EXAMINING PRIVATE EQUITY IN PUBLIC PENSION INVESTMENTS

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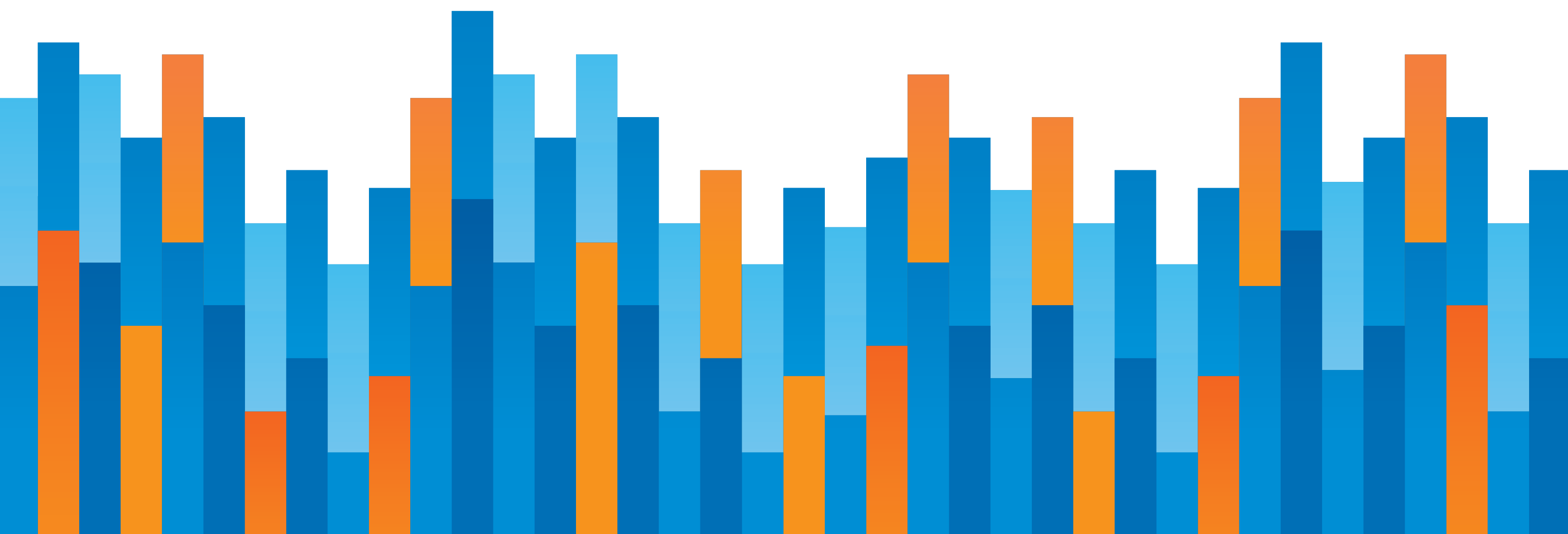

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EXECUTIVE SUMMARY

Private equity investing—buying shares in non-public companies—offers state and local pension system investment managers the promise of higher returns and greater diversification. Under pressure to meet challenging investment return targets, managers have increased their allocations to private equity and a related group of alternative asset classes like hedge funds and infrastructure investments.

However, there are reasons to be skeptical of public pension investment in private equity. While it is true that most private equity benchmarks outperformed the S&P 500 during the 2010s, it appears that public pension system investors did not benefit from this outperformance: their returns on public and private equity holdings were similar. Furthermore, it appears that private equity is underperforming in 2020 and may not recover its edge in the decade ahead.

Over a long time period, annual returns on leveraged buyout funds are highly correlated with those of the S&P 500, raising questions as to whether private equity meaningfully adds to the diversification of pension system portfolios.

Pension systems should thoroughly evaluate the downsides of private equity investing before increasing their allocations to this asset class. These disadvantages include illiquidity, challenges in obtaining timely and accurate valuations, high investment costs, and lack of transparency.

Some of these drawbacks can be mitigated through enhanced reporting. Systems should consider emulating and building upon the best reporting practices of CalSTRS, which provides a detailed list of portfolio holdings and relatively comprehensive reporting on investment fees.

An alternative to chasing the excess returns promised by private equity and other alternative asset classes is to lower assumed rates of return so that they can be achieved most of the time with a conservative mix of fixed income and public equity investments.

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PART 1

INTRODUCTION

Unlike public equity, private equity represents ownership shares of companies that are *not* listed on a stock exchange[1] or a broker-dealer network[2] (such as NASDAQ). State and local pension funds added public companies to their investment portfolios several decades ago. More recently, they have been investing more of their assets in private equity and other alternative asset classes. Given lower yields on fixed income securities and stock market volatility, investment managers have turned to these unconventional vehicles in an effort to more regularly achieve the annual return rates targeted by their systems.

This report examines the pros and cons of private equity investing. After placing private equity within the larger family of alternative investment vehicles, it addresses ethical considerations: Are private equity firms a bunch of "Wall Street looters" as Senator Elizabeth Warren alleged in 2019, and, if so, do their investment products rightfully belong in public pension system portfolios? After that, the study reviews the evidence on private equity returns both historically and going forward, addressing the questions of whether this asset class outperforms publicly traded stocks and whether it improves portfolio diversification. It then reviews various practical challenges with allocating assets to private equity, including valuation, transparency, and investment costs.

1 James Chen, "Private Equity," *Investopedia*, April 30, 2020. https://www.investopedia.com/terms/p/privateequity.asp (10 December 2020)

2 Chris B. Murphy, "Over-the-Counter," *Investopedia*, December 5, 2020. https://www.investopedia.com/terms/o/otc.asp (10 December 2020)

PART 2

PRIVATE EQUITY, ALTERNATIVE INVESTMENTS, AND THE DEBATE OVER THEIR SOCIAL VALUE

In most cases, pension funds gain exposure to private equity by purchasing shares in funds that own private companies.[3] These funds are sponsored by private equity management firms such as Apollo, BlackRock, Carlyle and KKR. In relation to the private companies they own, the private equity firms act as general partners, while the pension funds and other outside investors are limited partners who have restricted voting power and no day-to-day involvement in the business.[4]

[3] In relatively rare cases, pension funds own private companies directly rather than through a fund. For a discussion of the pros and cons of direct investing see Jordan Stutts, "The price of direct investing," *Infrastructure Investing*, June 26, 2019. https://www.infrastructureinvestor.com/price-going-direct/ (10 December 2020)

[4] Will Kenton, Limited Partner, *Investopedia*, May 6, 2019. https://www.investopedia.com/terms/l/limited-partner.asp

2.1 PRIVATE EQUITY WITHIN THE KALEIDOSCOPE OF ALTERNATIVE INVESTMENTS

Private equity is one of several alternative assets attracting increasing interest from U.S. public pension funds in the 21st century. Between 2001 and 2016, the share of pension plan assets invested in alternatives rose from 9% to 29%.[5]

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Generally, alternative assets are made up of investments that fall outside the familiar categories of stocks, bonds, cash equivalents (like bank deposits), and publicly available mutual funds.[6] Alternative asset investments share certain characteristics such as being:[7]

- relatively free of Securities and Exchange Commission (SEC) regulation;
- illiquid, meaning they cannot be easily sold or otherwise converted to cash; and
- perceived to have a low correlation to standard asset classes, meaning they do not necessarily move in the same direction as other assets when market conditions change.

