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"Private Equity & the Pennsylvania Public Pension Funds"

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Thank you for having me. I will talk about the costs and benefits of investing in Private Equity funds. Private Equity funds are investment vehicles. The two PA pension funds invested 40 billion in them over the last 25 years. They received 62 billion back, that is, a rate of return of about 11% p.a., and they paid an *estimated* fee of 12 billion.

Fees have not always been fully reported to pension funds. This may *partly* explain why no pension fund has reported the actual fee it has paid. And this is why 12 billion is an *estimate*. And this is why despite this estimate being probably on the low side, 12 billion is much higher than the *officially* reported amount. For instance, over the last ten years, total fees *reported* for Private Equity by the PA pension funds sum up to $2.2 billion, while I *estimate* the actual amount to be $6 billion. Again, this is an estimate. It is based on extensive academic research I have conducted in the past, but I had access to only very limited data on the PA pension funds. People at the treasury have requested a number of documents to the PA pension funds that would have helped to compute a more accurate number, but these requests have all been denied.

This situation is common to *all* the pension funds in the world, it is not unique to the PA pension funds at all. And this point has been made by many other people as well. For instance, this excellent cartoon appeared in a magazine called Institutional Investors and illustrates that very point. However, some pension funds, most notably in the Netherlands, are now required to report the *actual* total fee they pay. Public pension funds in California and some other American states have also recently been required to report more of the fees they pay (but still not all of the fees).

Many people argue that the amount of fees paid is actually irrelevant, because Private Equity funds deliver high returns after all of the fees. I have been hearing this argument since I started researching this field -- 15 years ago!

To evaluate this argument, it might be useful to start with fundamental theory. A large body of research in Financial Economics has taught us that you should always get what you pay for. There are very few if any 'good deals.' Good deals are investments paying you more than the fair return.

The idea that an entire industry could offer a good deal for more than fifteen years puzzles any financial economist, who necessarily reason that: If Private Equity fund managers can generate high returns, why would they not keep the excess return to themselves? In other words: Why would fund managers not just increase their fees to the point where excess returns are gone? There's always a level of fees high enough to turn a great investment into a fair one. And even if fees do not move, there’s always a level of capital flows that is large enough to push up prices to turn a great investment into a fair one.

The usual response to this theoretical argument is that Private Equity funds need to share excess returns with their investors to compensate for Private Equity investments illiquidity and higher risk. If an investor is more tolerant to the illiquidity and risk of Private Equity funds than the average investor out there then it should invest in Private Equity because it will earn these compensations while it does not care much about the associated drawbacks. Virtually all the Pension funds, Endowments and Sovereign Wealth funds I know of argue that they have a long horizon and as a result do not care about illiquidity and higher risk, and as a result, reason that they should invest significantly in Private Equity.

But if such a massive amount of capital does not care about compensation for illiquidity and risk, then it is *less* likely that these features would be rewarded with higher returns. An excess return can only be rewarded if enough people care about associated drawbacks.

There are two other important theoretical arguments that would make matters worse. First, there were basically no rules for presentation of Private Equity funds’ track records, and there are still very few rules. As we know from extensive research on mutual funds, it is relatively easy to window dress past performance, to make it look better than it actually is. Research on investment consultants from prominent scholars such as Professor Jenkinson at Oxford, and some observations of fundraising prospectuses from Private Equity funds, indicates that it is a widespread phenomenon. If investors are influenced by window-dressed numbers, then there would be excessive capital flowing into Private Equity funds, which can push returns below fair value.

Second, it is a lot more interesting to invest in Private Equity than in any other asset class. Private Equity is a fascinating hands-on investment approach. It is highly rewarding to travel to visit actual investments and hear from very clever people who invest and run actual companies. Investing in bonds and stocks is very boring in comparison, especially if it is done via so-called passive strategies. As a result, at the margin, investors may over-allocate to Private Equity, which might also push expected returns down.

This said, Private Equity may offer important diversification benefits, especially when one considers the reduction in number of publicly listed stocks. In addition, if an investor is able to select above-average fund managers, then this investor can obtain excess returns of course. More generally, there are many different types of private equity funds and investments, each with different costs and benefits. It may also be worth pointing out that ESG initiatives, for example, are more impactful if executed via private equity. Hence, overall, I think that the case for investing in Private Equity can be made in theory, but it is not a simple case. The usual argument saying: I need high returns, therefore I invest in Private Equity because I will earn an illiquidity premium, lacks theoretical soundness.

How about empirical evidence of excess returns?

First, we need to avoid window-dressed figures. The industry is nearly always showing so-called Internal Rates of Returns (IRRs), which are presented as rates of returns. But IRRs are close to rates of returns only in some very specific cases. Therefore, we should ignore the recurrent claims that some investors or funds earn 30% p.a., or more, over long periods of time. These numbers are all IRRs.

For example, Yale Endowment is world famous for its investments in Private Equity funds and it is often said that it earned a spectacular 30% p.a. in Private Equity. Its latest annual report shows that its investments in LBO funds (which is the largest type of Private Equity funds) returned 9% p.a. over the last ten years and 13% p.a. over the last twenty years. While it is clear that *some* LBO fund managers became spectacularly rich over the last twenty years, it is less clear that investors have had an equally spectacular fortune across their entire portfolio, at least as far as LBO funds are concerned.

