Pension Funds and Private Equity

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Private equity is an essential asset class for a public pension portfolio

Public pension funds are tasked with providing a secure retirement for many public servants—firefighters, police officers, teachers and other state employees. Regardless of market conditions, these pension funds are expected to provide steady payments to their retirees. To do this, pension fund managers invest in a number of assets seeking to maximize returns to meet their obligations.

Unfortunately, many of the public pension funds in the United States are underfunded, and state legislatures are under significant pressure to make up the shortfall. A 2018 report from the Pew Charitable Trusts found that the average U.S. pension fund is only 66 percent funded, the Pew report found that, in the aggregate, U.S. public pension plans had unfunded liabilities of at least $1.4 trillion[i]. These obligations must be met whether the pension funds have the resources or not. If these pensions remain underfunded, it will be up to taxpayers in their respective states to make up the shortfall through a reduction of services or an increase in taxes, or some combination of both.

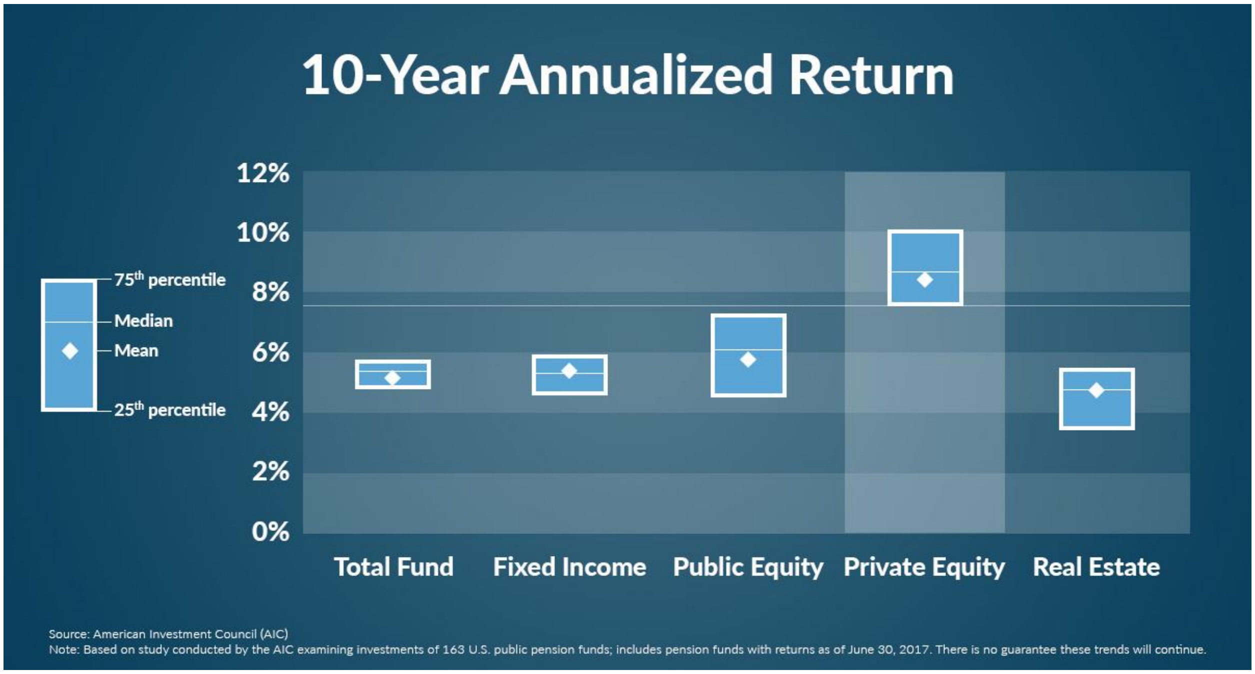
While there are several reasons that pension funds should make private equity investments, two important reasons are: performance and diversification.

Private equity is the best performing asset class

A wealth of research shows the significant contribution that private equity investments have made to the bottom line of public pension funds. Whether you are looking at internal rate of return or the public market equivalent, the results are clear – private equity investments are the best returning asset class for pension funds over the long term.