Categories of alternative assets are ill-defined and often overlapping. Table 1 describes some of the most popular types of alternative assets held by U.S. public pension systems

[5] Jean Pierre Aubry et al., "What Explains Differences in Public Pension Returns Since 2001?" *State and Local Pension Plans*, Number 60. July 2018, Center for Retirement Research. https://crr.bc.edu/wp-content/uploads/2018/07/slp_60.pdf (10 December 2020)

[6] Similar definitions of alternative assets are given by Lauren Landry, "What are Alternative Investments?" *Harvard Business School Online*, April 28, 2020. https://online.hbs.edu/blog/post/what-are-alternative-investments (10 December 2020) and James Chen, "Alternative Investment," *Investopedia*, March 6, 2020. https://www.investopedia.com/terms/a/alternative_investment.asp (10 December 2020)

[7] Natalie Chladek, "7 Types of Alternative Investments Everyone Should Know About," *Harvard Business School Online*, May 7, 2020. https://online.hbs.edu/blog/post/types-of-alternative-investments (10 December 2020)

currently. Most of the definitions are taken from the CFA Institute's alternative investments primer.[8]

TABLE 1: TYPES OF ALTERNATIVE INVESTMENTS

Alternative Investment Category	Description
Infrastructure	Investments in utilities, energy production, transportation projects, schools, hospitals, or other types of facilities providing the services necessary for society to function. This category is sometimes grouped with others into a broader "inflation-sensitive" category reported by pension funds.
Farmland	Portfolios of land holdings that generate crop or livestock income. The farms are typically managed by tenant farmers who pay rent to the investors.
Timber	Portfolios of forestland that are managed by timber investment management organizations (TIMOs). The TIMOs subtract a fee and then return residual income to investors.
Natural Resources	A broad category that includes farmland and timber, as well as energy infrastructure investments and those in mining and metal production.
Private Real Estate	Investments in commercial real estate such as office buildings, retail facilities, hotels, and senior living facilities. These investments can be made directly or through funds that—unlike public real estate investment trusts—are only available to institutional investors.
Private Debt	Illiquid forms of debt not generally held by conventional investors including bank loans (often called leveraged loans), distressed debt (high yield bonds and loans issued by companies that have a high risk of bankruptcy), and mezzanine financing (debt instruments that are hybrids of debt and equity, typically promising a fixed income stream with some upside participation if the borrowing company does well).
Hedge Funds	Investment pools that offer greater flexibility than traditional mutual funds by incorporating such features as large short positions, high degrees of leverage, and rapidly changing risk exposures. Hedge funds use a variety of strategies and objectives including absolute return (generating a steady stream of revenue regardless of how the stock market is performing), relative return (attempting to outperform a benchmark such as the change in a stock market index), macro (investing in the "big picture" mostly by buying and selling derivatives such as options and futures), event-driven (investing in the securities of companies that are expected go through a major transition, such as an acquisition, in the near future), and equity (taking long positions in stocks that are undervalued and short positions in stocks that are overvalued).
Venture Capital	Investments in small firms with the hope that they will thrive and mature to the point of going public (via an Initial Public Offering) or being acquired by a larger firm.
Buyouts (Private Equity)	Investment pools that purchase controlling interests in publicly traded firms. Usually a large portion of the funds needed to acquire public firms are obtained through borrowing; when debt is used this way, the term "leveraged buyout" is used.

Source: Donald Chambers, et. al., 2018

8 Donald Chambers, et al., "Alternative Investments: A Primer for Investment Professionals," 2018, *CFA Institute*. https://www.cfainstitute.org/-/media/documents/book/rf-publication/2018/rf-v2018-n1-1.ashx (10 December 2020)

The term "private equity" is most often used as a synonym for leveraged buyout vehicles but may also include some of the other categories listed in Table 1.

Several of the objections to private equity investments discussed in this paper pertain to some or all the asset categories in this list. These objections include lack of transparency, difficulty in valuing exposures, and high investment costs. One criticism more focused on leveraged buyout funds is that they destroy American jobs, although this critique may also apply to some types of hedge funds.

2.2 IS PRIVATE EQUITY A FORM OF "LOOTING"?

2.2.1 PROGRESSIVE VIEW OF PRIVATE EQUITY

In 2019, Elizabeth Warren proposed the Stop Wall Street Looting Act (S-2155) in hopes of rectifying what she saw as the excesses of private equity. The bill was co-sponsored by independent Bernie Sanders and three other Democratic senators.[9] A companion House bill (HR 3848) offered by Representative Mark Pocan (D-WA) was endorsed by 17 Democratic members.[10] Lacking bipartisan support, this legislation does not seem to have a path to passage for the time being, but it nonetheless serves as a vehicle for private equity skeptics to set forth their critique and their plan for reining in the industry.

Warren's news release announcing the bill summed up her view as follows: "private equity funds often load up companies with debt, strip them of their assets, and extract exorbitant fees, while guaranteeing payouts for themselves and walking away from workers, communities, and investors if the bets go bad."[11]

Progressive criticism of "asset stripping" dates back to the 1987 Oliver Stone movie *Wall Street*, in which the villain, Gordon Gekko, engages in this activity. In the 1980s, corporate

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9 S.2155 - Stop Wall Street Looting Act, *Congress.gov*, July 17, 2019. https://www.congress.gov/bill/116th-congress/senate-bill/2155/cosponsors?q={%22search%22:[%22H.R.+2%22]}&r=55&searchResultViewType=expanded (10 December 2020)

10 H.R.3848 - Stop Wall Street Looting Act, *Congress.gov*, July 18, 2019. https://www.congress.gov/bill/116th-congress/house-bill/3848/cosponsors?searchResultViewType=expanded (10 December 2020)

11 Elizabeth Warren's Senate Office, Warren, Baldwin, Brown, Pocan, Jayapal, "Colleagues Unveil Bold Legislation to Fundamentally Reform the Private Equity Industry," July 18, 2019. https://www.warren.senate.gov/newsroom/press-releases/warren-baldwin-brown-pocan-jayapal-colleagues-unveil-bold-legislation-to-fundamentally-reform-the-private-equity-industry (10 December 2020)

raiders who inspired the fictional Gekko character became notorious for acquiring companies with the intention of selling off their assets piece by piece rather than operating them as going concerns.[12] This practice, according to its critics, has exacerbated unemployment and blight.[13]

Like corporate raiders and activist hedge fund managers, private equity firms try to find companies that are undervalued on the public markets, acquire a controlling interest in them, and then effect some sort of transformation that unlocks previously untapped value. These investors—and their limited partners, which often include pension funds—are rewarded with capital gains.

The Progressive critique starts with private equity's negative impact on jobs and wages. A Harvard Business School study of private equity buyouts found that they were associated with a reduction in average wages of 1.7%. Further, in cases when a public firm was taken private, employment shrank by 13%.[14]

Surprisingly, the researchers found that when private equity firms took over non-public companies, employment at the target firms increased by 13%. But Co-Director of the Center for Economic and Policy Research Eileen Appelbaum speculated that this increase was due to the acquisition of add-on companies rather than through the creation of new jobs.[15]

Critics also charge that private equity firms harm customers in their search for profits. Appelbaum finds a link between private equity takeovers of physician groups and the use of surprise medical billing. Hospital patients rarely inquire whether the various specialists who treat them are in their insurer's network, but then receive very large bills from those that turn out to be out of network. When a private equity firm takes over a physician group, it might withdraw its physicians from an insurance network and then send plan members high out-of-network medical bills as a way of pressuring the insurance provider to take

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[12] "Asset Stripping," *capital.com*. https://capital.com/asset-stripping-definition (10 December 2020)

[13] Jane Coaston, Tucker Carlson on why conservatives should crack down on "vulture capitalism," *Vox*, December 10, 2019. https://www.vox.com/policy-and-politics/2019/12/10/21001843/tucker-carlson-paul-singer-fox-news-hedge-funds-populism (10 December 2020)

[14] Steven J. Davis et al., "The Economic Effects of Private Equity Buyouts," *Harvard Business School Working Paper*, No. 20-046, October 2019. https://www.hbs.edu/faculty/Publication%20Files/20-046_ceb00b98-e62a-45db-8d5f-9793ffd0226e.pdf (10 December 2020)

[15] Mayra Rodriguez Valladares, "New Study Shows Adverse Economic Effects of Private Equity Buyouts," October 7, 2019. *Forbes.com*. https://www.forbes.com/sites/mayrarodriguezvalladares/2019/10/07/new-study-shows-adverse-economic-effects-of-private-equity-buyouts/#2b41327269e1 (10 December 2020)

them back into the network at sharply higher reimbursement rates. The result is good for the private equity firm, but patients and their employers lose as insurance premiums rise.[16]

Because private equity firms also collect fee income, they have incentives other than maximizing enterprise value—a consideration that sets them apart from corporate raiders and hedge fund activists. In fact, the main critique underpinning Senator Warren's legislation is that private equity operators often bankrupt target firms by extracting too much value from them.

