Private equity in 401(k)s? Take a breath.

In June of 2020, the Department of Labor issued an Information Letter which indicated that ERISA doesn't necessarily prohibit the use of private equity investments in ERISA-qualified defined contribution plans. Much of the media and industry reaction was bipolar, bar belling between "the wolves are at the door" and "the playing field has been leveled."

Does the DOL's letter release the hounds to the hunted or is it a gift of fire from the investment gods? It's unlikely to be either.

SUMMARY

- Private equity investments are ownership interests in companies that are not publicly listed or traded on a stock exchange. This contrasts with public equities, where ownership interests ("stocks") are traded and valued via public markets (stock exchanges)
- In a June 3rd information letter, the DOL indicated that ERISA doesn't necessarily prohibit the use of private equity in ERISA-qualified defined contribution plans
- The letter, a response to a request from two private equity firms, is the first time that the DOL has provided the Department's views on the use of the private equity in defined contribution plans
- The letter addresses offering private equity as only one component of a diversified asset allocation option, such as a target-date, target-risk, or balanced fund – not as a stand-alone option
- Proponents of private equity cite the potential for higher returns compared to public equities
- Detractors cite high fees and little diversification benefit
- If experience with other alternative investments, like private real estate, is a guide, cost and complexity may make large scale use of private equity in allocation funds is unlikely – at least in the near term

BACKGROUND

The DOL issued an information letter in answer to a request from two private equity firms, British-based Pantheon Ventures LLP and Swiss-based Partners Group, represented by Groom Law Group (as disclosure, we also work with Groom). In the letter, the DOL confirmed that ERISA law doesn't prohibit the inclusion of a private equity allocation within a target date, risk-based, or balanced fund that offers exposure to a diversified range of asset classes. The Department explicitly noted that the guidance does not address the offering of stand-alone private equity options to participants, given the legal and operational problems such vehicles would present.

The letter also provides considerations that fiduciaries should take into account when determining if private equity has a place in their plan. Other guidance includes the recommendation that sponsors limit an asset allocation fund's private equity component from exceeding a specified policy percentage and that private equity investments be independently valued according to acceptable accounting standards and subject to an annual audit.

An information letter is a form of guidance; it doesn't create new rules or regulations, and it doesn't constitute a recommendation. Historically, however, courts have respected information letters, and this may provide some comfort to sponsors who want to offer (or are currently offering) private equity in a limited fashion.

WHAT IS PRIVATE EQUITY?

"Private equity" refers to ownership interests in private companies that aren't publicly listed or traded on a stock exchange, the valuation of which is determined through an appraisal process. In contrast, public equities (or "stocks") are ownership interests in companies that are listed on, traded, and valued via public markets (stock exchanges like the New York Stock Exchange).

Private equity investors include institutions (frequently pensions and endowments) and high net worth individuals. Investors might purchase ownership interests in companies directly, or they may invest through private equity funds. Private equity investments are long-term and illiquid, with average holding periods of four years or more (with variances by size, industry, and geography).

WHAT MIGHT PRIVATE EQUITY OFFER (OR NOT OFFER)?

The most common (and rational) motivation for allocating to private equity is the possibility of enhancing long-term returns, and historical data indicates that private equity has indeed outperformed public equity over many periods.[i] Today, a typical investor might target a long-term excess return of ~3% over public equities.

The idea that private equity would offer some return advantage does make intuitive sense. Private equity investments are less liquid than publicly traded stocks, and a rational investor would expect to be compensated for that characteristic. Illiquidity also limits forced sales, likely when values are low, potentially boosting long-term returns for the category. Given that there are plenty of seemingly rational individuals and institutions investing in private equity, the "market," at least, would seem to believe that there may be a return benefit to be gained by investing in private equity.

When setting expectations, however, investors must take care to avoid simplistic comparisons. Industry studies and marketing pieces often compare private equity returns to non-optimal benchmarks. For example, superficial articles may use the large-cap S&P 500 index for comparison. However, a mid-cap or small-cap benchmark such as the S&P MidCap 400 or Russell 2000 (or sub-sectors thereof) may be more appropriate given typical private equity investment targets or a specific fund's strategy.[ii]

Other frequently cited advantages of private equity are more debatable, given that they may be derived primarily from accounting.

On average, private equity values have dropped less than public equity values during bear market periods. In large part, this has been due to the differing methods by which private and public equity values are determined. Public equity returns reflect market value, which may be more likely to be impacted by investor fear or greed, forced selling, etc. On the other hand, private equity returns reflect an appraised value of the underlying portfolio, which may, in part, exclude the animal spirits of the daily market. Hence, private equity may be perceived as providing a buffer in down-market periods.

