjusted return indicates the efficiency of an expectation or result. With Saliency, private equity managers can now use the same language their clients are accustomed to using with their investments outside private equity.

### 3 How Saliency is different

**KEY INSIGHT**

Every operator already has a forecast. The product is not a better forecast — it is the *variance* of that forecast, attributed to named sources and priced at the margin.

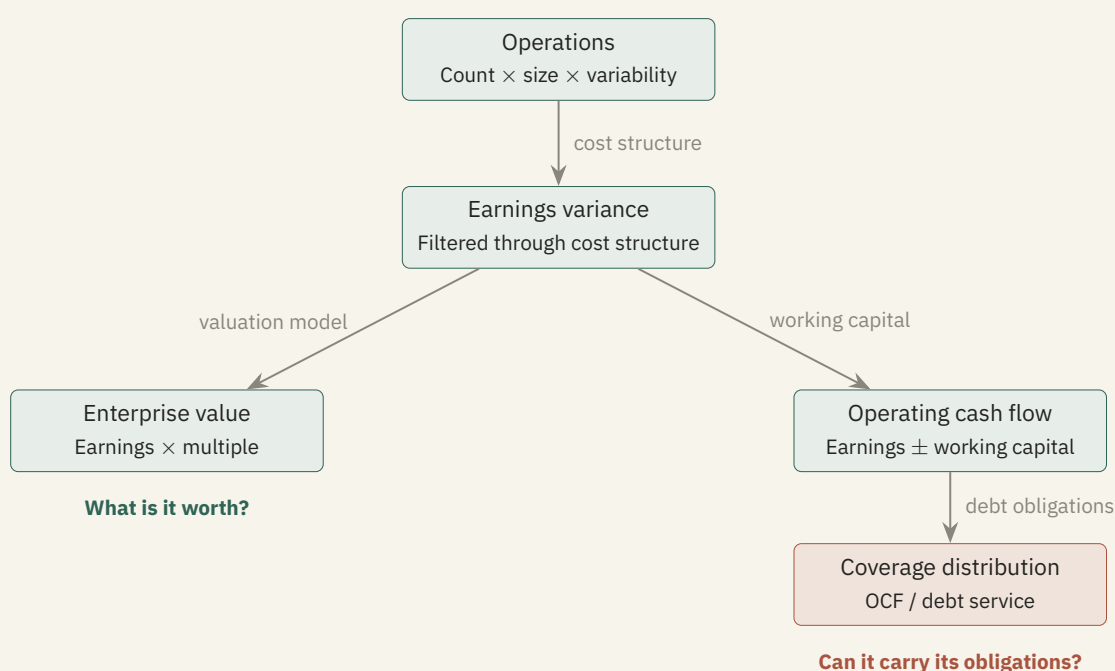
**It measures risk at the operational source.** A public-market risk model needs a price history, but a private company has none. Saliency instead measures risk in the operations of a business: how many revenue events the business generates, how large they are, how much they vary, and how the cost structure amplifies or absorbs that variation on the way to earnings variance. From earnings we fork in two directions. Earnings variance passed through a valuation model gives the variance of enterprise value. The same earnings variance passed through working capital gives the variance of operating cash flow, and

became clear, they became table stakes for best practice, something clients and stakeholders expect.

the distribution of debt service coverage ratios. With Saliency, operators can answer two important questions: what is this business worth, and can the business carry its obligations?

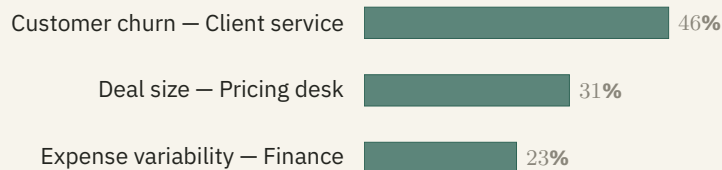
#### KEY INSIGHT

Variance does not originate in markets. It originates in the uncertainty of results from ordinary business activities — and those results have well-known statistical distributions. From them, and a compact set of operating data, Saliency estimates variance in revenue, earnings, valuation, and operating cash flow.



**PLATE I.** Risk measured at the source. Operational uncertainty flows into earnings variance, which forks into a valuation path (enterprise value) and a capital structure path (operating cash flow and coverage). One measurement answers both questions.

