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<u>MEDIA RELEASE</u>

Latest Research Concludes that Private Equity Funds Fail To Deliver Premium Returns.

State, County and Municipal Pension Funds Should Reconsider Their Exposure to Private Equity Investing.

- Recent studies show leveraged buyout funds and venture capital funds provide less investment return than a portfolio of public stocks duplicating the S&P 500 index.
- State, county and municipal pension funds are investing more in private equity, despite these new findings.
- The sizeable fees charged by fund managers are the principal contributors to the poor performance of private equity funds.

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<u>Private Equity Returns and Performance</u>

Potential Pitfalls for
State, County and Municipal Pension Funds

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<u>ABSTRACT</u>

This short paper contends that Maryland state, county and municipal pension plans should be wary of committing more monies to private equity funds. Recent studies conclude that leverage buyout funds and venture capital funds underperform the S&P 500 Index over time, despite their promises of overperformance.

Hedge funds represent a relatively new asset class for pension plan investors, and the historical performance track record of these funds, against the S&P 500, is unproven. One study concluded that the average hedge fund underperforms the public markets.

In this study, we conclude that (a) large fees are the principal contributor to fund underperformance; (b) the consultants advising pension plans sometimes have conflicts of interest; and (c) the future investment performance of private equity funds (vs. the S&P 500) is problematic.

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Background

Over 300,000 employees, retirees and dependents of Maryland state and local governments—including school teachers, police, fire fighters and other public servants—are promised pensions. Many of these benefits are guaranteed by state law or contract and represent liabilities for state and local governments and ultimately the taxpayers.

Pension benefits are paid from a fund made up of assets from employers' and employees' annual contributions and from the investment earnings from those contributions. The assets are a mixture of publicly-traded bonds, publicly-traded common stocks and "alternative investments," such as private equity funds, real estate funds, hedge funds and commodities. The State of Maryland pension fund, for example, has $39 billion of invested assets.

When the available assets, forecast contributions and investment earnings related to a pension fund are less than the forecast future payments to retirees, the pension fund is said to have an "unfunded liability." This means the pension fund does not have enough money to cover future payments.

On January 29, 2008, the General Accountability Office (GAO) released a report on the unfunded pension liabilities of state and local governments in the United States. Collectively, these governments have an unfunded liability that exceeds $1 trillion in present value terms.[1] In Maryland, there are numerous governmental bodies with unfunded pension liabilities, including the State of Maryland ($11 billion), Baltimore City ($300 million) and Montgomery County ($600 million).[2]

A government can reverse an unfunded liability by several means:

1. Increase government pension contributions, which requires higher taxes or a diversion of tax revenue from other uses;

2. Increase employee contributions or decrease retiree benefits. These actions are unfair in many instances, difficult to accomplish legislatively, or problematic at the bargaining table; or

3. Boost the rate of return on pension fund investments.

Public Pension Funds are Increasing Exposure to Private Equity to "Boost" Returns

Many state and local pension funds seek to reduce their unfunded liabilities, in part, by increasing their exposure to private equity funds, such as leveraged buyout funds and venture capital funds. The premise is that such funds provide higher rates of returns than conventional investments, such as publicly-traded stocks and bonds (i.e., tactic number 3 set forth above). The State of Maryland, Baltimore City and Montgomery County pension funds are increasing their exposure to private equity funds, according to their published reports.[3]

Research Indicates the Average Private Equity Fund Performs Worse than an S&P 500 Index Fund

Recent research by professors at the University of Chicago Graduate School of Business, MIT Sloan School of Management, INSEAD (France) and University of Amsterdam Business School, respectively, concluded that investors are better off investing in an S&P 500 Index Fund, rather than the average private equity (PE) fund. The private equity industry has produced no evidence to refute these studies.

In a groundbreaking paper, Professors Kaplan and Schoar (2005) used a Venture Economics database on individual PE fund performance and concluded that average PE fund (both buyout and venture capital) returns (net of fees) approximately equal S&P 500 returns. They found that returns generated across funds raised by individual PE partnerships had a better-than-average chance of being repeated. However, the probability of replicating success was far from absolute. For example, a partnership that was in the top quartile (25%) of all funds in terms of performance had just a 40% chance of being in the top quartile with a follow-up fund. [4]

Professors Phalippou and Zollo (2005) found that the performance of PE funds was below that of public stock markets. They noted that the PE asset class is illiquid; investors are locked into a 10 year commitment and cannot sell their investment easily. Furthermore, fund performance varies positively with both business cycles and stock market cycles, so it is not a hedge against public stock market performance. The professors offered explanations for why institutional investors continue to invest in PE funds despite the negative attributes of PE funds.[5]

In 2007, Professors Phalippou and Gottschalg completed a follow-up study, showing that PE funds underperformed the S&P 500 by 3% annually.[6]

Several of the institutional investors MTEF interviewed are cognizant of the under performance of the average private equity fund. They justify their continued investment in PE funds by saying their research (and that of their consultants) enable them to select funds that will fall into the top quartile of investment performance. Uniformly, however, the investors indicate that their analysis focuses on the historical performance of a fund manager, despite the evidence that historical results are not guaranteed into the future.

Note that the top quartile is the category at which a PE fund outperforms the S&P 500 by two to three percentage points annually. This means that three-quarters of PE funds are unable to do so, and most under perform the S&P 500.

