
DOES PRIVATE EQUITY HAVE A ROLE IN YOUR PORTFOLIO?

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Despite its attractions, private equity may not be suitable for the portfolios of many Taft-Hartley pension funds. These authors explain the intricacies of private equity and show that trustees who are considering this type of investment need to be aware of the critical practical considerations private equity entails.

Over the last several years, there has been growing awareness of and interest in *alternative assets*. Variouslly defined, these are usually understood to include private equity (includes venture capital, buyout and mezzanine funds), “market neutral” or “portable alpha” strategies and hard commodities. Of these, the one that has gained the most attention among Taft-Hartley plans is private equity. For example, within the past year, both the Carpenters and the UFCW national plans have committed hundreds of millions of dollars to it. A rising stock market, the emergence of the Internet and the excitement over genetics-based biotech are fueling a virtual explosion in the private equity market: This year alone, new commitments are expected to exceed \$100 billion and, if anything, the pace of investment is increasing.

But despite all the hype and as exciting as the prospect of staggering returns may be, the relevant question is whether not private equity is appropriate for the average Taft-Hartley plan. Here, we review some principal features of private equity and what makes it appealing, identify a few critical practical considerations and finally evaluate private equity from the standpoint of the typical Taft-Hartley plan (if there is such a thing).

Principal Features

The term *private equity* describes investments for which there is no public market. Typically one invests either directly in the equity or convertible debt of private companies or in a private partnership, which in turn purchases such instruments. There are two principal submarkets: venture investments in new or early stage companies and buyouts, which invest in corporate finance transactions. Though these are distinct markets, some firms are active in both, shifting emphasis with market conditions. Pension plans will usually invest either in one or more limited partnerships (whose general partners invest the partnership’s funds in individual companies or deals) or else hire a fund-of-funds manager, who in turn selects the partnerships in which to invest and may also make some direct investments for the plan.

What Makes Private Equity Appealing

The two principal economic appeals derive from the facts that the private market is informationally inefficient and that successful investments can produce astronomically high returns (high enough to more than make up for a much larger number of failures). On average, private equity has produced very high returns with low correlations to public stocks and bonds and real estate. In other words, private equity offers the prospect of both high returns and increased portfolio diversification. In some cases, private equity may also provide collateral benefits, e.g., a vehicle to make economically targeted investments to create or preserve union jobs. Finally, there is also the undeniable appeal of seeking innovative investments.

At least four things need to be kept in mind about private equity returns.

1. Until the investments go public or are liquidated, investments are carried either at cost or at prices set by larger rounds of financing. Except in this latter case, private equity is even harder to accurately value than real estate.
2. Ultimate returns have varied (and are likely to continue to vary) widely by “vintage year,” i.e., the year of initial investment, because of wide fluctuations in the business cycle. For example, the median 1986 private equity fund returned only 8.4% per year through 1997, whereas the median 1990 private equity fund returned more than 17% per year through 1997.¹
3. The performance differences between good and bad managers are much more significant than in public markets. Further, the distribution of returns is not “normal,” i.e., outstanding managers have extremely high returns, while poor managers often have abysmal returns. (In statistical terms, the mean return is much higher than the median). For example, for venture funds formed in 1989, an upper quartile manager returned almost 18% more *per year* than the lower quartile one from 1988 through 1997 (21.6% vs. 3.9%).²
4. Reputation is very important: The best deals and the largest investment flows tend to go to firms with the best track records. Consequently (and quite unlike public equity markets), success tends to persist. The result, however, is that it is often difficult, if not impossible, for new investors to get into the best partnerships or deals. Here, the services of an established fund-of-funds manager can be of real value.

Practical Considerations

Return Pattern

Because investors’ commitments are often called (drawn down) over three to six years, during which time the initial investments often have not yet had a chance to pay off, early year returns are often negative. Generally, venture capital investments take longer to mature than corporate finance/buyouts to generate positive returns. Of course, this has been less true recently, because of the extremely short time between when many dot.coms start up and when they go public. The main point, though, is that one has no real idea of what the final return of a private equity investment will be until the partnership liquidates or finishes distributing cash and/or publicly traded stock.

Diversification

Since private equity investments are illiquid, it is highly desirable to diversify by type of and number of investments, industry focus and vintage year. The less a plan has to invest, the less likely it will be able to buy into multiple partnerships. Unless a plan can invest hundreds of millions of dollars, commingled funds-of-funds are the most reasonable way to diversify a private portfolio. Further, since managers differ in their areas of expertise, and since most do not raise funds every year, it is generally neither

¹ Source: Venture Economics.