After a private equity firm executes a leveraged buyout (LBO), whereby it takes on debt to finance the purchase of an asset, it places the bank loan used to acquire the target company on the company's balance sheet. As a result, some of the company's cashflow must now be dedicated to servicing a debt obligation that it did not have prior to the buyout. In addition, the private equity firm may charge the acquired company a transaction fee, monitoring fees, and board meeting attendance fees.[17] The combined impact of debt service and fee expenses could tip an otherwise viable firm into bankruptcy. And even when bankrupt firms do not liquidate altogether, they often shrink, shedding jobs in the process.

The association between private equity ownership and bankruptcy has been especially pronounced in the retail sector. Of the 104 retailers that have been through a private equity acquisition between 2002 and the middle of 2020, 34 (or almost one third) have filed for Chapter 11 bankruptcy.[18] Among private-equity-controlled retailers filing for bankruptcy in recent years have been Toys R Us, Payless ShoeSource, Gymboree, Brookstone, H.H. Gregg, Nine West, The Limited, Charlotte Russe, Shopko, J. Crew, and Neiman Marcus (which was co-owned by the Canada Pension Plan Investment Board when it filed).

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16 Eileen Appelbaum, "Private equity is a driving force behind devious surprise billing," *The Hill*, May 16, 2019. https://thehill.com/opinion/healthcare/444011-private-equity-a-driving-force-behind-devious-surprise-billing (10 December 2020)

17 Elizabeth Anderson, "The Economics of Private Equity Investing: Understanding Fees," *Beekman Wealth Advisory*, 2013. https://beekmanwealth.com/wp-content/uploads/2019/08/Private-Equity-Investing-Fees.pdf (10 December 2020)

18 Ben Unglesbee, "In pandemic era, private equity-owned retail is as vulnerable as ever," *Retail Dive*, July 14, 2020. https://www.retaildive.com/news/in-pandemic-era-private-equity-owned-retail-is-as-vulnerable-as-ever/581252/ (10 December 2020)

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Supermarkets have also been a focus of private equity in recent years. In 2020, the popular upscale New York grocery chain Fairway filed for bankruptcy, closed locations, and terminated hundreds of unionized employees. Eileen Appelbaum and Andrew Park trace the chain's demise to its 2007 acquisition by Sterling Investment Partners, although Sterling had already sold off Fairway before its first bankruptcy filing in 2016. Fairway had $67 million in unfunded pension liabilities at the time of its most recent Chapter 11 filing.[19]

Other supermarket chains with private equity ownership that have gone bankrupt include A&P/Pathmark, Marsh Supermarkets, Fresh & Easy, and Southeastern Grocers. A much larger private-equity-owned supermarket group, Albertson's, avoided bankruptcy, but remained in a relatively weak financial position compared to its publicly owned peer, Kroger's. Supermarket chains employ several hundred thousand unionized employees nationally, many of whom participate in defined benefit pension plans. When Southeastern Grocers filed for bankruptcy, it withdrew from the union's defined benefit pension plan.[20]

2.2.5 HOW PRIVATE EQUITY CONTROL CAN BENEFIT COMPANIES AND THEIR STAKEHOLDERS

Private equity proponents point to the many companies that have benefited from being taken private. Examples listed by the American Investment Council (AIC), a private equity

[19] Eileen Appelbaum and Andrew Park, "How Private Equity Ruined a Beloved Grocery Chain," *The Atlantic*, February 16, 2020. https://www.theatlantic.com/ideas/archive/2020/02/how-private-equity-ruined-fairway/606625/ (10 December 2020)

[20] Eileen Appelbaum and Rosemary Batt, "Private Equity Pillage: Grocery Stores and Workers at Risk," *American Prospect*, October 26, 2018. https://prospect.org/power/private-equity-pillage-grocery-stores-workers-risk/ (10 December 2020). Albertson's returned to the public markets on June 26, 2020 when it began trading on the New York Stock Exchange.

industry trade group, include Hilton Hotels, Dunkin Donuts and Dollar General.[21] These firms prospered after their respective buyouts and continued to perform well after their Initial Public Offerings. Dollar General's stock has continued rising through most of the 2020 coronavirus downturn, achieving a market capitalization of $50 billion in August. Since its 2007 leveraged buyout, the company has doubled both the number of stores it operates[22] and the team members it employs.[23]

In contrast to private-equity-backed specialty retailers that failed before and during COVID-19, the Michaels Companies remains afloat. The craft retailer IPO-ed in 2014 after eight years under private ownership.[24] The firm was profitable in 2017, 2018, and 2019, placing it in a better position to withstand the pandemic than other chains.[25]

The bankruptcies of several retailers that went through leveraged buyouts are not conclusive evidence against the private equity model.

The bankruptcies of several retailers that went through leveraged buyouts are not conclusive evidence against the private equity model. With the growth of e-commerce, most national retail chains are under pressure and many are failing. Companies that filed for Chapter 11 under private equity ownership may have failed even if they had not been taken private in a leveraged buyout. Indeed, a Moody's analysis found that the overall bond

21 American Investment Council, Private Equity Across America. https://www.investmentcouncil.org/private-equity-at-work/in-your-state/ (10 December 2020)

22 Statista, Number of stores of Dollar General in the United States from 2007 to 2019, https://www.statista.com/statistics/253587/number-of-stores-of-dollar-general-in-the-united-states/ (10 December 2020)

23 Statista, Number of employees of Dollar General in the United States from 2007 to 2019, https://www.statista.com/statistics/253605/number-of-employees-of-dollar-general-in-the-united-states/ (10 December 2020)

24 Reuters Staff, "Crafts retailer Michaels raises $473 million in IPO," *Reuters*, June 26, 2014. https://www.reuters.com/article/us-michaels-compans-ipo/crafts-retailer-michaels-raises-473-million-in-ipo-idUSKBN0F203120140627 (10 December 2020)

25 Michaels Companies, 2019 Form 10-K. *SEC EDGAR web site*, March 17, 2020. https://www.sec.gov/ix?doc=/Archives/edgar/data/1593936/000155837020002829/mik-20200201x10k99adc6.htm (10 December 2020)

default rate on private-equity-owned companies between 2008 and 2013 was similar to that of companies not controlled by a private equity sponsor.[26]

While leveraged buyouts do add debt to the acquired company, operational improvements initiated under private ownership can more than offset the added debt service burden. For example, Hertz Corporation implemented numerous operational improvements after its 2005 LBO, such as consolidating car refueling and cleaning operations into a single workstation, thereby allowing faster turnaround of rental vehicles. Hertz's innovations appear to have inspired rental car rivals such as Avis-Budget and Dollar-Thrifty to implement their own process improvements.[27]

Finally, former CKE Restaurants CEO Andy Puzder recounted his own positive experience with private equity ownership in a 2019 *Wall Street Journal* op-ed. Puzder welcomed a buyout in 2010 because he believed his company "needed to de-emphasize quarterly earnings and focus on building the business, something the public market often punishes." Puzder continues:

> *Over the next three years we were able to expand the company, create jobs, lay the groundwork for growth, and sell the company to a second private-equity firm. Our shareholders, employees, suppliers, franchisees, lenders, and management all benefited…*[28]

In summary, private equity appears to have both pluses and minuses. At its best, leveraged buyouts can usher in operational and strategic changes that improve a company's prospects, potentially benefiting all stakeholders. At its worst, private equity buyouts can hasten a company's collapse by saddling it with debt service and fee payment obligations. In these cases, buyouts often result in the loss of union jobs and defined benefit pension benefits at target companies—an ironic outcome for the public pension systems and their largely unionized memberships that finance so much private equity buyout activity.