Pension Fund Consultants, "Gatekeepers" and Public Pension Funds

Many state and local pension funds use consultants that introduce the pension funds to PE managers (or partnerships) and assist the funds in the PE manager selection process. The consultants charge the funds a fee for this service. In theory, the consultants should be objective advisors to the pension funds, free of any conflicts of interest. However, the evidence shows that certain consultants receive compensation from PE managers for placing investors in the managers' respective PE funds.[7] Such consultants thus expose their pension fund clients to dual loyalties. Objective analysis indicates that consultants should recommend against increased pension fund exposure to private equity in many instances. Why? Because of the poor performance outlined above.

Sometimes, private equity funds hire placement agents to solicit investors for the funds. The cost of these placement agents (or "gatekeepers") can be 1% of the fund's size in addition to a small carried interest. It is not unusual for the institutional investors to bear a portion of the placement agent's fees.

Reasons for Private Equity Funds Failing to Beat the S&P 500

The principal contributor to the under performance of PE funds against the S&P 500 is the high level of manager fees. Professors Phalippou and Gottschalg (2007) found that fees cost investors 6% annually in terms of net-of-fees performance.[8] Thus, before fees, the average PE fund return exceeds the S&P 500 by 3%. After fees, it underperforms by 3%. Such fee estimates are consistent with analyses made by industry observers and MTEF.

Wharton professors Metrick and Yasude (2007) examined the fees of 238 buyout funds and found that most fees arise from fixed-revenue components that are not sensitive to performance.[9] Fees include asset management fees and incentive fees, as well as transaction fees and portfolio company monitoring fees. In other words, buyout fund managers are paid high fees whether or not they beat a relevant benchmark like the S&P 500.

Future Private Equity Fund Performance Is Problematic

It is unlikely that the current crop of PE funds will outperform the S&P 500.

In the buyout area, the funds paid higher prices (in terms of earnings multiples) from 2004 to 2007 than in previous years, according to the SDC Platinum database.[10] Higher prices tend to depress returns. Furthermore, over the last several years, perhaps one-third of buyout fund investment "exits" were sales of portfolio companies to other buyout funds. With the ongoing subprime crisis, this exit tactic will be increasingly restricted.

And finally, the U.S. economic slowdown will negatively impact the earnings and debt service capabilities of many leveraged buyouts. On June 12, 2008, Fitch Ratings issued a report that the credit quality of LBO deals done from 2004 to 2007 has "visibly" eroded over the prior 12 months.[11]

For venture capital funds, the dormant initial public offering (IPO) market will lead to longer holding periods. And, with merger and acquisition activity down by more than one third in 2008 (vs. 2007), selling a portfolio company at an attractive valuation becomes difficult.[12]

Hedge Funds

As noted earlier, hedge funds represent a relatively new asset class for large pension funds and their historical performance is not of long duration. Over the last 10 years, the industry grew to 8,000 funds from a few hundred, according to Hedge Fund Research, Inc. Most charge investors a fee of at least 1% of assets invested plus 20% of profits. Professors Fung (London Business School), Hsieh (Duke University), Naik (London Business School) and Ramadorian (Oxford University) concluded in a 2006 study that the average hedge fund did not outperform the public stock market.[13] MTEF does not include hedge funds in this discussion.

About MTEF

MTEF is a non profit, non partisan organization that studies budget and tax issues in the State of Maryland. Previous topics have included a $1.1 billion legal fee requested by the Angelos law firm, a $1.5 billion casino license giveaway proposed by the State of Maryland, Montgomery County school spending and performance, and other issues.

The website is:

www.marylandtaxeducation.org

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Footnotes

[1] The GAO report was completed at the request of Senators Baucus (D) and Grassley(R) of the Senate Finance Committee.

[2] The unfunded liabilities are disclosed in the pension plans' respective annual reports.

[3] The annual reports of the pension funds show an annual increase in PE investments from 2005 to 2007

[4] Private Equity Performance: Returns, Persistence, and Capital Flows," Steven Kaplan and Antoinette Schoar, (2005)

[5] "Performance of Private Equity Funds: Another Puzzle?" Ludovic Phalippoi and Maurizio Zollo (2005). The puzzle refers to why institutional investors continue investing in PE funds despite the poor performance. Supposedly, they should know better.

[6] Performance of Private Equity Funds," Ludovic Phalippou and Oliver Gottschalg (2007)

[7] The Securities and Exchange Commission has investigated the fact that many pension fund consultants being paid by public pension funds for objective advice are also be paid by private fund managers for services. See speech by Lori Richards, SEC Director of Compliance Inspection, dated December 5, 2005. Several newspapers, including the *New York Times*, have covered this issue.

[8] Phalippou and Gottschalg (2007)

[9] "The Economics of Private Equity Funds," Andrew Metrick and Ayako Yasuda (September 9, 2007)

[10] SDC Platinum's merger and acquisition database provides valuation metrics on leveraged buyouts of publicly traded companies. Other databases such as Mergerstat, Done Deals and Pratt's Stats include private LBO data.

[11] *Wall Street Journal* June 13, 2008.

[12] See T*he Washington Post* (July 1, 2008, page D-1) for a discussion of the dormant IPO market. See the Dealogic database for a summary of 2008 M&A activity during the first six months.

[13] "Hedge Funds, Performance, Risk and Capital Formation," William Fund, David Hsieh, Narayan Naik, and Tarun Ramadorai (2006)