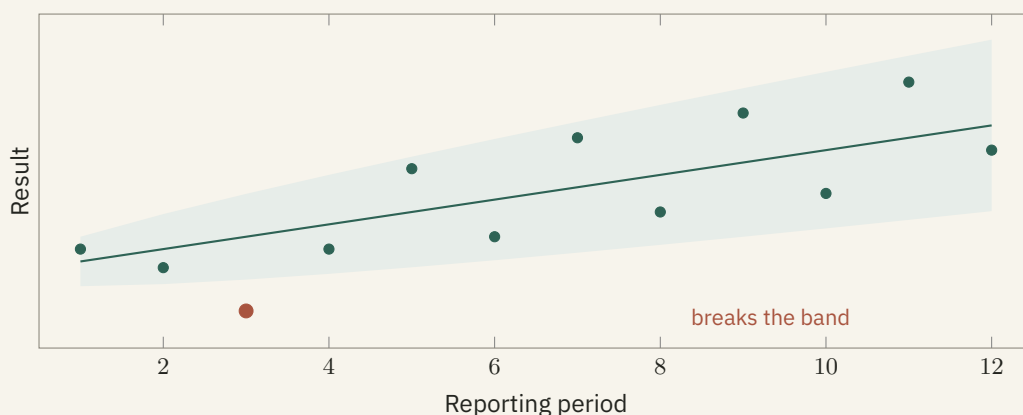
**It produces a roadmap, not just a number.** Saliency illuminates a private company's risk, but it also associates sources of risk with business activities. Customer churn belongs to client service. Deal size belongs to the pricing desk. Expense uncertainty belongs to finance. These departments can directly manage and reduce risk. This results in a ranked, cost-ordered list of actions: these interventions, in this order, buy the most risk reduction per dollar of effort. Reducing risk increases quality of earnings. In fact, earnings variance is the unit of quality of earnings. And all other things being equal, a higher quality of earnings will trade at a higher valuation.



**PLATE II.** The roadmap. Variance decomposes into sources, each owned by a business function, and sorts into a cost-ordered list of interventions — the largest share of risk, acted on first.

**It sizes capital structure to the risk, not the market.** The same measured risk that ranks the operating levers also sizes the leverage. Past a certain point, added debt stops improving the risk-adjusted return to equity and starts degrading it, because the extra expected return is small but the added chance of a distressed year is not. Where that point sits depends on how variable the company’s cash flows run. For a steady business it can sit near what the lender offers; for a volatile one it may sit well below.

**It is more responsive.** With variance comes significance bands. Each period, the company’s actuals land against its forecast significance bands, so a result reads as signal or as noise when it arrives rather than after several more periods confirm it. A light month that sits inside the band is the ordinary lumpiness of the business; one that breaks the band is a genuine departure worth acting on. The diagnostic comes earlier, and it rests on the company’s own measured variability rather than on a read of how unusual the number feels.



**PLATE III.** Significance bands, fanning as time elapses. The band is drawn from the company’s own measured variability and widens as period-to-period variance accumulates. A point inside is ordinary lumpiness; the point that breaks the band (period 3) is a genuine departure, legible in the period it happens rather than several periods later.

**It is more reliable.** Because Saliency decomposes risk into sources that can be worked down, the variability of results becomes something to manage rather than only to observe. Tightening the company's largest sources of variance brings its earnings closer to plan period after period. That steadiness is what we refer to as quality of earnings, the property a buyer pays a higher multiple for. Quality of earnings stops being a verdict rendered at diligence and becomes a quantity the company manages across the hold.<sup>3</sup> Higher quality of earnings also leads to higher total growth over time.

**It is more aligned.** A measured quantity of risk gives the company's management, its operating partner, and its board a single picture to work from. Alignment at the company reinforces the other two properties: when everyone watches the same risk, an early diagnostic reaches people already attuned to the signal. The same vocabulary later travels to the IC memo and the LP letter.

**It shows where risk concentrates, and where to manage it.** Computed for every holding in the same units, the measure of risk shows where the fund's risk actually sits: a company that is fifteen percent of the fund by value can be thirty percent of its risk. This gap stays invisible until risk is on a common scale that, once measured, sharpens two decisions a GP can use to move it. A follow-on can be weighed by what it adds to the fund's concentration as well as what it returns, so the firm sees when more capital into its strongest performer is also more capital into its largest risk. And a bolt-on can be judged on the combined company's variance rather than its own: a bolt-on whose revenue runs uncorrelated with the platform's can steady the platform even when it is more volatile alone, and now and then lowers the combined risk of a covenant breach while adding debt, the diversification arriving inside the deal.

**It composes.** The company is a set of business lines, and Saliency can model each as a source of variance. Lines compose into a company, which then composes into a fund portfolio. Now we can see across companies how risk concentrates and diversifies. Funds compose into total GP firm risk. At each stage we maintain full visibility. This means we can determine that churn rates in Company A held in Fund 1 are the largest contributor to the general partner's variance, followed by deal size in Company K held in Fund 2. One simple process measures risk and applies at the business line, the company, the fund portfolio, and the firm.

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<sup>3</sup>Lowering variance increases geometric growth independent of any valuation exercise, through the variance drain on the geometric growth of a random process.

## 4 The first move

### GET STARTED

See for yourself how Salience can give you an edge.

**[Book a demo](#)**

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Set in Spectral and IBM Plex. This note extends the framework of *Salience: A Better Way to Measure and Manage Business Risk* (Castille, 2026).