Pensions Brace for Private-Equity Losses

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Public pension funds are already reporting big losses in 2022. Things are likely to get uglier.

That is because the funds, which manage around $5 trillion in retirement savings for the nation's teachers, firefighters and other public workers, haven't yet factored in second-quarter returns on private equity and other illiquid investments.

"You should expect sometime over the next three to four quarters to see write-downs in the illiquid part of the portfolio," Allan Emkin, a consultant to large pension funds with Meketa Investment Group, told the board of the $300 billion California State Teachers' Retirement System last month.

The losses are yet another example of how the current market tumult offers almost no place to hide, and that even the investments usually considered havens are slumping. The Dow Jones Industrial Average on Friday closed at its lowest level of 2022, weighed down by concerns about inflation, weak global growth and whether the Federal Reserve's rate-raising campaign will tip the U.S. into recession.

In the coming weeks and months, public pension funds will calculate the second-quarter performance of their private-market assets based on estimates they receive from investment managers.Photo: Rodin Eckenroth/Getty Images

Public pensions have faced a funding crunch for years. Many have increasingly turned to private equity and other nontraditional investments over the past few years in hopes of plugging their shortfalls.

When pension returns fall short of targets, typically around 7% annualized, the states and cities sponsoring those pensions pay higher annual retirement contributions to make up the difference. Sometimes they must raise taxes or cut services to find the extra money.

Public pensions reported returning a median minus 7.9% for the fiscal year ended June 30, their worst losses since 2009, according to data from Wilshire Trust Universe Comparison Service published in The Wall Street Journal last month.

But the only performance figures from this year's brutal second quarter reflected in that 7.9% figure are for traditional publicly traded investments like stocks and bonds. The private-market returns baked into that figure are for the 12 months ended March 31, and include double-digit private-equity gains for the second quarter of 2021.

In the coming weeks and months, public pension funds will calculate the second-quarter performance of their private-market assets based on estimates they receive from investment managers. Warning signs are already visible in the secondary market, where investors can buy and sell private-equity assets midway through the life of the investments.

Investors who bought private-equity assets on the secondary market this year paid an average 86% of the value assigned to those assets in 2021, according to data collected by investment bank Jefferies LLC from transactions it worked on. While assets often sell at a discount in secondary trading, that was the lowest figure since data collection began in 2016.

Private-equity portfolios containing the debt or equity of struggling companies declined the most, Jefferies said. Those containing real-estate-related companies suffered the least, with infrastructure and industrial properties in particular demand. High supply likely also pushed down secondary-market prices, analysts said.

“We expect the absolute return of private equity to decline in the coming quarters,” Greg Ruiz, head of private equity at the $440 billion California Public Employees’ Retirement System, told board members Monday.

State and local plans held about $480 billion in private equity in 2021, up from $300 billion in 2018, according to estimates based on data from analytics company Preqin and the Federal Reserve. Illiquid assets including private equity represented nearly a quarter of their portfolios.

Institutions typically invest in private equity by turning over cash to a money manager who pools it with other investors’ money and uses it to buy, overhaul and sell private companies over a decade or so. While the investor might receive some money during that time, the overall performance of the investment won’t become clear until the final payout.

In the interim, the investor relies on the manager to provide an estimate each quarter of what the investment is worth. Managers come up with these estimates by trying to assess the current value of the private companies they hold based on a mix of factors, such as internal or outside evaluations of the companies’ current and future performance, and the trading prices of comparable public companies.

Andy Nick, a managing director at Jefferies’ private capital advisory arm, said private-equity managers tend to understate both gains and losses during individual reporting periods by factoring them over a longer period. He predicted that managers won’t price in the full extent of this year’s losses until December, when auditors review their accounting.

“You’ll have the quarterly marks but that’s as good as the paper it’s written on,” Mr. Nick said.

Private-equity investments have outperformed stocks over the very long term, according to a private-equity index maintained by the data analytics firm Burgiss that doesn’t include venture capital. For the three decades ended June 30, 2021, the Burgiss index yielded an annual return of close to 14%, about 3 percentage points more than the S&P 500.

However, the gap has all but disappeared as more investors have crowded into private equity. Over the 10 years ended June 30, 2021, the yield was the same as the S&P 500, 14.8%.

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