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26 John Rogers et al., "Post-Crisis Default Rates of PE-Sponsored and Non-Sponsored Companies Similar," *Moody's Investors Service*, June 18, 2014. https://www.moodys.com/research/Moodys-Post-Crisis-Default-Rates-of-PE-Sponsored-and-Non--PR_302105 (10 December 2020)

27 Serdar Aldatmaz and Gregory W. Brown, "Private Equity in the Global Economy: Evidence on Industry Spillovers," UNC Kenan-Flagler Research Paper No. 2013-9, *29th Annual Conference on Financial Economics & Accounting 2018*, August 22, 2019. https://ssrn.com/abstract=2189707 (10 December 2020)

28 Andy Puzder, "Warren would destroy private equity – at everyone's expense," *The Wall Street Journal*, December 15, 2019. https://www.wsj.com/articles/warren-would-destroy-private-equityat-everyones-expense-11576439453 (10 December 2020)

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Regardless of whether they are socially beneficial or detrimental, private equity investments offer the promise of high, uncorrelated returns.
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Regardless of whether they are socially beneficial or detrimental, private equity investments offer the promise of high, uncorrelated returns. Since pension system boards have a fiduciary responsibility to public employees and taxpayers, some have argued that they should prioritize investment performance over other considerations.[29] With that in mind, the next two parts evaluate private equity investment returns and risks.

[29] See, for example, Zachary Christiansen, “California pension funds should focus on improving funded ratios, not politics,” *Orange County Register*, October 30, 2019. https://www.ocregister.com/2019/10/30/california-pension-funds-should-focus-on-improving-funded-ratios-not-politics/ (10 December 2020)

PART 3

PRIVATE EQUITY RETURNS

3.1 PRIVATE EQUITY RETURNS HISTORICALLY

Because private equity vehicles are not publicly traded and their holdings are illiquid, measuring their returns is more complicated than assessing historical public equity returns. Overall performance in the public markets is captured in widely published stock indices such as the Standard & Poor's 500 Index, which are updated in real time.

"Because private equity vehicles are not publicly traded and their holdings are illiquid, measuring their returns is more complicated than assessing historical public equity returns."

Although less publicized and less frequently updated, private equity benchmarks are also available. Among the organizations that calculate private equity performance metrics are Pitchbook, Preqin, Burgiss, Boston Illiquid Securities Offering Network, Inc. ("Bison"),

Cambridge Associates, the Institutional Limited Partners Association (ILPA), and State Street Bank.

The American Investment Council collected various benchmarks from the last four of these organizations. For the 10 years ending December 31, 2019, annualized private equity returns as measured by these benchmarks ranged from 13.8% to 16.5% with a median of 15.2%. This median private equity return is 1.7% higher than that for public equities as measured by the S&P 500 (including dividends) for the same 10-year period.[30]

These results suggest that private equity performance has been quite strong over an extended time frame. However, the period included in the latest AIC update excludes both the Great Recession and the current coronavirus downturn. It is possible to observe the impact of the Great Recession on performance benchmarks by looking at an earlier 10-year period as shown in a previous AIC benchmarking report. For example, the organization's Q4 2015 report shows median benchmark returns of only 11.2% annually. However, it also shows a larger gap between private and public equity returns: 3.9%.[31]

3.2 CORRELATIONS BETWEEN PRIVATE AND PUBLIC EQUITY RETURNS

While the benchmark data support the assertion that private equity outperforms public equity, it is less clear that public and private equity returns are uncorrelated. Table 2 shows calendar year returns for Buyout Funds and the S&P 500 index.

[30] American Investment Council, Performance Update 2019 Q4. https://www.investmentcouncil.org/wp-content/uploads/2019-q4-performance-update-public-version.pdf (10 December 2020)

[31] American Investment Council, Private Equity Performance Report Returns as Reported Through December 2015. https://web.archive.org/web/20160803122037/http://www.investmentcouncil.org/app/uploads/2015-q4-performance-update.pdf (10 December 2020)

TABLE 2: PRIVATE VS. PUBLIC EQUITY CALENDAR YEAR RETURNS, 2000-2018

Calendar Year	Preqin Buyout Fund Internal Rate of Return	S&P 500 Total Return
2000	3.6%	-9.1%
2001	-3.2%	-11.9%
2002	-4.0%	-22.1%
2003	24.3%	28.7%
2004	30.3%	10.9%
2005	29.7%	4.9%
2006	32.3%	15.8%
2007	30.7%	5.5%
2008	-31.0%	-37.0%
2009	16.7%	26.5%
2010	22.6%	15.1%
2011	8.4%	2.1%
2012	15.1%	16.0%
2013	19.2%	32.4%
2014	14.5%	13.7%
2015	17.1%	1.4%
2016	12.4%	12.0%
2017	21.3%	21.8%
2018	12.8%	-4.4%

Sources: Preqin Private Equity Markets: Buyout Benchmark Report Q 2019 and Slickcharts S&P 500 Annual Returns

One way to measure how related one figure is to another is to use a correlation coefficient, which for the above two return series is +0.78.[32] Correlation coefficients range from -1 for series that vary inversely to +1 for series that move precisely in tandem, while a coefficient of 0 is indicative of series that are independent of one another. The coefficient for these two series is indicative of a high degree of correlation between private and public equity returns.

[32] This result is similar to correlations reported by Alexander Beath and Chris Flynn, "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States, 1998-2015 (Updated)," *CEM Benchmarking*, November 1, 2017. https://www.reit.com/sites/default/files/media/DataResearch/NareitCEMStudy2017.pdf (10 December 2020). They report a correlation coefficient of +0.85 between private equity and large cap US stocks.

Private equity funds often realize their returns by selling portfolio companies into the public equity market, so the valuation perspective of public market investors influences the performance of private equity investments.

The fact that private and public equity returns are correlated makes intuitive sense. Private equity funds often realize their returns by selling portfolio companies into the public equity market, so the valuation perspective of public market investors influences the performance of private equity investments.

Even if private equity is highly correlated with public equity, its higher performance would still justify significant allocations by public pension funds. But some scholars question the performance gap shown by the published benchmarks.

3.3 COMPARING PRIVATE AND PUBLIC EQUITY RETURNS

Oxford University economist Ludovic Phalippou recently argued that public and private equity performance has been roughly the same since 2006.[33] Specifically, he criticizes the use of large cap stock indices such as the S&P 500 as a proxy for public equity returns, because small and mid-cap stocks usually perform better. He notes, for example, that T. Rowe Price's Small Cap Stock Fund returned 1.8% more annually than Vanguard's S&P 500 Index Fund between 2006 and 2019.

Phalippou also argues that Internal Rate of Return (IRR) used in private equity benchmarks is inappropriate. He states:

[33] Ludovic Phalippou, "An Inconvenient Fact: Private Equity Returns & The Billionaire Factory," Working Paper at *Social Science Research Network*, July 15, 2020. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3623820 (10 December 2020)

> *IRRs are not rates of return. Something large PE firms have in common is that their early investments did well. These early winners have set up those firms' since-inception IRR at an artificially sticky and high level. The mathematics of IRR means their IRRs will stay at this level forever, as long as the firms avoid major disasters.*

Instead, Phalippou advocates benchmarking private equity performance against public equity by a measure known as the Kaplan-Schoar Public Market Equivalent (KS-PME).[34] KS-PME is the ratio of the present value of capital distributed by private equity funds to the present value of capital invested in them. All cashflows are discounted by the rate of return on a benchmark public equity index.

The result is a ratio between private and public market returns. For the period 2006-2015, Phalippou reports a KS-PME of 0.99 for all private equity funds tracked by Burgiss using the S&P 500 index return as the discount rate. This result indicates a slight *underperformance* of private equity for the period. Phalippou provides alternative measures of KS-PME using different private equity data sets and public market indices ranging from 0.96 to 1.16.

