THE NEW DRIVERS OF PENSION AND SWF INVESTMENT IN PRIVATE EQUITY

The rapid rise of "alternative" and non-listed asset classes has been one of the most remarkable phenomena in the institutional investment space since the start of the Great Recession 7 years ago. This trend is contributing to a profound transformation of the financial ecosystem as a whole. This unprecedented change is occurring against the backdrop of a growing disaffection for actively managed public equity, long the investment category of choice for institutional asset owners.

AN AGE OF AUSTERITY AND RELATIVELY LOWER RETURNS FOR LISTED 'CORE' ASSETS

The rapid rise of "alternative" and, more generally, non-listed asset classes has been one of the most remarkable phenomena in the institutional investment space since the start of the Great Recession seven years ago: together with the continued shift towards more low-cost passive management for "core" public equity and fixed income holdings[1], this trend is contributing to a profound transformation of the financial ecosystem as a whole[2] . Beyond what we may call the traditional, *positive* perceived benefits of the private equity asset class (statistical diversification stemming from partial decorrelation to listed securities, superior risk-adjusted returns over long periods, access to early-stage industries, fiscal paybacks for investments in SMEs, startups and innovative technologies… etc.) which were all highlighted in the 1950s by Georges Frédéric Doriot[3], there are also newer motives at work.

The new "Age of Austerity[4]" we live in seems to be characterized by durably lower yields for most government bonds and (at best) mediocre annualized returns for most listed equity markets when compared with the previous quarter of a century (1982-2007)[5]. In spite of the recent stock market rally off the 2008-2009 lows, more pension executives and trustees face political and regulatory pressure to reduce the expected return for listed equity investment used in their traditional actuarial models[6].

SUBSTITUTION EFFECT FAVORABLE TO PRIVATE EQUITY UP TO A CERTAIN EXTENT

Under such circumstances, it's only natural that "deep pocket" asset owners like pension funds, sovereign wealth and national reserve funds that have a generally low likelihood of facing liquidity shocks in the medium term (and thus can afford the required liquidity premia usually attached to alternative asset classes) would pursue a "quest for higher yields[7]" by increasing their allocation to less liquid investments such as real estate, infrastructure and private equity, with the expectation of earning risk-adjusted returns higher than government bonds (property and infra assets) and higher than listed blue-chip stocks (private equity). US pension funds have doubled their exposure to private equity in the past six years (2007-2013) and currently have an average target allocation to private equity of 8.5% of assets under management, roughly 25% higher than the global average[8] (with the exception of Scandinavia and Holland, Mainland European and Asian pension schemes tend to have a rather low exposure to the asset class, UK pension funds being generally around 5.5%). Recent surveys conducted by the Coller Institute confirmed that renewed interest for the asset class: "*private equity and publicly-listed stocks are viewed as* […] *substitute*[s]… [There is] *a strong negative*

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relationship between quoted equity and private equity allocations [by pension investors][9]". Paradoxical as it may seem, this "substitution effect" has always existed *to a certain extent*: short to medium-term (defined as periods inferior to 6 years) adverse economic circumstances that can harm traditional investments such as listed equity and fixed income can actually be propitious to pension fund investment in non -listed assets, as long as stock markets eventually recover: it is precisely the late 1970s, an era of rampant inflation and corporate decline in the United States and Western Europe when the world "malaise" entered our economic lexicon[10] that saw the first big wave of pension fund investment in private equity[11]. But, today, a different kind of malaise seems to be afflicting listed securities markets, prompting many pension and SWF executives to further reconsider their longstanding commitment to "actively managed" listed equity funds.

2012-2013: UNPRECEDENTED CRISIS OF CONFIDENCE IN LISTED EQUITY

The "Great Recession" took a particularly heavy toll on traditional equity buy-and-hold investors: pension funds who had bought US or European large-cap equity assets around 2006 or 2007 had to wait until January 2013 to see their investment outperform CPI inflation- even without factoring in management fees. The underperformance of an unusually high proportion of actively managed equity portfolios in 2008-2013[12] has laid bare the over-reliance on traditional benchmarking to construct complicated portfolios and measure investment performance "scientifically" on a quarterly basis, with many pension funds finding themselves unthinkingly over-exposed to banking and insurance (UK, France, Benelux) or mining (Australia, South Africa) sector risk when they thought they owned truly diversified equity portfolios made of relatively safe, big, household names that "couldn't go wrong".

In 2012, Rajat Gupta former CEO of McKinsey (a firm "advising most of the major listed corporations"), highly influential board member of Goldman Sachs, Procter and Gamble and American Airlines, three of the most iconic "bluest of blue chips" whose names came to symbolize *listed* financial services, consumer products and transportation respectively, was convicted of systematic insider trading [13]. And then in July 2013, the SEC brought a civil action against Steve Cohen, founder of hedge fund group SAC Capital Advisors, for "failing to supervise portfolio managers and prevent insider trading", which further eroded the collective confidence in the system. *But the problem has deeper roots and goes beyond classical accusations of "insider trading[14]"*: on certain days in 2011 and 2012, through a noxious combination of excessive leveraging and high-frequency trading, SAC Capital alone represented more than 10% of the daily volumes transacted in certain US blue chips, thus attracting all the *considerate attention* that fee-seeking investment bankers and stockbrokers could give, prompting some of them to devote the best and the brightest among their stock market traders and financial analysts teams to servicing quasi-exclusively such a profitable client… to the detriment of less "juicy" investors such as pension funds and SWFs.

