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Private equity profits called into question

By Dan McCrum in New York

Private equity has proved better at enriching its own managers than producing investment profits for US pension funds over the past decade, according to a study prepared for the Financial Times by academics at Yale and Maastricht University.

The industry faces mounting political scrutiny as the presidential candidacy of Mitt Romney, a former private equity executive, has drawn attention to its business model and favourable tax treatment. Mr Romney will release his tax returns today after pressure from Republican challengers.

From 2001 to 2010, US pension plans on average made 4.5 per cent a year, after fees, from their investments in private equity. In that period, the pension funds paid an average 4 per cent of invested capital each year in management fees. On top of those, private equity often collects a variety of other fees and a fifth of investment profits.

"Assuming a normal 20 per cent performance fee, this would amount to about 70 per cent of gross investment performance being paid in fees over the past 10 years," said Professor Martijn Cremers of Yale.

Private equity describes its fees as "two and twenty", a 2 per cent management fee and 20 per cent share of profits. However, the management fee is usually calculated as a proportion of total capital committed by the investor, which takes time to invest.

So in the early years, the management fee can be a much higher proportion of actual cash invested. For instance, if a $1bn fund invests $100m in its first year, the $20m management fee would be 2 per cent of committed capital, but 20 per cent of invested capital for that year.

From 1991 to 2000, US pension funds paid an average 2 per cent of invested capital each year in management fees, and received 21 per cent returns, after fees, annually from their private equity investments, according to data from the CEM Benchmarking database used for the study. The database covers about a third of US pension fund assets.

The rise in management fees since 2000 may reflect greater fundraising, meaning that more funds are in the early investment phase when fees are high. The increased use of third-party fund of funds to invest in private equity could also have added an extra layer of fees.

The Private Equity Growth Capital Council, a trade body, said that calculating fees on the basis of committed capital was the industry standard, and it was inappropriate to compare fees on the basis of invested capital.