Further, there is evidence that private equity returns experienced by public employee pension funds are not as strong as most benchmarks suggest. Cliffwater Research compiled 10-year return data from 66 large U.S. public pension funds, 39 of which reported returns on U.S. stocks and 35 of which reported returns on private equity. The median U.S. public pension fund reported a 13.88% annualized return on private equity versus a 14.35% for U.S. stocks over the same 10-year period.[35]

"*The median U.S. public pension fund reported a 13.88% annualized return on private equity versus a 14.35% for U.S. stocks over the same 10-year period.*"

[34] KS-PME is explained in Martin Sorenson and Ravi Jagannathan, "The Public Market Equivalent and Private Equity Performance," November 1, 2013. *Netspar Discussion Paper,* Number 09/2013-039. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2347972 (10 December 2020)

[35] Cliffwater, LLC, Long-Term State Pension Performance, 2000 to 2019, May 2020.

As cited earlier, AIC reported benchmarks ranged from 13.8% to 16.5%. It appears that median pension fund performance is at the low end of the benchmark range. Since Cliffmark relied on pension fund reports for the 10-year period ending June 30, 2019, and the AIC data are for the 10-year period ending December 31, 2019, there is a small timing discrepancy between the two sets of measures, however the impact should be quite limited since late 2009 and late 2019 were both bullish periods.

Overall, the evidence on returns presented here is mixed, but it appears that in the 2010s both public and private equity investments provided U.S. public pension systems with similarly strong returns. Evidence over a longer period that includes bear markets shows that public and private investment returns tend to move together, suggesting that the diversification benefit of adding private equity to a portfolio already invested in public equity is limited.

3.4 PRIVATE EQUITY RETURNS DURING 2020

As of this writing, we only have some preliminary indications of private equity performance in 2020. The South Carolina Retirement System has reported fiscal year 2020 performance by asset category. Overall, the system returned (or in this case lost) -1.58% on assets. Global public equity returned 0.68% while private equity returned -6.75%. Other alternative asset classes also performed poorly: private debt returned -5.64%, Global Tactical Asset Allocation (a hedge fund strategy) returned -5.49% and "other opportunistic" investments returned -22.45%.[36]

CalPERS has also reported returns by asset classes for the year ending June 30, 2020. That system, the nation's largest, showed net returns of -5.1% on private equity versus +0.6% for public equity.[37]

36 South Carolina Retirement System Investment Commission, Quarterly Report: June 30, 2020. https://www.rsic.sc.gov/Reporting/QuarterlyReports/PDFs/FY20-Q4.pdf (10 December 2020)

37 CalPERS, CalPERS Trust Level Quarterly Update - Performance & Risk, September 14, 2020. https://www.calpers.ca.gov/docs/board-agendas/202009/invest/item05c-01_a.pdf (10 December 2020)

> *Although the evidence thus far is limited, there are strong reasons to believe that private equity will significantly underperform public equity during the unusual conditions of 2020 and will not be able to consistently outperform its public counterpart after conditions normalize.*

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If PE indices are benchmarked against the S&P 500, that index's heavy weighting toward large cap technology stocks must be considered. In January, CNBC reported that five tech companies—Apple, Microsoft, Alphabet, Amazon, and Facebook—made up 17.5% of the S&P 500 index.[38] As these companies have outperformed the broader market in 2020, their weighting in the S&P 500 has increased. By the end of November, these five companies accounted for 22% of the S&P 500.[39]

> *Private equity firms are not normally able to acquire highly profitable large-cap firms, so if these firms heavily influence a public equity benchmark, private equity will be at a relative disadvantage for which it cannot easily compensate.*

[38] Ari Levy and Lorie Konish, "The five biggest tech companies now make up 17.5% of the S&P 500 — here's how to protect yourself," *CNBC*, January 28, 2020. https://www.cnbc.com/2020/01/28/sp-500-dominated-by-apple-microsoft-alphabet-amazon-facebook.html (10 December 2020)

[39] Gabe Alpert, Top 10 S&P 500 Stocks by Index Weight. *Investopedia*, August 21, 2020. https://www.investopedia.com/top-10-s-and-p-500-stocks-by-index-weight-4843111. (10 December 2020)

Private equity firms are not normally able to acquire highly profitable large-cap firms, so if these firms heavily influence a public equity benchmark, private equity will be at a relative disadvantage for which it cannot easily compensate. Further, there is some evidence that private equity industry allocations were disadvantageous coming into the coronavirus downturn. To the extent that private equity funds were focused on energy and hospitality names and underweight technology, they are likely to have underperformed in an environment in which physical travel has been replaced by online interaction. Without access to a full breakdown of private equity holdings by industry, it is not possible to say with certainty that PE funds were poorly positioned for the pandemic; however, the limited evidence available suggests this is the case.

First, private-equity-backed firms have been among the high-profile 2020 bankruptcies, including those of health club operator 24 Hour Fitness, retailers J. Crew and Neiman Marcus, and Chesapeake Energy.[40] Pitchbook reported that a record 16 private-equity-owned companies filed for bankruptcy in May 2020.[41]

Second, a review of 2019 private equity financings in which at least one of the four major private equity firms participated reflects a pre-pandemic deal flow inconsistent with strong returns in this year's investment environment. The 11 investments listed were found by querying CrunchBase, a web-based database of private equity and venture capital deals. Two of the three biggest deals shown in Table 2 involve energy companies, while the third involves a firm that provides financing for commercial airplanes. The only two investments that could be considered information technology plays were among the smaller positions: Superbet, a Romanian gambling company developing an international online gaming platform and HH Global, which provides marketing services for major brands with the assistance of an online procurement platform.

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40 Chesapeake was no longer under private equity ownership when it filed for bankruptcy in June. But Carlyle Group owned 9% of the company until May, after suffering losses on its position. See Bill Holland, "PE giant Carlyle unloads all of its leading stake in Chesapeake Energy," *S&P Global*, May 15, 2020. https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/pe-giant-carlyle-unloads-all-of-its-leading-stake-in-chesapeake-energy-58662212 (10 December 2020)

41 Adam Lewis, "Private equity-backed bankruptcies surged in May, but future might not be so bleak," *Pitchbook*, June 5, 2020. https://pitchbook.com/news/articles/private-equity-backed-bankruptcies-surged-in-may-but-future-might-not-be-so-bleak (10 December 2020)

TABLE 3: SELECTED INVESTMENTS INVOLVING LARGE PRIVATE EQUITY FIRMS IN 2019

Company	Money Raised ($M)	Industry
Abu Dhabi National Oil Co.	$4,000	Oil and Gas
Altavair	$1,000	Finance, Commercial Aviation Finance
NextEra Energy Partners	$900	Renewable Energy
Metro Pacific Hospital Holdings	$685	Health Care, Hospital
Rothesay Pensions Management	$613	Business Development
FerGene	$570	Genetics, Life Science, Therapeutics
India Grid Trust	$400	Construction, Financial Services
Toorak Capital Partners	$250	Financial Services, Lending, Real Estate
Superbet	$196	Casino, Gambling, Online Games, Sports
Aakash Educational Services	$191	Education
HH Global	$130	Advertising, Information Technology, Manufacturing, Marketing

Source: Crunchbase, http://www.crunchbase.com (5 September 2020).[42]

3.5 PROSPECTS FOR RETURNS POST-2020

This has been an idiosyncratic year, but beyond 2020, there is a strong reason to believe that any return advantage of private over public equity will diminish and possibly invert. As more money is invested in an innovative strategy like private equity, opportunities for outsize returns become harder to find. Any low-hanging fruit (i.e., companies with obvious mismanagement and high upside potential) has already been picked, and fund managers may be obliged to pay more for acquisitions amid increased competition.

[42] I queried Crunchbase's proprietary database for private equity funding rounds in 2019 in which Apollo, Blackstone, Carlyle and KKR participated and where the amount of money raised was provided. In some cases, Crunchbase provided money raised amounts in a foreign currency; I converted these to U.S. dollars.