In August 2013, two seemingly unrelated stories drew the attention of long-term institutional investors, contributing to the growing crisis of confidence: shares of Facebook closed for the first time at their IPO price level of May 2012, thus bitterly reminding pension investors they had actually lost billions of dollars by acquiring Facebook shares sold to them by investment banks working on behalf of private equity firms eager to "realize" colossal paper returns by offloading their stakes into the "lower echelons of the financial food chain". And then the CEO of BlackBerry Limited, a listed Canadian company formerly known as Research In Motion (RIM), that had generated returns superior to 700% in two years for its founders and early private equity investors[15] abruptly announced that "the company was for sale"! News of a possible delisting brought little relief to traditional listed equity investors who had seen the stock price loose nearly 90% since 2011.

PE INVESTORS ULTIMATELY NEED HEALTHY, EFFICIENT STOCK MARKETS…

In the past two years, as discontent grew among patient institutional investors, the natural owners of long-term assets and thus traditional providers of stable capital for listed companies large and small, more pension and sovereign wealth funds have understandably decided to raise their relative allocation to un-listed companies: according to in-depth surveys conducted recently by various think-tanks, research centers and investments banks, more than 40% of 'limited partners' (pension funds, sovereign wealth funds and other large institutional investors) plan to increase their allocation to private equity during the first half of 2014[16], an unprecedented surge that should come as no surprise given the general malaise afflicting listed securities markets.

Caught between severe cost-effectiveness imperatives (rapid rise of low-cost indexing and passive management) and the continued migration of "smart money" towards private equity and hedge funds[17], the stock market is in need of a major overhaul. This is also important for PE investors who know more than anyone else that healthy and efficient public equity markets are vital for the financial system as a whole, as they ultimately provide the relevant levels of liquidity (IPOs, sale to and/or merger with larger listed companies) and valuation metrics needed by limited partners to properly exit their private equity funds after a typical 8 to 10 year investment horizon…

A LOOK AT SECTORS – FOCUSING ON INDIRECT PE INVESTMENTS

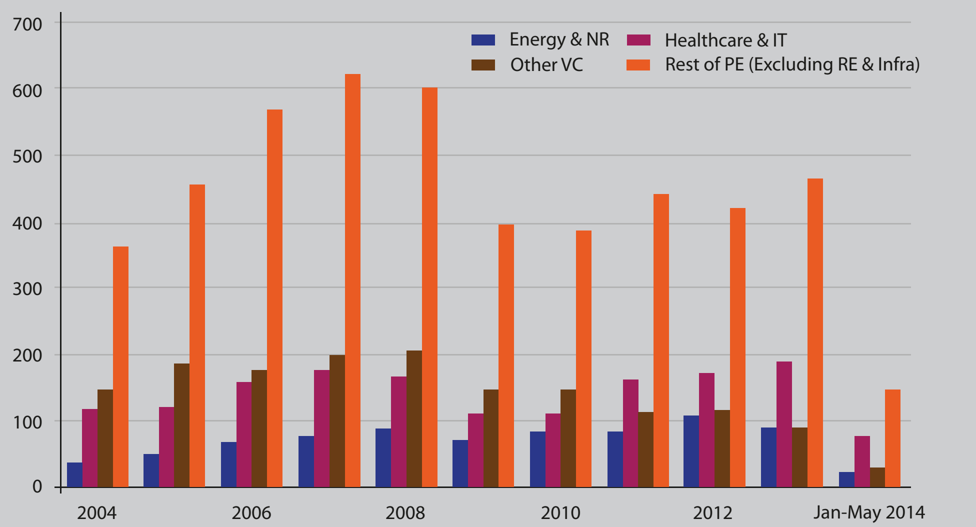
Most institutional investors wishing to gain a degree of exposure to the asset class still invest essentially through funds managed by specialized fund management companies ('private equity firms'). Apart from a handful of very large (typically US and Canadian) public pension funds and (Asian and Gulf area) SWFs who can choose to also invest into non-listed companies by acquiring part or all of their capital ('directly'), the indirect route (through PE funds) still constitutes the institutional mainstream.

Contrary to a fairly common misconception, "energy and natural resources" and "healthcare (HC) and information technology (IT)" (including the "other VC" category see chart below) don't dominate disproportionately the private equity investment scene to the detriment of traditional industries and services- this even though the former have grown faster than the latter since 2005 as energy prices stabilized at a relatively high level in spite of the Great Recession and Silicon Valley underwent a remarkable rebirth driven by smartphone technologies and "social media" (bankrolled by massive pension investments in tech-oriented PE funds).

Our analysis of data compiled by Preqin, the main data provider for alternative asset classes (focusing on institutional investments flows into funds i.e. 'indirect investments') over the past ten years shows that "the rest" defined as consumer staples, consumer discretionary, financials, utilities, and other traditional sectors excluding energy/HC/IT-oriented services and industries still accounts for 53% of all private equity funds launched (vs. 56% in 2005) and 70% of capital raised in the asset class (vs. 80% in 2005). ■

TAGS: Asset Allocation, Alternative Investments, Austerity, Equity, Governance, Great Recession, Non-Listed, Pension Funds, Private Equity, Public Policy, SEC, Sovereign Wealth Funds, UK, US.

NO. PRIVATE EQUITY FUNDS RAISED (2004- 2014)



The "Energy and Natural Resources" category includes some funds that can occasionally also invest in energy infrastructure assets. The "January-May 2014" period ends June 6th 2014

Source: Preqin

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