Private Equity & The Pennsylvanian Public Pension Funds

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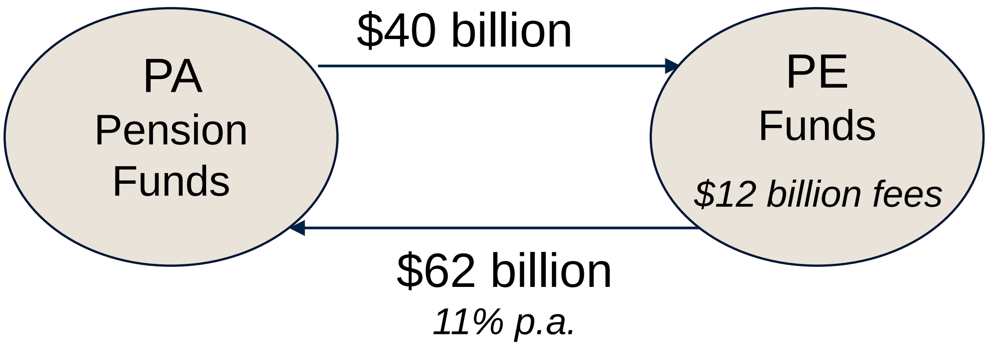
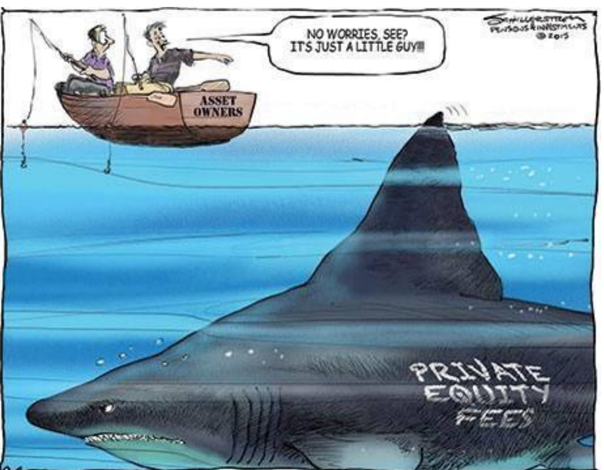
PA pension funds & PE funds





Last ten years reported PE fees: $2.2 billion
Estimated actual PE fees: $6 billion

Should PE funds deliver excess return?

- Why don't they increase their fees?
- Why isn't there money flowing in, up to the point where it's gone?

- Usual response: it is an illiquid investment, hence PE funds have to share excess returns with those willing to provide them with capital

  → If you are someone who does not mind this, go for it, you'll get the reward and won't mind the cost.

  → But need enough people to care out there, for a compensation to exist

Could be worse (in theory)

- If, due to absence of rules/regulation, PE fund managers can window dress their track records, then
  - ➔ Too much money might be allocated to PE

- If people find it fun, then
  - ➔ Too much money might be allocated to PE

Or better (in theory)

- There might be diversification benefits, might do better than have with fund selection abilities etc.

- Conclusion: The case for investing in PE is (in theory) a lot less trivial than commonly accepted, but perfectly plausible

Empirical evidence

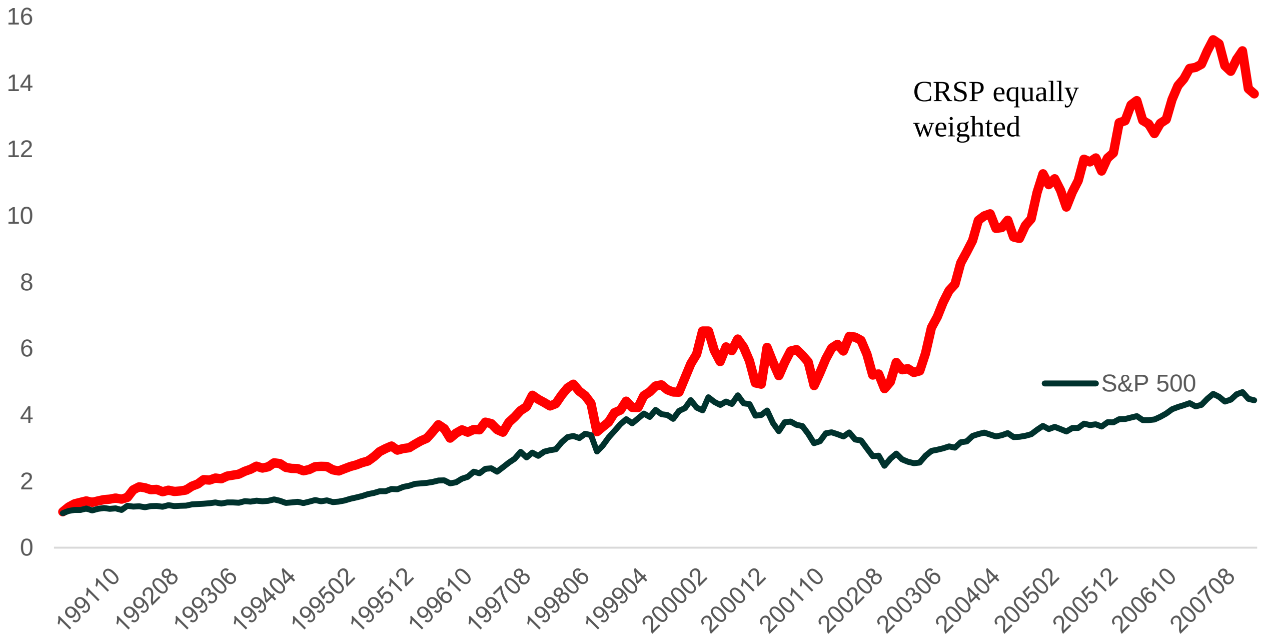
- Forget about war stories, no one earned 30% in PE, or even 20%, these figures popping up frequently in presentations and marketing material are all IRRs and not true rates of returns

