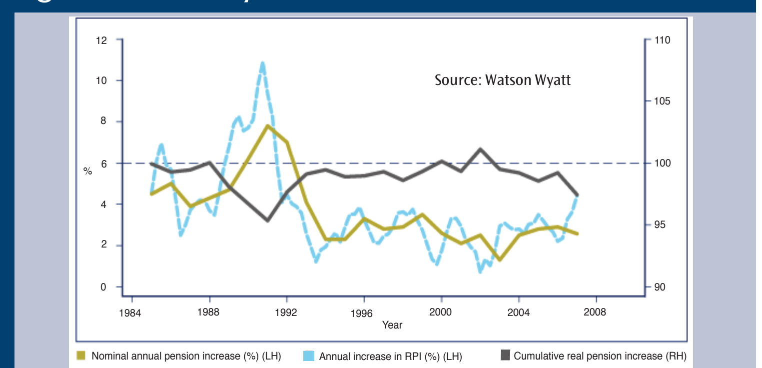
High returns from private equity

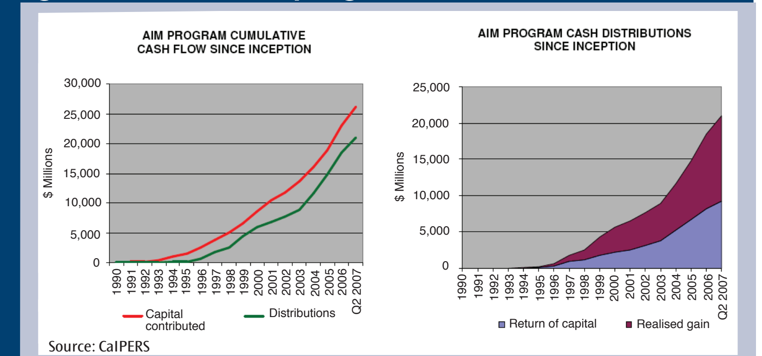
Cyril Demaria argues that private equity is essential for secure pension investment management

Fig 1: Watson Wyatt UK Pension Increase Index



Note: This index is calculated by weighting the increase given by each of 60 large UK pension schemes for pensions above the guaranteed minimum pension by the number of pensioners.

Fig 2: CalPER's AIM programme



Private and public pension funds have substantial assets under management and these assets will be distributed progressively as baby-boomers retire. In the meantime, pension funds have the opportunity to increase these assets substantially by investing for the mid to long term.

Pension trustees can no longer target index returns. The sense of security that index returns provide is misleading since passive management provides neither downside protection nor volatility management. Moreover, with the pressure to deliver increasing returns, pension funds must achieve the highest absolute returns possible given a certain level of risk.

Private equity is one of the few asset classes that can provide high returns substantially, consistently and over the long term. To provide downside protection, pension plans need to invest with an appropriate risk/return profile that fits their expectations. This is best done through funds of funds.

Some of the leading US pension funds and endowments have already identified the return potential of private equity as an asset class and have increased their allocation to private equity. In September last year, CalSTRS allocated 7.3% of its assets to private equity and set a target of 9% over the long term.

US pension funds have also demonstrated that a continuing commitment to private equity investments can be financially rewarding. For example, since its inception in 1990 to the end of June last year, the California Public Employees Retirement System (CalPERS) private equity investments – known as the alternative investment management (AIM) programme – has generated $11.8bn in profits and a net internal rate of return (IRR) of 14.1%. This compares with a 10-year rolling average return of 11.2% for the fund's custom Wilshire 2500 Index plus 300bps.

The result is a substantial premium of 600bps on average over stock market returns at no increase of marginal risk for the pension portfolio. This premium is even higher for the most recent investments. To address the young age of the partnership portfolio (2004 and later), CalPERS adopted a short-term benchmark, the Venture Economics Custom Young Fund Universe. This measures performance of the AIM Partnerships in the first four years against a similarly-aged universe of Venture Economics data.

