Retirement News Highlights

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Private Equity May Be A Ticking Time Bomb For Public Pension Plans

It won't just be people in the private equity industry who suffer. Millions of Americans who hold a public pension plan could be squarely in the blast radius.

By Molly Redden
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Two years ago, when the economy was a runaway train, so were the returns on private equity investments. Among the biggest winners were large public pensions, which had invested a staggering $500 billion out of a total $4.5 trillion in private equity — one dollar out of every 10.

But with stock prices now plummeting, experts are fearful that private equity returns are not far behind. Accusations are flying that private equity firms are spinning an elaborate fiction to hide their losses.

"Everybody is happy to go along with the game until the music stops," said Eileen Appelbaum, the co-director of the Center for Economic and Policy Research. "We could be reaching a dangerous and scary point."

Private equity firms make money by buying companies, restructuring them and trying to sell them at a profit. But until the sale, and in some cases even after, it's the private equity firm that declares what the company is "worth."

Even as the value of publicly traded companies has plummeted, those valuations have stayed high, making those guesstimates look increasingly fanciful.

"It's getting ridiculous," said Jeffrey Hooke, a senior lecturer at the Johns Hopkins Carey Business School. By one count, "In the first three quarters of 2022, the stock market fell 24%, while private equity said we only dropped 7%. It doesn't make any sense. It seems to be totally illogical and inflated."

At some point, firms need enough cash to pay back investors. In a doomsday scenario, the stock market won't recover, and it will become impossible for firms to keep up the fiction.

The head of Europe's largest asset manager, Amund, last year likened the market to a "pyramid scheme," in part because so many private equity firms are selling portfolio companies to one another as a way to keep their prices inflated.

If the unthinkable happens, it won't just be people in the private equity industry who suffer. Millions of Americans who hold a public pension plan could be squarely in the blast radius.

"Everybody is happy to go along with the game until the music stops."
- Eileen Appelbaum, co-director of the Center for Economic and Policy Research

Public pension funds have been ratcheting up their investments in private equity for almost a decade. With the workforce getting older, low-risk investments and the contributions of younger workers aren't enough to fund benefits for all of the teachers, firefighters, transit workers and other public sector professionals who are at or near retirement. The nationwide shortfall stands at a staggering $1 trillion, leading pension officers who have an obligation to close the gap to turn to riskier, so-called alternative assets like real estate, private loans, hedge funds — and private equity.

Private equity firms, for their part, smelled their desperation and exploited it in order to pocket billions of dollars in fees. Firms typically take a 2% management fee whether or not an investment pays off, meaning a $1 billion failed investment would still result in a $20 million windfall for the private equity firm. When the investment earns money, their fee balloons to 20% of the profits.

At least, that's the industry standard. Wall Street has amassed so much political power in state capitals that many states have laws that keep the terms of their investing relationships a secret. In one recent example of their political might, Indiana exempted private equity firms from a proposed ban on investing state funds with firms that have taken ESG pledges. Conservatives have derided ESG — or responsible environmental, social and governance investing — as "woke investing," so it's notable that they would offer such a major loophole.

The industry and its lobbyists have cultivated deep ties to the officials who vet and approve investments, dangling everything from private sector gigs to lavish paid trips. In one particularly egregious example, a firm called Apax Partners helped pay for a pair of Michigan officials fly to Florence and explore the Tuscan countryside on vintage Vespas, according to Bloomberg. In Kentucky, which has the worst-funded pension in the country, hedge funds and private equity firms were able to net $1.3 billion in investments in a five-year period by paying just $12 million to influential middlemen, The Intercept reported. The first of those investments was in a hedge fund that folded 2 1/2 years later.

They're often courting outmatched trustees. Unlike in other countries, overseeing a public pension in the U.S. doesn't require a background in accounting or finance, and the position is often a political one. A 2011 SEC rule banned people working in finance from making campaign donations to public officials, like governors or state auditors, who decide where to invest pension funds. But the rule only applies to direct contributions, not outside groups like super PACs. And no sooner had the rule taken effect than executives started finding ways around it.

It's not hard to see why experts warn that private equity investments are a bad deal for the public. The process is captured. The investments are risky. Pensions typically agree to lock up their money for at least 10 years, with the only performance updates coming in the form of guesstimates generated by the private equity firm itself.

It's this last factor that has experts so worried. "The public is who's going to be holding the bag," Hooke said. "When this shakes out, state governments and university endowments will either have to cut benefits or increase taxes or employee contributions."

Spooked by recent warnings, some public pension funds are scaling back future private equity investments. But they are already locked into billions in existing commitments. Maryland's state retirement fund is aiming to cut back its private equity portfolio to 16% from almost 22%.

"Everybody has already drunk the Kool-Aid," Appelbaum said. "They can't get out immediately. They can only, as these commitments mature, choose not to reinvest."

"The public is who's going to be holding the bag."
- Jeffrey Hooke, senior lecturer at the Johns Hopkins Carey Business School

Hooke largely blames regulators for the runaway valuations.

