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Private Equity Industry Overstates Returns, Downplays Fees and Risks

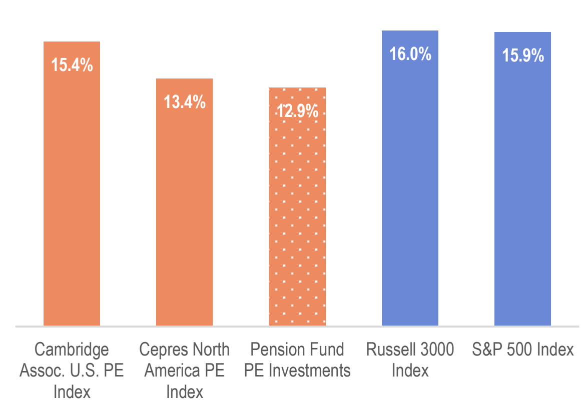
The private equity (PE) industry promotes itself as serving the investing public — including union and other public pension funds — by providing reliably superior returns than the stock market. But the reality is that PE investments are not necessarily better performers, their promises too often rely on manipulated or misleading numbers, and they can pose serious risks for investors — including high fees, liquidity risk, lower transparency, higher risks associated with extreme levels of leverage and reputational risks as a result of PE investments in activities that are harmful to workers, consumers, or the environment. Moreover, private equity firms do not have a fiduciary duty to serve the interests of active workers and retirees, as pension funds do, which allows PE firms to pursue any investments, even those that could jeopardize the retirement security of the pension fund members.

Private equity performance is lagging industry promises

The PE industry offers rosy projections of high returns, but the reality for investors like pension funds can be substantially more anemic. Private equity firms prey on the actuarial concerns some pension funds have to pursue PE's promised higher returns to compensate for inadequate employer contributions as well as losses suffered during the 2008 financial crisis.[1] But it has become increasingly clear that PE investments are not providing substantially better returns than the stock market.

Even financial industry insiders are increasingly dubious about their performance. In 2018, J.P. Morgan's economic projection study reported that recent private equity returns have "not delivered a meaningful premium over the public markets."[2] The PE industry focuses its promotional materials on returns over several decades, but its recent returns have been less impressive and more volatile as more profitable opportunities are evaporating.[3] In late 2019, Morgan Stanley Wealth Management reported

Fig. 1: 10-Year Return Private Equity v. Stock Market



Source: AIC 2019; median PE fund index (without venture capital), stock indexes include dividends)

that private equity returns are evaporating and that investors "need to downgrade their expectations."[4]

A 2015 study by the University of Virginia found that the post-2005 vintage private equity funds did not exceed the performance of stock markets — and new vintages may be performing *worse* than the stock market with recent increases in PE fundraising.[5] Despite the boosterism in its promotions, the private equity trade association American Investment Council's own latest performance benchmark report demonstrates that PE investments do little better — or even worse — than comparable investments in the stock market. In 2019, AIC reported that the 10-year median return for major PE indexes (excluding venture capital) was slightly below the 10-year return for stock indexes (including dividends) (see Figure 1).[6]

Pension fund investments in private equity performed even worse than typical PE investments and worse than the stock market over the past decade, according to the PE industry's own data.[7] In 2018, collectively bargained retirement plans and pensions had over $7 trillion in invested capital and about 9 percent of it — about $610 billion — was invested in private equity funds.[8]

Even when average returns appear rosy, many individual PE funds have indifferent performance. One report suggests that more than half the PE funds perform only as well as — or worse than — the stock market.[9] The University of Virginia study found that only the top quartile of funds exceeded the stock market; if investors put money into the bottom three-fourths of fund performers the results were comparable to or worse than the stock market.[10] In addition, a 2015 academic study found the past performance of PE funds and managers no longer predicts future performance — the "performance persistence has disappeared" for past high-flying fund managers.[11]

Private equity performance promises are inaccurate and misleading

Limited partners (institutional investors like pension funds) rarely see the returns the private equity industry promotes. Several studies have found that limited partners receive far less favorable returns than the PE industry advertises.[12] The industry uses performance indexes that are easy to manipulate, it refuses to share data that would allow investors or the public to independently evaluate individual fund's performance, and it frequently reports returns in ways that obscure the impact of fees investors pay, or what income is going just to general partners at the PE firms themselves rather than to investors.

Self-reported performance metric deeply flawed: The PE industry's performance metric, the self-reported internal rate of return (IRR), "is notoriously prone to manipulation," according to Nobel prize winning economist Joseph Stiglitz.[13] Warren Buffett has said that IRR is "really not calculated in a manner I would regard as honest."[14] Among the problems: PE firms calculate the fund's IRR based on the performance of portfolio assets (from purchase to sale), but they exclude investors' committed funds that are held in reserve (known as dry powder) but not yet deployed. But PE firms do not instantly purchase assets with the committed money, which shortens the performance horizon of purchased firms and artificially juices the apparent rate of return (which would not apply to the entirety of the investor's commitment).[15] Another key issue is that the IRR presumes that long-term performance mirrors early returns, but these early returns can be artificially inflated by early dividend payments from target firms, early unloading of high flying portfolio companies, or other financial engineering, that can overstate returns over the life of the fund.[16] The use of borrowed funds through lines of credit (instead of tapping investors' committed funds) can artificially improve returns substantially, making IRR "a tool which is highly manipulated due to credit lines and other financial engineering tricks. It has no correlation with the risk taken," according to one industry insider.[17]

Lack of transparency prevents accurate performance assessments: It is difficult for institutional investors to evaluate the actual performance of private equity funds or portfolio companies. The Center for Economic and Policy Research noted that "no comprehensive, unbiased, and widely available data yet exists that can be used to evaluate PE performance."[18] Private equity firms are not required to provide the financial performance information that publicly traded companies must disclose. Nor must they provide comparable information to different potential investors, allowing PE firms to sell the same investments at different prices to different institutional investors. Joseph Stiglitz noted that "even some of the most sophisticated investors on the planet — pension funds, university endowments — can't obtain that data from private equity firms."[19] The quality, quantity, and form of financial disclosure essential to providing equitable access to market information that is necessary for investors, the public, and functioning markets is not currently available for private equity investments.

