THE JOURNAL OF
INVESTING
VOLUME 30, NUMBER 1 DECEMBER 2020

We put this special issue together in order to help increase awareness of what I consider to be the most significant danger we are facing in the retirement system today: overinvestment in private equity. In all the years since I founded this journal for Institutional Investor in 1990, this could be the most important topic we have covered.

What is the issue? Investment in private equity continues to grow due to the belief that returns will be greater than public equity going forward. Former CALPERS CIO Ben Meng's quote regarding his decision to substantially increase the allocation to private equity is typical. "If your aim is a 7% return and there's only one asset class forecast to deliver that, and more, you need that asset class in the portfolio, and you need more of it." The concern is that private equity will not achieve investor's expected returns due to a multitude of reasons, which are listed below.

1. Investors are making a behavioral decision error of framing their expectations of future returns on past return data without looking to see if conditions are different.
   a. Wide dispersion of performance among private investments means the range of investors' performance is similarly disparate
   b. Historical strong performance of multi-billion dollar investment pools has generally not been available to smaller pools and may not be available to any investors going forward
2. Inaccurate or misleading performance, accounting, and return calculations are used.
   a. Not marked to market
   b. IRR, not TWR or PME
   c. "Since inception" IRRs overstate performance
   d. Use of leverage
   e. Lack of write-downs for zombie companies
3. PE firms do not appear to improve the business or operations of the acquired firms.
4. The current flood of new capital into private equity creates concerns.
   a. Valuations are at all-time highs, suggesting lower returns for current and near-future vintage years
   b. $2 trillion of dry powder waiting to be invested
   c. Recent performance is lower than long-term performance

5. Not marking to market on a frequent basis creates artificially lower volatility.
   a. Lower volatility is incorrectly interpreted by investors as lower risk
   b. Touted diversification benefits may be ephemeral, the result of appraisal-based accounting
   c. Some investors don't care about artificial low liquidity since it makes their institutional portfolios look better to their boards
6. Private equity needs higher returns to cover the higher fees charged.
   a. Fees estimated to be as much as 6%–7% of AUM
7. There are risks in private equity.
   a. No liquidity can be problematic in times of market distress like 2008
   b. Committed capital creates short-term liabilities for future capital calls,
   c. Capital call feature will incur lost opportunity costs to maintain liquidity and can prove problematic during market disruptions
   d. High leverage levels and low-quality credit create significant default risk and exacerbate cyclicality
8. When private equity is taken public, firms may not achieve the valuation they are carried at, as seen in some recent IPOs.

We should all be increasingly concerned that investors are pouring money into an illiquid, risky asset class without knowing all the facts. This asset allocation shift could strain the entire United States retirement system if return expectations are not met. We have provided articles from leading authorities so investment decision-makers can make informed decisions.

We had lots of help in putting this issue together. I'd like to especially thank Jim Schrager from the University of Chicago and former editor of *The Journal of Private Equity*, Jason Zweig from *The Wall Street Journal*, Bob Maynard from Idaho PERS, and Dan Rasmussen from Verdad whose excellent article in *American Affairs*[1] sparked the idea for this issue.

As always, we welcome your submissions. We value your comments and suggestions, so please email us at journals@investmentresearch.org.

Brian Bruce
Editor-in-Chief

[1] Rasmussen, Daniel. 2018. "Private Equity: Overvalue and Overrated?" *American Affairs 2*, no. 1. https://americanaffairsjournal.org/2018/02/private-equity-overvalued-overrated/.