² Ibid.

feasible nor desirable to attempt to fund all of a private equity allocation in a short period of time.

Contract Terms

Since plan trustees should not be fiduciaries for individual private investments, a basic issue is whether the manager is willing to be an ERISA fiduciary. Keep in mind that, since most private investors are not benefit plans subject to ERISA, not all managers are willing to be ERISA fiduciaries.

A second issue is the form of the investment vehicle itself. The main choice is between a fund-of-funds vehicle (which invests in a number of limited partnerships) and a focused limited partnership, with the latter being the most common. One needs to ensure that the financial interests of the general and limited partners are reasonably aligned. Relevant issues include distribution policies (how and when general and limited partners receive profits as investments are liquidated); the timing and type of distribution (cash vs. securities); restrictions on the general partners' outside activities and the conditions under which the limited partners can stop contributions to and/or replace the general partner(s).

Fees

These are different in partnerships and funds-of-funds.

Partnerships

These traditionally consist of a 1.5-2.5% (of total committed capital) management fee with a 20% (or more) carried interest (i.e., share of profits). Preferably, carried interest should be based on the partnership's aggregate profits after all limited partners' capital has been distributed, not on the profits of individual investments realized during the life of the partnership.

Note that in some partnerships annual management fees are not fixed but instead either adjust in response to annual operating budgets or else ramp up and down over time. The former are based on annual budgets that the general partner presents to an advisory board or to the limited partners for their approval. Fund-of-funds managers often sit on advisory boards and help to keep operating expenses at a reasonable level. The process by which the budgeted fees are negotiated and how conflicts are resolved should be in the partnership agreement. Since sliding fee schedules reflect the fact that more time and effort are expended during the early years of a fund than after it is fully invested, they tend to decline over time.

Finally, partnerships often receive fees for investment banking activities (e.g., arranging mergers or initial public offerings (IPOs)). Common past practice was that the general partners kept all such transaction fees. Today it is more common to split these with limited partners.

Funds-of-Funds

Annual management fees range from 0.5% to 1.5% of total committed capital. Some managers also take a carried interest, usually above a preferred rate of return to the investors. Note that these fees are in addition to whatever fees are charged by underlying partnerships.

Foreign Investments

Though currently many foreign investments are in Western Europe and provide financing for existing companies, venture capital investment is growing rapidly. Because many leading general partners require that they be allowed to invest to some extent overseas, it is very hard to construct a high-quality private equity portfolio without some portion going into foreign investments. Since these partnerships tend to be heavily oversubscribed, the general partners have little (if any) incentive to change this policy to accommodate Taft-Hartley plans that object to foreign investments. In short, though it is possible to construct exclusively domestic portfolios, doing so both substantially limits the number of potential partnerships and can negatively impact returns.

Economically Targeted Investments (ETIs)

One way to make private ETIs is to invest in the (few) partnerships that specialize in the area. Another way is for one's manager to make such investments directly (i.e., not through an underlying partnership). This is the approach taken by some large public plans, e.g., New York City Employees' Retirement System.

Summary

Private equity is here to stay, though, if the past is any indication, the current overheated venture market may cool off unpredictably. In buyouts, strategic corporate investors have been bidding up the prices of prospective acquisitions, making it more difficult for financial investors to find good deals. Based on their announced policies, endowments, investment banks, family offices, large corporate plans and some public plans will continue to be major participants. They have the staff, resources and market clout to invest directly in individual deals, companies and partnerships. Smaller participants (and this includes all but the very largest Taft-Hartley plans) have fewer options. For them the safest approach is to go the fund-of-funds route.

But for all its attractions, there are several reasons why private equity may not be suitable for many Taft-Hartley plans. We list five, in no particular order:

1. Even if the trustees are willing to invest in illiquid assets, many may feel more comfortable with real estate, which has more tangible assets and can be expected to throw off cash income.
2. The foreign component of many private partnerships poses a major policy issue, one that is probably insurmountable for plans that don't permit even publicly traded foreign securities.
3. Many trustees may object to the high fees involved.

4. Trustees may not wish to invest in an asset class when there is no assurance that one will have access to the best deals, especially when the downside risks are so high and the investment cycle is seven to 12 years.
5. Illiquid investments such as private equity take much more time to supervise and therefore may consume a disproportionate amount of trustees' time relative to their percentage of plan assets.

In short, in our view, the potential benefits associated with private equity come with monitoring costs and risks that are too high for most Taft-Hartley plans.