Private equity is also often shown as having lower volatility than public equities. However, there may be accounting forces at play here, as well. There is evidence that private equity returns have tended to be "smoothed." Valuation is appraised on a quarterly basis (vs. the intra-day market pricing of publicly-traded stocks), meaning that simple monthly return computations may reflect stale prices. Additionally, there is evidence that the valuation of private equity fund holdings may sometimes be "managed" to spread out the profits and losses of private equity funds over time. Smoothed returns can create a perception of lower volatility similar to looking at average quarterly stock market volatility instead of daily fluctuations. When private equity numbers are "de-smoothed" (adjusted to account for these valuation factors), the difference in private and public equities' volatility shrinks considerably.[iii]

Lastly, private equity returns are sometimes cited as having a low correlation (tendency to move in step) with publicly traded stock returns. As with volatility, much of this diversification appears to be due to the different means of valuation. De-smoothing of returns results in higher correlations between private and publicly-traded equities. The de-smoothed results more closely resemble the relationship between US stocks and emerging market stocks than between assets with low correlation, such as stocks and bonds.[iv]

As the notion of enhanced return is intuitive, it is intuitive that long term private and public equity volatility would be similar and that correlation would be high. At the core, investors in publicly-traded stock hold ownership in corporations; investors in private equity do as well. Aside from valuation methods, accounting methods, and holding periods, the two could be expected to behave similarly.

OTHER CONSIDERATIONS

Aside from primary considerations of private equity's investment efficacy and whether or not such an investment is appropriate for plan and participants, sponsors also have to consider the category's cost and complexity.

Cost will be a significant focus of a plan sponsor considering an allocation to private equity, especially given the current ERISA litigation environment. Fees for private equity funds are typically similar to those charged by hedge funds: 1.5-2% per year management fee and a performance fee of ~20% of value appreciation or profits.[v] This range is much higher than the average 401(k) actively-managed fund, where even an expense ratio as high as 1% is becoming rare. Even if private equity constitutes only a portion of a multi-asset fund allocation, that level of fee would have to be carefully and confidently justified.

Fiduciaries must also be confident that they possess sufficient experience and understanding to select and monitor their investment. Private equity investments may have more complex structures and strategies compared to more common defined contribution investments. Disclosure and other regulatory requirements may present challenges. As discussed, private equity valuation is calculated through appraisal, which lacks the transparency and pricing validation of public markets.

Liquidity will be another key consideration. By nature, private equity investments are less liquid than investments in publicly-traded stocks or bonds. Investment horizons are long, and the ability to redeem one's investment may be limited during lock-up periods. Any private equity allocation will need to be thoughtfully structured to take illiquidity into account.

A PRECEDENT

The use of private real estate (also called direct real estate) in defined contribution plans may provide insight into the future of private equity in the DC space.

Most plan sponsors are familiar with a more common form of real estate fund, one where the fund has ownership interests in liquid, publicly-listed real estate investment trusts (or REITS) or similar entities. In contrast, a private real estate investor or fund has direct ownership of an asset such as an office building, mall, or apartment complex. The concept is similar to private equity, substituting property ownership for company ownership.

Private real estate has been available for use in defined contribution retirement plans for many years; however, it remains relatively uncommon in DC plan menus.[vi] Compared to real estate strategies based on public securities, private real estate faces a few headwinds, including the relative greater complexity of selection, monitoring, and valuation. The high sensitivity to fees prevalent in the defined contribution world also plays a part: private real estate strategies tend to be pricier than institutional options investing in public securities (though attractively priced options certainly exist).

Liquidity has also been a point of concern. In large part, private real estate strategies designed for the DC market have accommodated daily liquidity needs by allocating some portion of the portfolio to liquid securities like REITs (commonly 15 to 20%). Under ordinary circumstances, this has worked quite well. However, the memories of how a few sponsors experienced challenges while attempting to exit positions during the Financial Crisis of 2007-2008 are still fresh in the minds of many.

OUR PERSPECTIVE

While private equity has legitimate investment applications, we don't expect widespread incorporation into DC multi-asset investments anytime soon. We believe that the most natural fit for private equity is likely with mega-market defined contribution sponsors who incorporate it elsewhere in their benefit complex. An example may be a state or a large corporation, likely with sophisticated internal capability, that currently utilizes a private equity allocation within a defined benefit program.

Aside from the challenge involved in selecting and monitoring strategies, we have several concerns regarding the use of private equity in defined contribution plans.

- Cost - One of the very few "known knowns" in investing, it's also been a hot-button for ERISA litigation for the last decade. A private equity allocation would likely be the most expensive investment component within a plan. Even when combined with other less costly investments within an asset allocation fund, a plan sponsor would want to be very confident that the benefit to participants would justify the expense.

- Performance - We believe that the weight of evidence indicates that private equity has provided outperformance compared to public equities over many periods in the past. However, the lack of transparency inherent in private markets makes that evidence imperfect.

