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Public Pensions Tweak Approaches to Private Equity

By Fola Akinnibi November 15, 2018

Public pensions are changing the way they approach private equity, along with their expectations for the asset class as a provider of outsized returns.

The Arizona State Retirement System (ASRS) recently moved private equity under the umbrella of a wider equity portfolio, meaning the fund no longer treats or manages private equity as a separate asset class to public equities. For the $39 billion pension, the change in organization and philosophy reflects how it views private equity in its portfolio, says CIO **Karl Polen**.

Now, ASRS has no specific private equity target, which allows it to focus on high-conviction strategies, says Polen.

This change also lets ASRS consider new risk management techniques. Currently, it is exploring the potential use of private equity as a risk overlay, which would allow it to do things like adjust public market sector exposures based on over or underweights in its $3.5 billion private equity portfolio, says Polen.

“We don’t see private equity as a separate asset class. Its purpose is to enhance the returns of the equity portfolio,” says Polen. “If we didn’t think private equity was going to outperform [the public markets], we wouldn’t own it. It’s that simple.”

This year, private equity has seen more commitments than any other asset class by a wide margin. It has accounted for nearly 28% of all commitments through the first three quarters of 2018, according to eVestment data. At the end of 2017, there was $3.06 trillion in assets under management in the industry, up from $2.56 trillion, representing the highest year-over-year growth recorded by Preqin.

There’s a real need for excess returns, given the post-financial crisis stagnation in funded levels, and for many plans private equity has become the answer. Thanks to smoothed valuation reporting, the asset class appears to have low correlation with the public markets and relatively low volatility, while providing great returns, according to **Alex Beath**, a senior research analyst at CEM Benchmarking.

However, that doesn’t paint a full picture.

Private equity firms mark investments to market three to five months late, so when the investments are corrected for time they tend to be extremely volatile and correlated with the public markets, says Beath.

In addition, the asset class does perform extremely well in some cases, but performance varies wildly depending on the fund.

“There’s just so much idiosyncratic risk in [private equity],” says Beath. “The experience from one fund to the next can be extremely large — way beyond what you might see in public equities.”

The heightened flows into private equity have pushed investors’ return expectations down. Today’s investors expect an average return of 11.6%, down from 14.1% in 2015, according to Preqin.

A private equity fund that’s producing public market returns simply isn’t worth it, says **Eileen Appelbaum**, a private equity expert and the co-director of the **Center for Economic and Policy Research**.

“Private equity before the financial crisis was beating the market,” says Appelbaum. “You can understand why in 2008, 2009 and maybe 2010, why they were looking to private equity as their savior.”

The $350 billion California Public Employees’ Retirement System (CalPERS) is grappling with these lower expectations for its massive $27 billion private equity program.

In July, the pension lowered its private equity benchmark from a customized public market equivalent with a 3% risk premium to a general global equity market benchmark with a 1.5% risk premium, which some panned as lowering the bar, as reported.

On Tuesday, acting CIO **Eric Baggesen** told the CalPERS board that the change in benchmark reflects the new market reality.

"All of that capital moving into that asset class, in our minds, means that we should reduce our expectation of the return going forward," Baggesen said at the board meeting. "If we had lots of other alternatives, then maybe we would say that we don't like the liquidity, we don't like the fees, we don't like a lot of things about it…We don't have a lot of substitutes to try to generate that level of excess return."

The smaller end of the private equity spectrum has managers that really outperform, but for CalPERS to put any meaningful amount of money to work in this space would be prohibitively expensive, says Appelbaum. At the same time, as private equity firms scale up they run into issues putting money to work, making it harder to beat the market.

This leaves a huge investor like CalPERS in a tough spot.

"It's a dilemma for them," says Appelbaum.

Despite these types of challenges private equity will remain a key element of CalPERS' asset allocation.

"We do not have any other easy-to-identify alternatives to try to add that excess value on top of what we extract from the public equity markets, which is one of the reasons that private equity is such a core component [of the fund]," says Baggesen.

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