When an investment strategy is relatively new, investors have a greater opportunity to earn alpha—excess returns above those expected in return for taking greater risk. But as the strategy becomes more widely known and practiced, the chance to gain alpha is competed away.

This trend has been apparent in the hedge fund sector and in value investing for some time. After providing excellent returns during the 1990s and 2000s, hedge funds underperformed in 2010s. The Hedge Fund Research Inc. (HFRI) 500 Hedge Fund Index of the largest hedge funds returned only 4.28% annually during the 2010s[43]—well below private and public equity returns.

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Straight comparisons between hedge fund returns and equity index movements are not appropriate because hedge funds often take short positions and invest in fixed income securities. Sullivan computed hedge fund alpha—their excess returns over a more comparably weighted average of stock and bond indices. He found that between 1994 and 2008, hedge funds provided alpha of 3.4% annually, but between 2009 and 2019, hedge fund alpha was negative, -1.0%.[44]

Various explanations have been given for the decline in performance, but the increase in hedge fund assets seems to be a factor. Between early 2000 and mid-2008, hedge fund industry assets under management rose from $214.3 billion to $2,348.8 billion, a more than

[43] Author's analysis of data provided by Hedge Fund Research, Inc. HFRI 500 Fund Weighted Composite Index. August 31, 2020, https://www.hedgefundresearch.com/indices/hfri-500-fund-weighted-composite-index (password required - 10 September 2020)

[44] Rodney N. Sullivan, "Hedge Fund Alpha: Cycle or Sunset," Winter 2021, *The Journal of Alternative Investments*, Number 2020.1.117. Available at SSRN: https://ssrn.com/abstract=3498595 (10 December 2020)

10-fold increase. After a sharp contraction during the global financial crisis, hedge fund assets resumed their rise reaching $3,140.0 billion at the end of 2019.[45]

The 2010s were also difficult for value investors, those who buy and hold stocks that they believe to be undervalued by the market based on the company's long-term fundamentals. The strategy was popularized by Benjamin Graham in his 1949 book *The Intelligent Investor*, and its leading practitioner has been Warren Buffett,[46] whose Berkshire Hathaway generally outperformed stock indices for decades.[47]

But for the period 2010-2019, however, Berkshire slightly underperformed the S&P 500, returning a total of 242% versus 257% for the large-cap stock index.[48] A smaller investment partnership that used the same approach decided to close in 2018 because it no longer saw sufficient opportunities to apply value investing principles. In announcing the closure of SPO Partners after 49 years, co-managing partner Eli Weinberg said: "Businesses we admire, in well-positioned sectors with attractive growth prospects, are priced to perfection." In other words, improved market efficiency had made it difficult for the $5 billion fund to earn alpha. As ValueWalk reported at the time, value-oriented hedge fund managers such as David Einhorn and Eddie Lampert were also struggling in the late 2010's market environment.[49]

[45] BarclayHedge, Hedge Fund Industry: Assets Under Management – Historical Growth of Assets. https://www.barclayhedge.com/solutions/assets-under-management/hedge-fund-assets-under-management/hedge-fund-industry (10 December 2020)

[46] Adam Hayes, "Value Investing," *Investopedia*, July 26, 2020. https://www.investopedia.com/terms/v/valueinvesting.asp (10 December 2020)

[47] Al Root, "Breaking Down the Buffett Formula: Berkshire Hathaway's Returns by the Numbers," *Barron's*, February 25, 2020. https://www.barrons.com/articles/berkshire-hathaways-investing-returns-a-breakdown-by-numbers-51582633800 (10 December 2020)

[48] Dan Caplinger, "The 1 Thing Warren Buffet's Critics are Missing," *Motley Fool*, February 25, 2020. https://www.fool.com/investing/2020/02/25/the-1-thing-warren-buffetts-critics-are-missing.aspx

[49] Mark Melin, "Beta Market Environment Claims Another Value Hedge Fund Victim," *ValueWalk*, November 9, 2018. https://www.valuewalk.com/2018/11/spo-partners-beta-market-environment/ (10 December 2020)

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In the 2010s, private equity has been following the hedge fund growth trajectory of a decade earlier, According to Preqin, private equity assets under management rose from $2.49 trillion in June 2016[50] to $4.11 trillion in June 2019.[51] The large volume of fund inflows poses challenges for fund managers. As Preqin reported:

> *[T]he influx of investable capital and intensifying competition have helped to drive up asset prices. Just over half (51%) of fund managers and over two-thirds of investors (69%) feel that private equity portfolio company prices are higher compared with 12 months ago. And 44% of fund managers experienced more competition for private equity transactions.*[52]

With potential acquisitions "priced to perfection" it will be more challenging to buy, re-engineer, and resell companies at market-beating margins going forward. Further, to provide investors with excess returns, private equity managers must offset the high costs of their business model. As Phalippou notes:

> *To acquire all these assets, many professionals (lawyers, consultants, advisers, accountants) spend long hours analysing companies from every angle, designing business*

[50] 2017 Preqin Global Private Equity and Venture Capital Report, *Preqin*. https://docs.preqin.com/samples/2017-Preqin-Global-Private_Equity-and-Venture-Capital-Report-Sample-Pages.pdf (10 December 2020)

[51] 2020 Preqin Global Private Equity and Venture Capital Report, *Preqin*. https://docs.preqin.com/samples/2020-Preqin-Global-Private-Equity-Venture-Capital-Report-Sample-Pages.pdf (10 December 2020)

[52] Ibid.

> *plans and complex corporate structures (aimed at minimizing tax bills among other things). After the acquisition, there may be more work to be done by consultants, investments bankers and some additional fees charged by the PE firms.*[53]

He estimates these costs at 3.3% of invested capital. This implies that if private equity managers outperform public equity benchmarks by less than 3.3% on a pre-expense basis, their investors will see lower returns than they would in the public equity market.

[53] Phalippou, "An Inconvenient Fact: Private Equity Returns & The Billionaire Factory."

PART 4

CHALLENGES WITH PRIVATE EQUITIES

4.1 VALUATION AND TRANSPARENCY ISSUES

As of this writing it is not possible to conclusively characterize private equity performance for Fiscal Year 2020 due to reporting lags and other transparency challenges. For frequently traded stocks, exchange-traded funds, and many fixed income securities, it is possible to obtain valuations in real time and at no cost from websites such as Yahoo Finance and Marketwatch. For traditional mutual funds that hold exchange-traded securities, net asset values are updated daily. As a result, it is possible to track the returns on these instruments without significant time lags.

This is not the case with private equity funds and most other types of alternative assets. Limited partners must wait for statements from general partners, which are typically produced quarterly and with a lag that can be days or even weeks. These lags help explain why pension funds are unable to provide more-frequent performance updates and immediately advise stakeholders about annual performance after the end of each fiscal year. If pension funds invested solely in publicly traded securities, their performance could be monitored more continuously.

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Further, private equity valuations are subject to error and potential bias. Because shares of companies owned by private equity funds are not publicly traded, the value of these shares can only be estimated. It is only when the privately held company is sold or its shares resume trading that its value can be precisely established.

Thus, the valuations provided by private equity fund sponsors may underestimate or overestimate the resale value of fund holdings. Since fund sponsors have an incentive to report better returns, they may be biased toward estimating higher valuations. This is especially the case when a private equity fund manager is raising capital for new funds, since investors are more likely to provide capital to fund managers that post strong results.[54]

Researchers and other interested parties have added difficulty monitoring private equity funds because the assets held by these vehicles—the portions of the companies they own—are not a matter of public record. While a mutual fund must periodically publish its list of assets in accordance with Securities and Exchange Commission rules,[55] no such disclosure obligation attaches to private equity funds because their shares are not offered to the public.[56]

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[54] Americans for Financial Reform Education Fund, "Private Equity Industry Overstates Returns, Downplays Fees and Risks," February 2020. https://ourfinancialsecurity.org/2020/02/fact-sheet-private-equity-overstates-returns-downplays-fees-risks/ (10 December 2020)

[55] Securities and Exchange Commission, "Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies," May 10, 2004. https://www.sec.gov/rules/final/33-8393.htm (10 December 2020)

[56] Private equity funds may seek an exemption from SEC disclosure requirements under Rule 506(b) of Regulation D which offers safe harbor to securities offerings for which there is "no general solicitation or advertising to market the securities" and can only be sold to accredited investors and no more than 35 non-accredited investors. The rule is described at: Securities and Exchange Commission, Private placements - Rule 506(b), March 12, 2020. https://www.sec.gov/smallbusiness/exemptofferings/rule506b (10 December 2020). Accredited investors are institutions as well as individuals whose income or non-real estate net worth exceeds SEC-specified thresholds.