"Basically, the two supervisors aren't supervising," Hooke said. One is the U.S. Securities and Exchange Commission, which is only nominally supervising the private equity sector. "They haven't said anything about these vast, unexplained differences in returns. They're supposed to be the sheriff on the beat, but they're not there." Auditors, meanwhile, have claimed to him they don't have the bandwidth to dig deeply into these valuations, he said. "They sort of just rubber-stamp the values."

That leaves only the investors themselves to ask hard questions — and they are incentivized not to. In recent years, sky-high private equity prices have allowed state pension funds to post some of their highest-ever returns.

"Eventually," Hooke said, "Even though they're all enjoying their phony happiness — the returns made the pension funds look better and better, everyone gets promotions and raises — eventually, the chickens will come home to roost."

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Top Gun: Why Defense Stocks Will Continue Their Rise

War and international tension spell increased arms spending and, thus, higher military contractor share prices.

By Larry Light
chief investment officer
April 4, 2023

The war machine also is a profit machine, which nowadays is reflected in strong stock performance for the defense industry. Its market results are cyclical, albeit not in the usual way of tracking the economy: Instead, they are linked to government military spending, and the current trend is for more outlays on armaments.

Upshot: "Defense stocks are a good place to be," thanks to this new emphasis on the armed forces by the U.S. and its allies, said Fall Ainina, director of research at James Investment. The U.S. is increasing orders for everything from missiles to mortars as it ships weapons to Ukraine to fight the invading Russians, while also strengthening the Pentagon to counter China's expanding armed forces.

Defense stocks outpaced the broader market in 2022, and heightened spending is likely to continue, said Lauren Sanfilippo, a senior investment strategy analyst at Bank of America, in a research note. Perhaps owing to the military category's cyclical nature, institutional investors tend to keep their exposure to arms-maker equities at around 1.6%—the sector's weight in the market.

At the same time, environmental, social and governance edicts, which many allocators follow, do not categorically rule out defense-related investments. Some, though, avoid manufacturers of certain weapons that can injure civilians years after a conflict has ended. Example: cluster bombs, small munitions dropped from aircraft or fired from artillery, that are scattered over a wide area in wait for someone to stumble upon them.

This century, Pentagon budgets and defense stocks have had their ups and downs. U.S. military spending surged during Republican George W. Bush's presidency as the nation geared up to fight terrorism and the Iraq war. It dipped for much of Democrat Barack Obama's tenure, aided by a 2011 agreement with Congress to trim federal expenditures. Then the military budget rose again under Republican Donald Trump. While Democrat Joe Biden talked of trimming defense outlays, Russia's invasion of Ukraine instead has prompted even bigger budgets for the Pentagon.

Military contractors' stock performance has largely followed those trajectories, although small, quarter-to-quarter fluctuations are common for share prices and earnings. Weapons contracts are multi-year commitments, and the cash flow sometimes is not steady, which can affect equity prices. The question always is: What new deals has a contractor signed?

A good proxy for the industry is Lockheed Martin, the largest defense company, whose stock had a 32% advance last year, as the S&P 500 lost 19%. Thus far in 2023, the company's stock is flat, with the index ahead 7%. The average analyst price target for the next 12 months is $500, per Nasdaq research. That would be a hike of 6% from the present $472 close on Friday.

As Morningstar analyst Nicolas Owens wrote, "Biggest isn't always best, but Lockheed (and investors) benefit from the sheer scale of its tens of billions of dollars of contracts that provide defined, decades-long revenue and profit streams." The same could be said for the other large defense contractors.

Through consolidation, the industry is a five-company oligopoly, controlling much of the Defense Department's procurement. Aside from Lockheed, the companies in this group are: Raytheon Technologies, Boeing (40% of its revenue is military, with the rest commercial aircraft and other uses), General Dynamics and Northrop Grumman. "Only a few players dominate," says Max Wasserman, co-founder of Miramar Capital, and their customer base is growing. "Worldwide demand [for arms] is up in places that had been sleeping, like Germany and Poland," until Russia's belligerence awakened them.

More broadly, the iShares US Aerospace and Defense exchange-traded fund, which covers 35 military contractors (including the five biggest such as Lockheed) and began in 2006, trails the returns of the big five firms. The ETF enjoyed a 10% increase last year, when the S&P 500 was deeply in the red. This year, however, the fund is up 3%, Many strategists think the small 2023 rise for the ETF stems from profit-taking.

Arms and the Allocators

Sure, periodically, military contractors have been controversial. A special Senate committee held hearings in the 1930s on the industry's influence over U.S. politics, as rumbles of war were growing,. The panel's chair, an isolationist North Dakota Republican named Gerald Nye, condemned the arms-makers

as “merchants of death,” and accused them of maneuvering President Woodrow Wilson into entering World War I.

In the 1970s, fueled by animosity toward the Vietnam War, Congress whittled down the armed services’ budgets, and lawmakers decried what President Dwight Eisenhower first dubbed “the military-industrial complex.”

Arms manufacturers are far from being the tobacco business, which pension programs, endowments and foundations largely eschew. Still, the scope of defense stocks’ fan base is limited. Finding a large allocator position in defense stocks is hard, as institutions tend to keep their allocations in line with the S&P 500 weightings for the sector.