According to research:

- Professors Robert Harris, Tim Jenkinson, and Steven Kaplan reported that private equity outperformed public markets by 3 to 4 percent each year, throughout the 1990s and early 2000s[ii]. More recently, professors Gregory Brown and Steven Kaplan found that private equity continues to generate returns that are 2 to 3 percent above the returns of public markets in an April 2019 paper examining more recent vintage years[iii].
- Cliffwater, LLC, an investment advisory service to institutional investors, found that the private equity investments by state pensions outperformed the pensions public equity benchmarks by 4 percent on an annualized basis[iv].
- The American Investment Council annual public pension study found that median annualized returns of public pension fund's private equity investments exceeded the investments in public equities over a ten-year period.



Furthermore, given pensions long-term investment focus, it is logical to invest in private equity to take advantage of the illiquidity premium that is realized by investments in illiquid assets[v].

Research from the British Venture Capital Association examined "realization risk" of private equity investments. An estimate of the probability that a fund would lose value from "observation until the end of the fund's life." This analysis found that the probability for an investor to lose capital on private equity investments is only 1.4 percent if that investor has a portfolio with 20 funds, and this probability is reduced even further if an investor's portfolio includes 50 funds[vi].

Finally, research has shown that private equity investments offered greater downside protection than investments in public markets during the financial crisis in 2008[vii]. Other studies have shown that private equity-backed companies fared better than companies not backed by private equity during the financial crisis[viii].

Diversification is important when constructing a portfolio of investments

Institutional portfolios must seek alpha, returns beyond those of the market. Given the pressure on public pension funds to reduce significant and persistent funding gaps, investment officers must invest in asset classes that provide exposure to areas where they can achieve returns beyond public market indexes. Additionally, it is essential that a pension funds invest in non-correlated assets – meaning that each asset class does not move in lockstep.

As with all investing, it is wise to maintain a diverse portfolio. While in the past that may have been achieved by investing in the public markets, the number of public companies has fallen. Pension funds, like all portfolios benefit from holding assets that provide diversification and investments in private equity provide an additional source of diversification.

Over the past 20 years, we have seen the number of publicly traded companies in the United States decline[ix].

- In 1996, according to data from the World Bank, there were approximately 8,090 domestic listed companies in the United States[x].
- By 2018, that number had dropped to 4,397[xi].

Historically, many companies financed growth by floating shares on the public market. "Unicorns" such as Uber Technologies, likely would have tapped public markets long before their recent initial public offering in 2019. Tapping public capital markets either for equity or debt investments, in the past, was the traditional route many businesses took to raise the capital needed for the businesses to grow.

Today, a number of factors have led more companies to stay private. Due to high levels of capital allocated to the private markets growing companies no longer need to go public to access capital. Instead, companies can raise the capital they need through private capital investors, such as private equity. Remaining private longer allows for growing companies to focus on improving the business without the quarterly reporting requirements and other pressures of being a public company.

As a result, listed companies are older than they have been in the past. According to the Wall Street Journal, the average age of a public company has increased from 12 years in 1996 to 18 years in 2016[xii]. Today, U.S. public markets consist of mature companies. Investing in private equity allows U.S. public pension funds to gain exposure to growth companies which have the potential to provide outsized returns.

In recent years, private equity funds have increasingly purchased venture capital-backed companies. In 2017, private equity buyouts were responsible for over 18 percent of venture capital exits. While strategic acquisitions and initial public offerings remain the most common forms of exit from a venture capital investment, buyouts have steadily increased[xiii]. This is particularly true in the technology sector where several private equity firms have invested in venture capital backed companies[xiv]. These companies provide exposure to some of the world's most innovative and fastest growing companies and allow pension funds and other institutional investors to gain exposure to businesses they could not access through public market investments.

The universe of listed companies has shifted. The number of IPOs has reduced from the peaks of the 1990s[xv]. Increased regulatory burdens along with the rise of activist investors has changed the calculus of whether it is in a company's best interest to be public.

Pensions will continue to allocate to private equity

This presents an opportunity for private equity to offer exposure to these growing companies and allow for their investors to participate in these types of investments and earn healthy returns. Pension fund managers cannot let politics get in the way of sound investment decisions. With many pension funds facing massive liabilities, pension fund managers should be empowered to invest in assets which will help to fund the retirement of scores of public servants. In order to continue to provide the benefits they guarantee, pensions must continue to invest in private equity. Some of the most dynamic pensions are taking steps to expand their exposure to the asset class. For example, the California Public Employees Retirement System CIO is seeking to increase its allocation to private equity.

For these reasons, pensions across America will continue to turn to the private equity industry to ensure that they are able to meet their financial obligations to their pensioners.

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