Listings of private equity fund investments are available on the Bloomberg Professional Terminal and other paid services, but these subscription-based tools may be too costly for oversight agencies, taxpayer groups, public employee advocates, and other concerned citizens.

4.2 IMPROVING PENSION FUND REPORTING ON PRIVATE EQUITY HOLDINGS

> *Pension systems could improve transparency by disclosing their stakes in private equity funds and the list of companies each of these funds owns. Such disclosure would enable third parties to identify problems that may impact future returns.*

Pension systems could improve transparency by disclosing their stakes in private equity funds and the list of companies each of these funds owns. Such disclosure would enable third parties to identify problems that may impact future returns. For example, this author previously reported that CalPERS invests with a private equity group, CVC Capital Partners, that owns a stake in an Italian casino operator, Sisal Group SpA.[57] It is likely that Sisal suffered a loss in value due to the coronavirus pandemic, which resulted in temporary closures of casinos followed by reduced patronage. In May, Standard & Poor's downgraded the firm's credit rating from B+ to B,[58] suggesting a heightened risk of bankruptcy and thus a negative outcome for private equity investors. Without knowing the amount of exposure CalPERS has to Sisal Group—if any—it is impossible to assess the impact of this downgrade on CalPERS' private equity portfolio.

Short of reporting underlying private equity fund portfolios, systems could at least provide lists of the funds in which they invest with some summary information. The Government

[57] Marc Joffe, "COVID-19's Negative Impact on Public Pension Systems," Reason Foundation, April 10, 2020. https://reason.org/commentary/covid-19s-negative-impact-on-public-pension-systems/ (10 December 2020)

[58] CBonds, "S&P Global Ratings downgrades Local Currency LT credit rating of Sisal Group to "B"; outlook negative," May 6, 2020, http://cbonds.com/news/item/1235029 (10 December 2020)

Accounting Standards Board (GASB) requires pension systems to report their asset allocations but not detailed lists of portfolio holdings. Some systems exceed GASB requirements, but reporting formats vary making comparisons across systems challenging. The South Carolina Retirement System publishes an "Annual Investment Report." For private equity, SCRS reports the name of the fund, unit price of their shares, initial cost, and current value.[59] CalPERS provides a similar level of disclosure. For private equity funds, CalPERS lists the fund name, book value, and current value.[60]

The California State Teachers Retirement System (CalSTRS) also issues separate investment listings but provides greater detail. For each private equity fund, CalSTRS lists fund name, year acquired, capital committed, capital contributed, capital distributed, and internal rate of return (IRR).[61] This presentation offers important insights not available from the SCRS and CalPERS reports. The difference between capital committed and capital contributed is the amount that the PE fund can require CalSTRS to invest through capital calls (often on short notice). Capital distributed refers to amounts that the private equity fund has remitted to CalSTRS after selling certain holdings. This data point provides an indication of realized returns that are no longer subject to valuation estimation error on the part of fund managers.

The level of detail CalSTRS offers could serve as a model for other pension systems. Ideally, such reports would be produced quarterly and accompanied by the names of the companies held by each private equity fund.

4.3 INVESTMENT FEE REPORTING

Private equity funds, like hedge funds and other actively managed alternative investment vehicles, often charge limited partners substantial management fees and other investment costs. Due to a lack of standardized fee reporting, it is not possible to provide national

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59 South Carolina Retirement System Investment Commission, *Annual Investment Report*, June 30, 2019. https://www.rsic.sc.gov/_documents/Reporting/2019-annual-report.pdf (10 December 2020)

60 CalPERS, CalPERS 2018-19 Annual Investment Report, November 21, 2019. https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2019.pdf (10 December 2020)

61 California State Teachers' Retirement System, *Private Equity Portfolio Performance*, September 30, 2019. https://www.calstrs.com/sites/main/files/file-attachments/private-equity-performance-093019.pdf?1584720937 (10 December 2020)

investment cost statistics by asset classes, but a couple of reports from individual systems illustrate the gap.

CalSTRS regularly reports investment costs by asset class, providing thought leadership in this area of transparency as well as in portfolio reporting as discussed previously. For the most recently available year, 2018, CalSTRS reported private equity investment costs totaling 3.840% of net asset value (NAV) compared to a cost rate of just 0.184% for its global public equity portfolio. Investment costs for private equity were far higher than any other asset class included in the CalSTRS report. Real estate—the second-costliest category—had total investments costs of 1.676% of NAV.[62]

A large portion of CalSTRS private equity investment costs is related to carried interest, which some other plans exclude from their cost reporting.

A large portion of CalSTRS private equity investment costs is related to carried interest, which some other plans exclude from their cost reporting. Carried interest is the share of profits "paid to the general partner upon the profitable exit from an investment and only after specific performance thresholds have been achieved (e.g. a preferred rate of return). Typically, carried interest is not paid until limited partners receive back all contributions (including fees and expenses) and a preferred return hurdle is met."[63] Of the total 3.840% private equity investment costs incurred by CalSTRS in 2018, 1.737% was carried interest. Between 2015 and 2018, CalSTRS carried interest costs varied widely—ranging up to 3.084% in 2017, while all other costs remained within a narrow range of 2.020% to 2.126%.

South Carolina's Retirement System Investment Commission also reports investments costs, including carried interest, by asset class. Its latest report showed private equity as the

[62] Debra Smith et al., *Annual Investment Cost Report*, *CalSTRS*. November 6, 2019. https://resources.calstrs.com/publicdocs/Page/CommonPage.aspx?PageName=DocumentDownload&Id=6d7d1928-de94-409c-aa64-6bcb82d1ce91 (10 December 2020)

[63] Ibid.

costliest investment class, with aggregate fees totaling 4.00% compared to only 0.25% for global public equity.[64]

Fee reporting standards would enable stakeholders to obtain a more complete picture of the investment cost landscape for private equity and other alternative asset categories. The Institutional Limited Partner Association (ILPA) has developed a standard fee reporting template, available in Excel and XML formats. Although ILPA reports that more than 200 general partners are using the template,[65] there does not appear to be a public repository of completed templates.

Given that the historical performance data presented earlier were reported net of fees, private equity funds have been able to match or surpass returns on public equities despite the investment costs they levy. The mere existence of high fees is not necessarily a reason for pension funds to avoid private equity investments. If an investment vehicle can provide superior risk-adjusted returns net of investment costs, the absolute level of these costs should not deter investors from choosing such vehicles.

The mere existence of high fees is not necessarily a reason for pension funds to avoid private equity investments. If an investment vehicle can provide superior risk-adjusted returns net of investment costs, the absolute level of these costs should not deter investors from choosing such vehicles.

That said, for reasons presented above, it will be harder for private equity funds to outperform public equities because increasing fund inflows will compel general partners to find less-attractive investment opportunities. Competition for new acquisitions could force expected returns down toward public market equivalents. If that dynamic does play out, high fees would result in underperformance.

[64] Retirement System Investment Commission, Fee Transparency. https://www.rsic.sc.gov/what-we-do/fee-transparency.html (10 December 2020)

[65] Institutional Limited Partner Association, Reporting Template. https://ilpa.org/reporting-template/. (10 December 2020)

4.4 CONFLICTS OF INTEREST AND CORRUPTION

> *Another concern with high investment fees is that they contribute to conflicts of interest and even possible corruption.*

Another concern with high investment fees is that they contribute to conflicts of interest and even possible corruption. In several cases, pension fund executives have lost their positions or faced litigation due to ethical lapses associated with private equity investing.