How much did investors earn overall by investing in LBO funds? The landmark study on this issue is that of Bob Harris, Tim Jenkinson and Steve Kaplan, published in the Journal of Finance. Data are as of 2008 and they find that US LBO funds outperform by 3% p.a.

First note that this is the most accurate estimate we have as of 2008 and it is likely to be slightly optimistic because investors who gave the data consented to the data being shared for research, these investors might be more advanced than the average investor in PE, data are backfilled, it is a US-only sample, but hopefully, these biases are negligible. Either way, this is the best data academics have access to.

Second, note that some costs are not included: due diligence, legal advice, currency management, illiquidity and credit line management, higher investment risk, higher governance risk due to the lack of control on underlying investments and on the ultimate fees and expenses charged by fund managers, etc. All of these are costs for the pension funds that are not included. But, maybe they are all negligible.

Third, note that back in 2005-2008, most investment presentations, be it for gold or for PE was using the S&P 500 index as a benchmark. Coincidentally perhaps, the S&P 500 was one of the worst performing stock indices back then. It was not the only one: Russell 3000 and 2000 indices also had poor returns and were also popular benchmarks.

Interestingly, the average stock in the US outperformed the S&P 500 index. It did so by 3% p.a. That is, the average stock in the US had the same return as the average Private Equity fund, and both did better than the S&P 500 index.

Let's now move to more recent history. Over the last 10 years, using the same comprehensive dataset as that used by Harris, Jenkinson and Kaplan, I find that Private Equity funds have had basically the same returns as the S&P 500 index. Similar results have been derived using other data sources by other people (e.g. Pitchbook, CEM). One interpretation of the finding that Private Equity has returned as much as listed equity is that too much capital has gone into Private Equity over that time period and that returns have compressed as a result. It is possible.

There is another possible explanation though: from 2008 to 2017 the return on the S&P 500 index has been EXACTLY equal to the return of the average listed stock. Hence, over the last ten years, just like over the ten years before that, Private Equity matched the returns of the average listed stock.

As an aside, over the last four years, the S&P 500 index has disappeared from many investment presentations and the MSCI world index has appeared instead. Coincidentally perhaps, the MSCI world index is one of the worse performing indices over the last 10 years, mainly due to underperformance of emerging markets. Hence, beware of strategically chosen benchmarks.

But let's accept that Private Equity funds returned 18% p.a. gross of fees, charged an estimated 6% p.a., to return 12% p.a. and that public equity returned 9% p.a. Let's also assume that Private Equity will continue to deliver twice as much as public equity before fees going forward. I guess it is not controversial to assume that expected returns are currently lower than past returns for any asset class. If public equity would deliver 5% p.a. and Private Equity funds therefore deliver 10% gross of fees, then after fees this 10% becomes 5% net (simply applying the average fee structure that has been agreed to).

To sum up, even if Private Equity will deliver twice as much as public equity before fees, in a low-return environment, given existing fee structures, investors might earn as much with Private Equity as they would with listed equity after fees.

The bigger point is: the enduring belief of great past performance -- mostly based on a misleading return metric -- means that a lot, and perhaps too much, capital has gone into Private Equity AND any serious conversation about reducing fee levels and having better interest alignment has not occurred. Perhaps as a consequence, many large asset owners have aggressively pursued various alternative strategies to access private market investments, which basically consist of reducing the reliance on traditional Private Equity funds.

To conclude on the empirical evidence: Past performance has not been bad, overall, but it has not been this large outperformance many people invoke when justifying Private Equity investments. Yet private markets have an important role to play in asset owner portfolios, not least because of the decaying role played by public equity. But, if people base their investment decision on false information and statistics they will not obtain what they are hoping for out of private markets. This is why transparency and honesty are paramount.

As mentioned earlier, many people actually argue that if we like the soup, we do not need to know the recipe. Fees are therefore irrelevant, performance net of fees is all that matters. I disagree. First, because future performance is uncertain but most of the fees are certain, knowing how fees are computed better informs us about expected net of fees returns, which what we ultimately care about. More accurate expectations should lead to more balanced negotiations and better outcomes.

Second, we may care about fairness. In this case, we would like to know how much was paid in total to Private Equity funds, to compare it to what they have delivered. In the case of the PA pension funds it is, at least, $12 billion that was retained by Private Equity funds to deliver 11% p.a. Some will find this fair, some not, but there cannot be a debate and an endorsement without knowing the actual figure.

It is my belief and opinion that we ought to care about how much fees are paid, and about how good past performance has really been. There ought to be a transparent and honest conversation.

Active mutual fund managers for years argued that no one should look into their fees and potential for conflicts of interest because investors should only look at the net of fees returns. An active mutual fund today who would use this argument would be shown the door anywhere, and very quickly. For the health of private markets, of the many great Private Equity fund managers out there, and the many pension funds who want to do the best they can for the pensioners, I believe that we ought to apply the same standards of transparency and performance reporting to private market managers as we do to public market managers.