The AIM Partnership estimated the young fund net IRR at the end of March last year was 27.6%, beating the Wilshire Young Fund Universe median return of 6% by 2,160bps. Investment in private equity is a long-term commitment, yet long term is no longer synonymous with illiquidity but rather with professionalism. Partial and regular liquidity, as early as five to six years of holding, is possible with private equity investment, and at low risk – that is, with products rated AAA.

It is therefore possible to determine the size of annual private equity commitments to build up a self-sustaining private equity portfolio with a constant allocation target. This enables pension funds to meet the needs of their pensioners and at the same time target absolute returns.

Under conservative assumptions, it takes about 10 years with a typical private equity fund of funds to reach a total invested capital of €100m. The positive net cash flows start after seven years, and the cash break-even is expected to occur after 10 years.

Pension funds can use private equity to match their targets, through creativity in terms of product structuring, servicing and an understanding of the strategic asset management issues. In that respect, private equity is no longer a fashionable exotic element to add to a mainstream asset management strategy, but a 'must have' given current demographic and financial shifts.

Pension funds not only want to achieve absolute returns, but also maximise the rotation of their assets to be able to leverage their performance. Financial structuring enables owners of large, high quality portfolios to benefit from structuring techniques, which not only shorten the ownership time of a given portfolio but also maintain relationships with underlying fund.

Combined with this financial structuring, pensions can also over-commit given that once the programme is launched, the net contribution of the pension is never negative and the maximum drawdown, reached by the fourth year, is roughly 70%. The stability and the relative predictability of the cash flows means that it would even be possible to leverage a structured fund of funds.

Pension funds should therefore move in the mid-term towards an allocation of 15% of assets under management to private equity through structured funds of funds programmes. This would seem to be a suitable strategy to actively prepare for the demands of retirement in the future.

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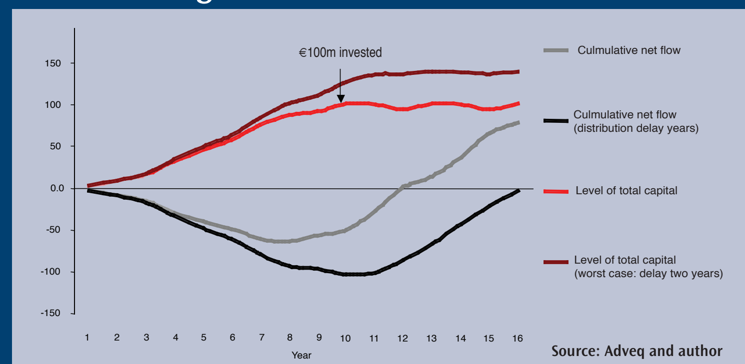
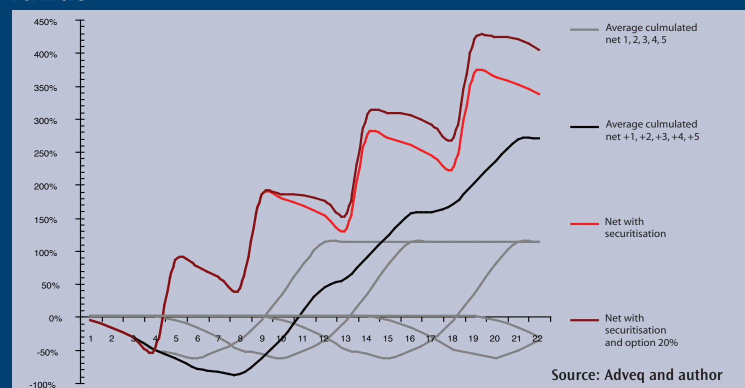
Fig 3: Cash flow and investment patterns in a self-sustaining blended US/EU fund of funds



Source: Adveq and author

Fig 4: Cash flow patterns of a structured fund of funds



Source: Adveq and author