In August 2020, Ben Meng, the chief investment officer of CalPERS, was compelled to step down when it emerged that he failed to recuse himself from a decision to invest CalPERS assets in Blackstone private equity funds, when he owned Blackstone stock. Given that the value of his Blackstone shares was relatively small—about $70,000—the failure to report may have been a simple oversight and his Blackstone holdings did not influence the investment decision he made on behalf of CalPERS. Nonetheless, the appearance of impropriety prompted his departure and triggered calls for an investigation.[66]

Meng's troubles came a decade after CalPERS suffered through a true "pay for play" scandal involving private equity investments. In May 2010, then California Attorney General Jerry Brown sued former CalPERS Board Member Alfred Villalobos and former CalPERS CEO Frederico Buenrostro for fraud in connection with their efforts to influence the fund to invest in private equity funds, thereby generating $40 million in "placement agent" fees. A placement agent is an intermediary who is compensated by an investment fund for helping it raise capital. As Brown explained in his press release,

> *… Villalobos spent tens of thousands of dollars to lavishly entertain key senior executives at CalPERS, who then influenced the Board to authorize investments that generated over $40 million in commissions to Villalobos. … None of these actions were disclosed as required by law, as state pension holders and taxpayers have every right to expect.*

[66] Amanda Cantrell, "The Crucifixion of Ben Meng," *Institutional Investor*, August 16, 2020. https://www.institutionalinvestor.com/article/b1mz3b224c6m4y/The-Crucifixion-of-Ben-Meng (10 December 2020)

According to the complaint, Villalobos influenced these CalPERS officials by, among other things, taking two of them on an around-the-world trip, taking another on a private jet trip to New York, and giving Buenrostro a $300,000 job and a condo when he left the pension fund.[67]

Ultimately, Buenrostro pleaded guilty to a federal corruption charge and agreed to testify against Villalobos, who committed suicide shortly before his criminal trial. Villalobos' estate agreed to pay the California Attorney General's Office $20 million to settle the civil matter.[68]

Another corruption scandal involving private equity investments resulted in the conviction of a former New York State comptroller. Alan Hevesi pleaded guilty to a felony charge of "receiving reward for official misconduct" due to an investment in Markstone Capital, LP, a private equity fund that invested in Israeli companies. According to a press release issued by then-Attorney General Andrew Cuomo:

> *Hevesi acknowledged receiving nearly $1 million in gifts in exchange for improperly favoring and approving a $250 million investment in Markstone Capital Partners, L.P. from the New York State Common Retirement Fund. The gifts consisted of $75,000 in travel expenses for Hevesi and his family, $380,000 in sham consulting fees for a lobbyist friend, and over $500,000 in campaign contributions as directed by Hevesi. Hevesi also acknowledged that while he served as Comptroller he was aware that Henry "Hank" Morris—his paid political adviser and campaign manager—was using the pension fund for a pay-to-play scheme in which Morris personally received fees from pension deals and steered investments to friends and political associates.*[69]

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67 California Attorney General's Office, "Brown Files Suit Against Former CalPERS Officials And Freezes Assets of Alfred Villalobos," May 6, 2010. https://www.oag.ca.gov/news/press-releases/brown-files-suit-against-former-calpers-officials-and-freezes-assets-alfred (10 December 2020)

68 "California settles with Villalobos' estate for $20 million on CalPERS bribery scandal," *Pensions & Investments*, May 16, 2016. https://www.pionline.com/article/20160316/ONLINE/160319896/california-settles-with-villalobos-estate-for-20-million-on-calpers-bribery-scandal (10 December 2020)

69 New York State Office of the Attorney General, "Cuomo Announces Felony Guilty Plea By Former Comptroller Alan Hevesi In Pay-to-play Pension Fund Kickback Scheme," October 7, 2010. https://ag.ny.gov/press-release/2010/cuomo-announces-felony-guilty-plea-former-comptroller-alan-hevesi-pay-play#:~:text=October%207%202010-,Cuomo%20Announces%20Felony%20Guilty%20Plea%20By%20Former%20Comptroller%20Alan%20Hevesi,play%20Pension%20Fund%20Kickback%20Scheme&text=Hevesi%20pleaded%20guilty%20to%20a,to%20four%20years%20in%20prison (10 December 2020).

Kentucky has also seen conflict of interest allegations in connection with pension fund investments in private equity and other alternatives. Kentucky Retirement System CIO Adam Tosh resigned as auditors found that he had a previous working relationship with a placement agent. The agent, Glen Sergeon, collected nearly $6 million from seven separate KRS investments.[70] The Kentucky attorney general has also filed a lawsuit against Blackstone, KKR, and others alleging that they sold KRS "unsuitable investment products."[71]

Because a new pension fund investment in one of these vehicles produces a large amount of income for asset managers, they have a strong incentive to generously fund sales efforts. This funding creates temptations for internal sales staff, third party placement agents and pension fund clients to make ethical compromises.

These incidents are a byproduct of the high fees charged by private equity funds and other alternative asset managers. Because a new pension fund investment in one of these vehicles produces a large amount of income for asset managers, they have a strong incentive to generously fund sales efforts. This funding creates temptations for internal sales staff, third party placement agents and pension fund clients to make ethical compromises. Investments in public securities, by contrast, generate limited fees and commissions. The sponsors of public investment vehicles thus have much less of an incentive to finance ethically dubious sales activities.

70 John Cheves, "Audit examines role of middlemen in state pension investment deals," *Lexington Herald-Leader*, August 13, 2010. https://www.kentucky.com/article44044200.html (10 December 2020)

71 Rob Kozlowski, "Kentucky sues Blackstone, former KRS execs over fiduciary breaches," *Pensions & Investments*, July 23, 2020. https://www.pionline.com/courts/kentucky-sues-blackstone-former-krs-execs-over-fiduciary-breaches (10 December 2020)

PART 5

CONCLUSION

In an environment characterized by very low risk-free returns and high return targets, it is understandable that pension system investment managers are seeking unconventional investment options. With private equity funds reporting consistently strong returns during the 2010s, increasing exposure to this asset class would seem to be a reasonable choice.

But, over the longer term, the adage “there ain’t no such thing as a free lunch” applies to financial markets. As opportunities to receive excess risk-adjusted returns become known, they are “arbitraged” away through competition.

Whether private equity’s excess returns ended before the coronavirus recession, are ending as a result of the downturn, or may resume for a few more years is open to debate, but it seems inevitable that this asset class, like hedge funds before it, must fall back to earth.

Once private equity stops offering a free lunch—assuming it has not already stopped doing so—fund managers will be left only with the downsides of this asset class, which include high fees, lack of transparency, and valuation challenges.

Rather than wager on private equity, on other alternative assets, or on the next trendy investment category, pension system boards and elected officials should consider the more prudent approach of lowering assumed rates of return so that they can be achieved most years with a conservative mix of fixed income and public equity investments.

If pension fund investment managers continue to invest in private equity, they should facilitate external oversight of these investments by providing detailed portfolio listings (including commitments to and realized returns from each holding) as well as fee disclosures on a regular basis.

ABOUT THE AUTHOR

Marc Joffe is a senior policy analyst at Reason Foundation. Before pursuing a second career in policy research, Joffe worked in financial and IT roles for several financial institutions including HSBC, CIBC, and Moody's Analytics, where he was a senior director until 2011. His research has been published by the California State Treasurer's Office, the Mercatus Center at George Mason University, the Haas Institute for a Fair and Inclusive Society at UC Berkeley, and the Macdonald-Laurier Institute, among others. His op-eds have appeared in *The Fiscal Times*, *RealClearMarkets, Bloomberg View,* and the *Guardian,* as well as in numerous local outlets. Immediately before joining Reason, Joffe was the director of policy research at the California Policy Center. He has a BA and an MBA from New York University and an MPA from San Francisco State University.