The Mixed Case for Private Equity in Retirement Plans

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By Anne Tergesen June 25, 2020

With the help of regulators and lawmakers, 401(k) plans are trying to become more like the old-fashioned pension plans they replaced. The latest example involves private equity, an illiquid investment that is a staple in pensions and now wants to be in your 401(k).

While the addition of shares of privately held companies may boost 401(k) investors' returns, there are reasons for concern, including high fees and a lack of transparency.

Earlier this month, the Labor Department issued guidance confirming that 401(k) plans can offer private equity in a diversified fund, such as a target-date fund. These portfolios shift from stocks to bonds as people age. Because they serve as default investments in many 401(k) plans that automatically enroll workers, they receive more than half of employees' contributions.

For private-equity firms, some of which have been trying for a decade to break into the $7.9 trillion market for workplace retirement plans, this is a victory.

"401(k) plans have become a huge pool of long-term money," said Fred Reish, an attorney who specializes in employee benefits. He said other illiquid investments, including hedge funds, may also use the guidance to market themselves as additions to target-date funds.

The Labor Department's move follows a 2019 law that encourages 401(k) plans to replicate another feature of old-fashioned pensions by offering annuities, insurance contracts that turn savings into a monthly income for life.

The downside, critics say, is that after years in which fees on 401(k) accounts have been declining, the two investments would raise costs for workers. That makes it hard to know whether the move to replicate pensions represents a win-win for investors, private-equity funds and insurers—or whether those industries stand to gain at investors' expense.

Proponents say the addition of a small amount of private equity to a retirement portfolio—say, up to 15%—would give 401(k) plans access to an investment that has historically boosted returns for pensions, endowments and wealthy individuals.

With the number of firms traded on public stock exchanges down by half over the past 20 years, private-equity funds also offer a way to "participate in the greater percentage of the economy that is privately held," said David O'Meara, senior investment consultant at Willis Towers Watson, which advises 401(k) plans.

Critics note the effect fees can have on fund returns. Private-equity fund managers generally collect a 2% management fee plus 20% of the profits, versus less than 0.5% a year, on average, for the stock funds that dominate 401(k) menus, according to BrightScope Inc.

Private-equity funds must generate consistently higher returns to compensate for those fees and the extra risk investors run when buying illiquid securities, said Rosemary Batt, a professor at Cornell University. After fees, they "shouldn't just meet the stock market but beat it" by at least 3 percentage points, she said.

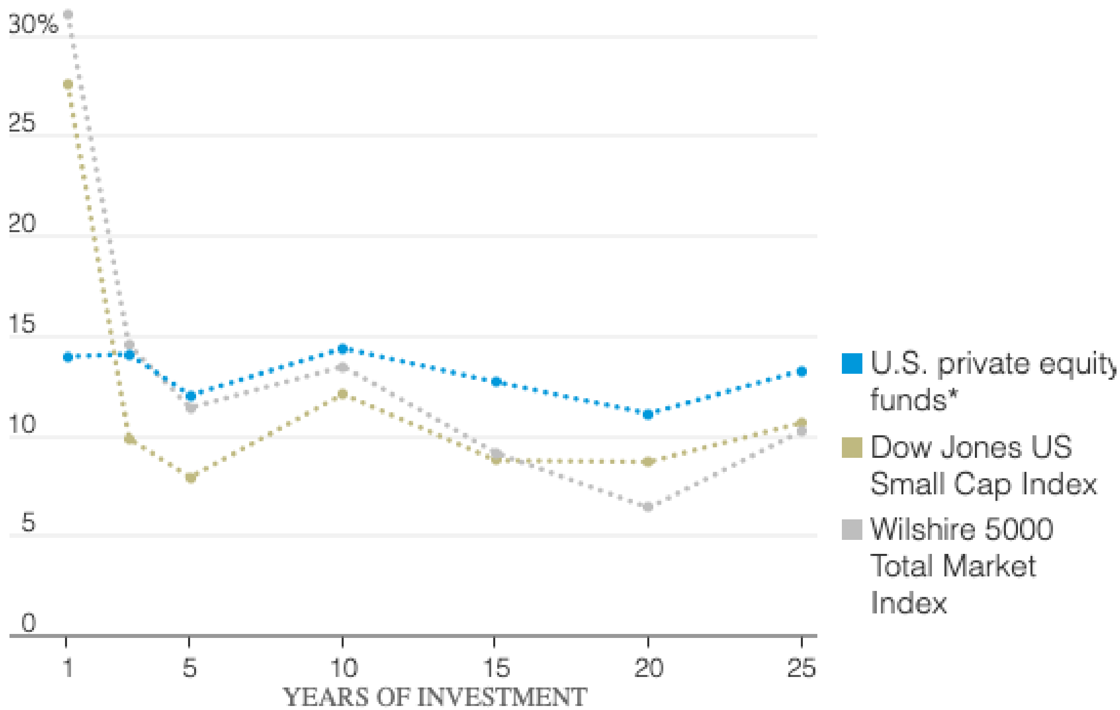
It is hard to tell how much return private equity delivers.

The average annual return for an index of U.S. private-equity funds after fees over the decade ended Dec. 31 was 14.35%, versus 13.44% for the Wilshire 5000 Total Market Index, according to Cambridge Associates.

But a new study from an economist at Oxford University says U.S. public pension funds earned average annual returns of 11% after fees in private equity over the past 25 years, about the same return as small- and midcap U.S. stock-market indexes.

Average annual return

*US Private Equity Index after fees
Note: As of end of 2019
Source: Cambridge Associates



Mutual fund giant T. Rowe Price Group, one of the three largest in the target-date fund market, says the contradictory results are because of differing views on the reliability of the performance metrics. The method the industry favors is sensitive to assumptions and "can overstate the benefit from a risk-adjusted perspective," the company said in a written statement.

Moreover, "there is a wide dispersion of results" between private-equity funds, making it important to pick a top manager, the statement said.

Currently, two private-equity firms— Partners Group and Pantheon Ventures, which jointly sought the Labor Department's guidance—have introduced funds for the 401(k) market.

While neither reports returns on their 401(k) funds, their offerings registered with the Securities and Exchange Commission may offer clues.

Over the four years through March 31, Partners Group Private Equity Master Fund LLC returned 7.34% a year after fees, on average, versus 7.48% for the Wilshire 5000.

Like T. Rowe Price, the two largest target-date fund providers, Fidelity Investments and Vanguard Group, say they continue to evaluate private equity but have no immediate plans to add it to those funds.

Through a partnership with a Boston-based firm, Vanguard recently began offering private equity to the pension plans, endowments and foundations it manages money for.

Some say the Labor Department's guidance may help employers overcome reluctance to add higher-priced investments to 401(k) lineups amid a continuing wave of lawsuits over fees. These include a suit against Intel Corp. over using private equity and other alternative investments in its target-date funds.

Jerome Schlichter, an attorney whose St. Louis-based firm pioneered 401(k) fee litigation, said employers must demonstrate "that adding private equity will increase after-fee returns."

"These are quite high-priced investments and it will be difficult to determine that they are likely to beat the market after fees."

Private Equity Could Be Coming to Your 401(k) Program
Other hurdles are logistical. For example, private-equity funds typically bar shareholders from exiting for as many as 10 years.

Robert Collins, a partner at Partners Group, says the fund invests a small portion of assets in publicly traded stocks to cash-out departing investors. It also provides the daily pricing 401(k) plans require.

Mr. Collins expects large companies with pension plans that invest in private equity to be among the first to add it to their target-date funds. The fund has two pension-fund clients but no takers among 401(k) plans—yet.

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