Proper measurement

- Shows that PE returned about 10-12% p.a. over the last two decades

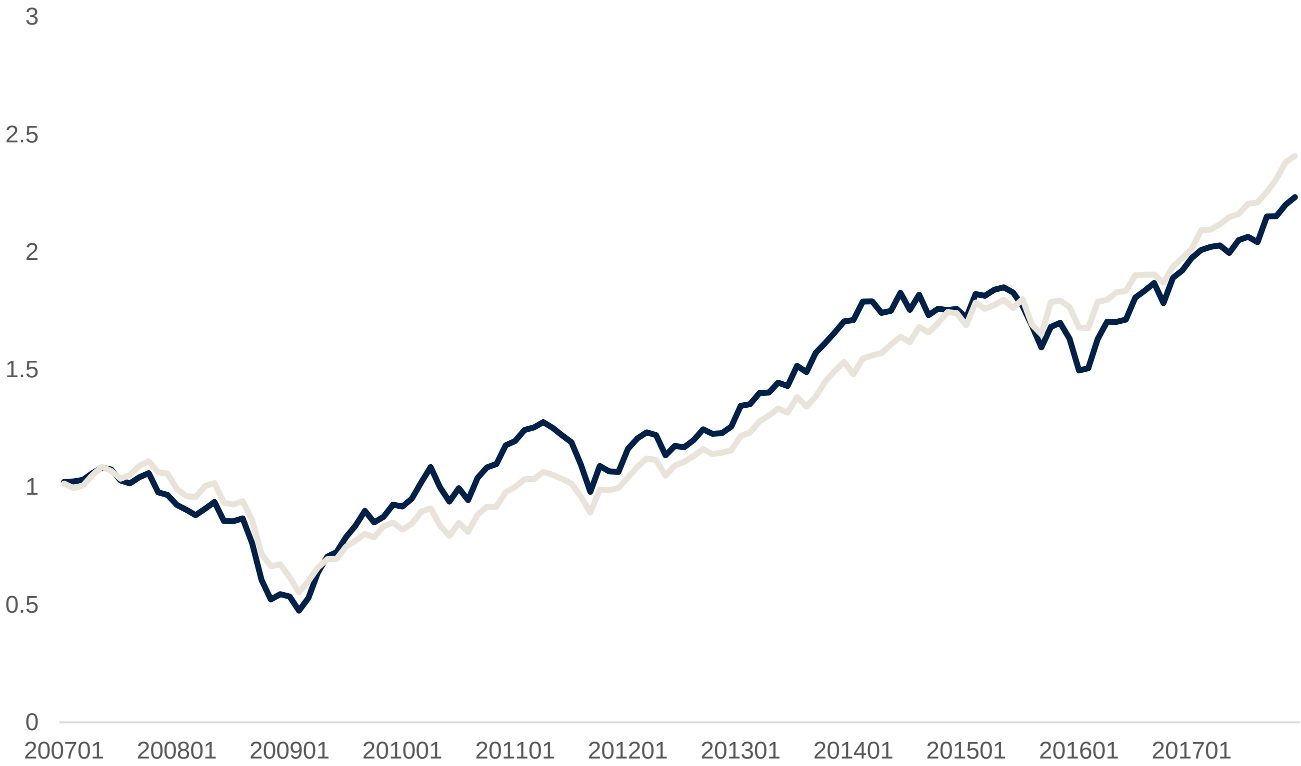
- Decade 1: 1998-2007
  - US large stocks do poorly, S&P 500, Russell indices etc. have low returns, PE outperform them by 3% p.a.
  - The average stock returns as much as PE
- Decade 2: 2008-2017
  - US large, mid-cap, small, value, growth stocks perform similarly, PE performs the same
  - Emerging market stocks do poorly though, PE outperforms global indices (e.g. MSCI world)

The S&P 500 index versus the average US stock, 1991-2007, Annualized spread in performance: 3%



LBO funds outperform S&P 500 by 3% p.a.

And then, these two indices from 2007 to 2017



LBO funds performance equal to that of S&P 500

How about expected returns

- Gross of fees PE returned 18% p.a., twice as much as S&P 500 returns

- If returns are lower going forward and PE still earns twice what public equity earned, then
  - Fees are such that it will be more difficult for PE to outperform public equity returns
  - E.g. 10% gross of fees would generate a 5% net of fees

Conclusion

- Past returns are alright
- They do not seem to be anything to write home about though
- Fee are high and fee structure is such that outperformance is less likely in a low return environment
- Private markets are the future, public markets are probably doomed, hence

➔ need a new model

→ transparency and honesty can only help the many great professionals working in PE, but will probably hurt not so good ones

Shall we care about fees that were paid?

- Typical answer: If you liked the soup, no need to know the recipe

- I object because:
  - Just mentioned that knowing fee structure gives insight in future returns because fees are certain, performance is not
  - Fairness/Ethical issue?

Analysis of the Penn Public PFs

- Together gave $40 billion to PE funds
- Received $50 billion back, and non-exited investments are worth $12 billion
- Same return as CalPERS and average PE fund, about 11% p.a.
- Estimated fees paid for this (net-of-fees) return: **$12 billion**
- Note: PE is an expensive investment strategy, this is not the profit made by fund managers (but about half of it is the performance-related fee they personally received)