Opinion **Inside Business**

Pension funds and private equity: a puzzling romance

Investors are supposed to be paid extra for lack of liquidity in investments. Not any more

JONATHAN FORD

Calpers is seeking to raise the proportion of its giant fund in private equity by a third © Getty

Jonathan Ford FEBRUARY 2 2020

It is a guiding principle of finance that there is a premium to pay for tying up investors' money in illiquid investments. The tighter those knots are, and the longer holders are bound in for, the higher the price.

Take private equity, where investors commit their cash for up to a decade in unsaleable investments.

You might think at first glance that this rule goes without saying. After all, don't most buyout industry handouts show private equity investments returning much more than public market alternatives?

Returns data from the British Private Equity and Venture Capital Association's 2018 performance measurement survey provide an example. These show that over the previous decade, UK private equity generated returns of 13.7 per cent a year, net of fees, far outpacing the 9.1 per cent on the FTSE All-Share index.

They suggest that when pension schemes fling their cash at buyouts, they can expect some reward for their patience. That is schemes such as Calpers, which is seeking to raise the proportion of its giant fund in private equity by a third, or Britain's Universities Superannuation Scheme, which has roughly 21 per cent of its assets tied up in "private markets".

So all's well with the world then? Not so fast.

Look more carefully at that data and you start questioning the existence of the so-called "illiquidity premium". Doubts centre on the numbers, and whether they present a realistic picture of the relative performance of buyouts.

Academics have long questioned whether the internal rate of return (IRR) calculations favoured by buyout firms overstate their performance against quoted stocks.

Consequently, most recent studies favour the so-called "Public Market Equivalent" measure, which takes all the cash flows between the investors and a buyout fund, net of fees, and discounts them at the rate of return on the relevant benchmark (for example the stock market). On this basis, the outperformance vanishes.

A large study conducted in 2015 by three academics looked at nearly 800 US buyout funds between 1984 and 2014. They found that before 2006, these funds delivered an excess return of about 3 per cent per annum, net of fees, relative to the S&P 500 index. In subsequent years though, returns have been about the same as on the stock markets. A study of European markets produced similar results.

So why are pension fund investors continuing to pump huge allocations at private equity? Last year $301bn was poured into US buyout funds, a quarter more than the previous record set in 2017.

One intriguing explanation is that offered by the well-known hedge fund manager, Cliff Asness, in a recent article. He argues that pricing opacity and illiquidity are not actually bugs in the private equity model, but features that investors willingly pay for.

The reasoning runs as follows. Most pension funds know that they need to boost returns if they are to redeem the costly promises they have made to investors. The only way they can do this is to take more risk — a.k.a more leverage.

Liquid, accurately priced investments let you know how volatile they are and smack your face with i

Cliff Asness, hedge fund manager

In theory they could do this without private equity. A pension scheme could assemble a leveraged portfolio of quoted stocks. True, it would sacrifice both control and the superior management skills private equity allegedly brings. But there's a silver lining to this modest sized cloud: the fund would save private equity fees, presently running at 6 per cent a year.

One reason pension funds don't do this, Mr Asness suggests, is not that it is beyond them. Rather it is the unwelcome freedom that transparently-priced liquid equity brings. A bad downturn, or a spell of fierce volatility, might persuade them, or their trustees, to crack and sell out at a disadvantageous moment.

"Liquid, accurately priced investments let you know how volatile they are and smack your face with it," he says.

Opaquely-priced and illiquid private equity, by contrast, obliterates the temptation. Just as Odysseus stuffed beeswax in his crew's ears and had them lash him to a mast to resist the call of the sirens, pension funds use the manacles of a private equity contract to resist liquidity's lure.

Of course, there are ways they could avoid paying up for the privilege, such as trimming that average 6 per cent fee charged by private equity.

But that presumes it is a conscious decision, not something they have slipped into almost out of habit.

Odysseus may have understood what he was doing when he had himself trussed up. But how many of the pension funds accepting private equity's "illiquidity discount" are doing so knowingly?

Illiquidity is not costless. That is why it is supposed to be compensated. Those costs have been suppressed in recent years, when bear markets have tended to be short and sharp. But consider the impact of a prolonged 1970s style downturn. Then investors might rue the shackles they paid to don.

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Letters in response to this column:

Fair deal for pension fund investors? You decide / From Peter Morris, London, UK

Private equity fees are not quite so straightforward / From John Barber, Senior Partner, Bridgepoint, London W1, UK

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