  We also understand that past performance is not necessarily indicative of future results.[vii] The scale of investment in private equity has exploded in recent years. Investment data firm Preqin indicates that private equity and venture capital assets have doubled since 2015, growing from $2.3 trillion to $4.4 trillion at the end of October 2020. Prequin forecasts another doubling, to $9.1 trillion, by 2025 (while most other alternatives experience slow growth).[viii] There is potential that the continued inflow of assets, combined with competition from vehicles such as special purpose acquisition companies (SPACs), could result in inflation of target prices or overpayment for deals, and therefore an erosion of returns.[ix]

- Liquidity - Defined contribution plans are inherently liquid environments, and traditional private equity is an inherently illiquid investment. Currently, DC plans implement liquidity constraints in the form of limits on trade frequency or stable value equity washes, but none compare to those required by typical private equity funds.

An asset allocation fund structure may ease liquidity challenges. However, it's still likely that a private equity fund's liquidity would need to be enhanced to accommodate defined contribution plans. This has been the case with private real estate, where funds used in DC plans generally have a liquidity sleeve invested in REITs. Private equity funds may take a similar approach, through a liquidity sleeve (public stock, return replication strategy, cash, etc.), positioning in a liquidation hierarchy, or some combination of mechanisms.

This leads to the concern that steps taken to increase liquidity could dilute private equity's potential advantages (similarly to how a liquidity sleeve of REITs dilutes a private real estate fund's perceived benefit of lower volatility).

SUMMATION

Despite the momentary excitement, we view the DOL's Information Letter as somewhat of a non-event for the great majority of plans and participants - or, at the least, a very early-cycle event. In reality, the letter creates little change. It provides guidance but doesn't alter or prescribe policy. The few sponsors that currently offer private equity investments may feel more comfortable. Other sponsors may consider adding private equity. The pace of product development may pick up. However, it's exceedingly unlikely that the letter alone will open the floodgates: concerns regarding cost and complexity will keep adoption slow.

Few participants will be either thrown to the wolves or be given access to a golden ticket (depending, of course, on your point of view), and few private equity firms will experience a meaningful impact on their bottom lines, at least in the near term.

Contact Jay Young (jay.young@vergencepartners.com) or me (tom.douglas@vergencepartners.com) with any comments or questions. Visit www.vergencepartners.com to see what else we're thinking about.

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[i] As an example, in 2020, Bain & Company compared returns through 6/30/2019 for US private equity buyouts and a public market equivalent (PME) method that used the S&P 500 as the proxy. Bain used the Long-Nickels public market equivalent (PME) which creates a theoretical investment into the S&P 500 mimicking private equity fund cashflows. For example, when a capital call is made by a PE fund, the same amount is "invested" in the index; when a PE fund makes a distribution, the same amount is "sold" from the index. Over 30 years, the private equity return of 13.1% annualized outpaced the PME public equity return of 8.1%.

[ii] The value of private equity buyouts often lands between $1 and $5 billion, which would indicate that a mid-cap index might be a more appropriate benchmark than the large-cap S&P 500 for most deals. In addition, buyouts tend to be focused in certain sectors (e.g., technology, industrials, services, and transportation), potentially adding further sector-weighting specificity to a reasonable benchmark. When Alexandra Coupe of PAAMCO constructed a proxy composed of S&P MidCap 400 sectors reflecting the by-sector volume of private equity buyouts, she found that private equity enjoyed a much smaller return advantage than when compared to the S&P 500.

[iii] In 2016, PAAMCO examined private equity returns between March 2005 to September 2014 using Cambridge Associates private equity return series. Smoothed returns had a volatility of 9.64%, while de-smoothed reflected 16.63%.

[iv] FactorResearch investigated the correlations of private equity and public equities from 1994-2019. They found that the correlation of annual private equity internal rates of return and annual S&P 500 returns was extremely low – (0.15). However, when they compared quarterly instead of annual returns, the correlations crept up to 0.74.

[v] Note that performance fees are generally only taken after a minimum level of return, or "hurdle rate", is achieved. An 8% hurdle rate is common.
[vi] For example, the TIAA CREF Real Estate Account is about 25 years old and has around $26 billion in assets.
[vii] For example, in their 2020 comparison, Bain & Company found that the returns of private and public equity since 2009 were roughly equal, with US buyout funds returning 15.3% and S&P 500 PME returning 15.5% annualized. This is in contrast with the longer-term results described above.
[viii] For comparison, global public market capitalization (the value of all publicly listed stocks) was roughly $90 trillion at the end of Q3 2020.
[ix] Special purpose acquisition companies (SPACs), also called "blank check companies", have no commercial operations. SPACs are formed strictly to raise capital through an initial public offering (IPO), then use that capital to acquire an existing company. SPACs have been around for decades. They've become more popular in recent years, raising a record amount of IPO money in 2019. Many private equity firms see SPACs as alternative to traditional approaches of raising private equity funds.

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