PE downplays risks from high fees, low liquidity, challenges to accurate asset valuation, and bankruptcies

Private equity funds can pose unique risks that can harm even sophisticated large institutional investors. The Securities and Exchange Commission director of compliance noted that PE funds can pose "risks and temptations that are not present" in the public market.[20] Private equity's lack of transparency to investors about what portfolio companies they own and acquire, and about the business strategies they plan to pursue at those firms, is another impediment to investors' effective assessment of the costs and benefits of specific fund investments.

Sky-high fees eat into performance: Private equity does not adequately report to investors about the fees it collects. Private equity firms charge high fees for their purported management expertise. According to *Bloomberg*, these fees "yield a geyser of profit" for the PE firms and their general partners.[21] Firms typically charge 2 percent of the assets in the portfolio (including undeployed dry powder) as well as 20 percent of any asset appreciation once certain benchmarks are reached.[22] Some PE firms charge even higher fees. The 2 percent management fee alone is more than twice what most money managers charge and has not changed even as fund sizes have ballooned.[23] For the $610 billion in pension fund PE investments, fees of 2 percent would amount to over $12 billion annually.

In addition to the fees collected from investors, PE managers also often charge fees and expenses to the portfolio companies they own. These fees represent income for the general partners, but not for the investors, and when they affect the finances and cash flow of the portfolio firms they may come at the firms — and the limited partner investors — expense.[24] These fees are often not visible to investors. For example, private equity firms charge monitoring fees and can require portfolio companies to pay "operating partner" consultants that are not fully or clearly disclosed to institutional investors.[25] In fact, the funds may require investors to sign agreements specifically stating that they do not have the right to know what fees the PE firms are collecting.

Substantial and increasing leverage risks portfolio bankruptcies and lower returns: Funds buy assets with the investors' money and a considerable amount of debt. The PE firms pony up about 2 percent of the purchase price, the investors put in the rest of the equity, and the remainder is typically debt financing (about 60 percent debt over the past five years).[26] As the stock market has boomed, takeover costs have surged and PE firms are paying much higher premiums for target companies. In 2018, PE firms paid more than 11 times target firm's financial performance — approaching multiples not seen since before the financial crisis.[27]

Higher purchase multiples mean that the takeovers require more leverage and higher debt loads, leaving the target portfolio firm with a larger loan payment that could threaten performance. One industry review found that half of takeover deals at valuation multiples over 10 times lost money — and the aggregate returns for these high-multiple deals (including those that made money) was just slightly positive, returning only slightly more than was invested.[28]

Large debt loads can and do drive target companies into bankruptcy. Private equity portfolio firms are significantly more likely to go bankrupt than firms that were not taken over by private equity. A 2019 California Polytechnic State University study of nearly 500 leveraged buyouts between 1980 and 2006 found that 20 percent of the firms went into bankruptcy — ten times higher than the 2 percent of comparable non-LBO firms that went into bankruptcy.[29] Even if target firms do not collapse into bankruptcy, it may be harder for PE firms to profitably sell assets that were purchased at high price premiums; if the purchase price was overvalued it would require even higher exit prices to get promised returns. But bankruptcies and low exit prices reduce earnings for limited partner investors.

Liquidity risk: Investments in private equity funds are especially illiquid; investors can be required to keep their money locked into the fund for a decade or more.[30] J.P. Morgan observed that the "illiquidity risks [investors] are taking on in private equity may be underestimated."[31] The illiquidity of PE investments represents an opportunity cost, as these investments cannot be reallocated to other, potentially more profitable assets.[32] It is difficult for institutional investors to exit until the PE firm winds down the fund or sells off the fund's entire portfolio of target firms and assets.[33] It is almost impossible to sell PE stakes because there is little secondary market for private equity investments. In 2018, there were only $57 billion in secondary private equity transactions — less than 1 percent of private equity's $5.8 trillion global assets under management.[34]

Valuation risk for institutional investors: It is almost impossible to assess the value of PE-owned businesses and assets while they are held by the PE firm. Unlike publicly traded assets, there is not the constant pricing data from investors continuously trading the stocks.[35] Accurate values are difficult to arrive at for assets that have not changed hands.[36] Moreover, the initial purchase price is often highly overvalued, with high and rising valuation multiples, which can make it hard to secure returns. And it can be difficult to distinguish increases in PE-owned company values from overall appreciation in publicly owned companies during bullish stock markets.[37] A 2013 study found that PE firms tended to fundraise for new funds after profitable exits and/or after artificially inflating net asset value (which was subsequently marked down after the fundraising).[38]

In addition to all of these concerns, PE returns may rely on activities that will harm the medium and long-term interests of working people and retirees, including those whose money is invested in them, for example by raising health care costs through surprise billing[39] or housing costs through aggressive rent increases.[40] Some PE investments could undermine the number of fund participants and the pension's financial strength, such as a public pension with nurses working in correctional facilities that might make an investment in a PE fund that invested in a private prison healthcare company. The opaque nature of private equity also risks pension investors funding businesses or practices that harm their communities (through bankruptcies and layoffs) or are at odds with the interests of the workers or retirees (such as private equity price gouging for housing or healthcare).

Notes:

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[25] *Ibid.*
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