A look at the defense holdings of the three largest U.S. public pension plans shows a remarkable similarity: They all own the top five contractors’ shares, amounting to 1.5% for the California Public Employees’ Retirement System, 1.4% for California State Teachers’ Retirement System and 1.1% for the New York State Common Retirement Fund.

At the Maryland State Retirement & Pension System, CIO Andrew Palmer keeps his defense holdings at 1.1% of assets under management. MSRP holds the top five contractors, with Lockheed its second-largest among the quintet, after Raytheon. “Lockheed is a Maryland company,” Palmer points out, since it is based in Bethesda, Maryland, right outside Washington, D.C., where much of its business is done.

Allocators do make changes to their defense stock positions at the margin. Caisse de Dépôt et Placement du Québec, the giant Canadian pension fund, has long had a position in Lockheed Martin. As of 2022’s final quarter, CDPQ had trimmed its holding in the stock by 41% to 150,000 shares.

The Lockheed investment, now worth around $93 million, is only about 0.30% of CDPQ’s portfolio. The pension plan declined to comment on why it made this move. In total, its exposure to defense is much smaller than its American counterparts, at 0.4% of assets.

Are Military Contractors ESG-Friendly?

It’s telling that CalPERS, CalSTRS, New York Common and the Maryland plan are all ESG supporters, yet own Pentagon contractor stocks in line with the index. Hardly anyone is pushing for them to divest and most prefer engagement to divestment, which was used with morally objectionable investments in South Africa during apartheid in the 1980s or tobacco stocks in the 1990s.

Today, any opposition to Pentagon spending is muted, amid alarm over Russia’s aggression in Ukraine and a possible Chinese attack on an independent Taiwan, which Beijing considers a province. “We don’t have a ban list” for investments, says Maryland’s Palmer, although he admits the MSRA stays away from Iran, Sudan and Russia, which are among the countries subject to sanctions programs by the U.S. Office of Foreign Assets Control.

The pro-military spirit prevails when it comes to ESG’s relationship to the industry. After all, U.S. warriors do kill people; sometimes non-combatants get in the way. Only about 11% of 395 ESG-oriented mutual funds and ETFs exclude military contractors, according to data from Morningstar Direct for Bloomberg. The ESG investment prohibition roster is larger for specific munitions dubbed “non-precision,” meaning they imperil civilians: 59% shun companies that produce controversial weapons such as cluster bombs, anti-personnel mines and nuclear warheads.

Nonetheless, that leaves a lot of investment managers that accept military products among their investible assets in general. BlackRock's iShares ESG Aware MSCI USA—the world's largest ESG-focused ETF— includes shares of missile manufacturer Raytheon Technologies, nuclear submarine maker Huntington Ingalls Industries and electronic warfare technology outfit L3Harris Technologies.

Among backers of the military-industrial complex, there's a high-minded rationale for robust offensive capabilities: to ward off autocratic regimes' zest for conquest that, if successful, would presumably crush ESG policies. Jan Pie, secretary general of the Aerospace and Defence Industries Association of Europe, has asserted, "If you don't have security and stability, if you can't defend the open values of democracies, you cannot have any kind of sustainability. Unfortunately, I think there is evidence of that going on in Ukraine as we speak."

Certainly, as Senator Nye would attest, the notion of profiting off enormous carnage and ruin does have an unseemly aspect. The Ukraine war, the largest conflict in Europe since World War II, has demonstrated the enormous destruction that modern weaponry can unleash, with entire cities flattened.

But the defense industry has shown repeatedly that it has resilience. In 1956, amid the nuclear anxiety of the Cold War, folk singer Pete Seeger sang in a protest ballad: "Ain't gonna study war no more." The fortunes of the so-called merchants of death were climbing then and, despite some slumps, have continued ever since.

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Why Infrastructure Investments Are the New Bonds

Investments in physical assets did better and promise more than fixed income.

By Larry Light
chief investment officer
April 3, 2023

The framework of civilization—infrastructure—also is increasingly a go-to holding for investors, who want steady income (often in high single digits) without the inflation vulnerability of bonds or the volatility of stocks. Performance in infrastructure is also noncorrelated to those traditional assets.

Plus infrastructure investments are available in both public and private markets.

Bonds, like their fellow legacy investment class, stocks, have gotten skewered over the past year. Infrastructure, however, can offer the same steady results that fixed income once did. The Bloomberg Agg, which measures bond performance, dropped 13% in 2022, and the S&P 500, the stock benchmark, fell 19%. Infrastructure, whether on public or private markets, didn't lose and is expected to romp going forward.

Hence, infra's increased investor popularity. Allocators committed 4.6% of their holdings to infrastructure in 2021 and targeted 6.6%, meaning they were scrambling to extricate themselves from other allocations and plug the money into investments tied to physical assets. Fundraising for the asset segment's funds hit $162 billion last year, almost equaling 2019's record $166 billion, per the Infrastructure Investor database. By contrast, stocks and bond funds both endured investor flight in 2022.

Steven Wittwer, group head of infrastructure at Duff & Phelps Investment Management Co., ticks off all the ways infrastructure investments have supplanted bonds in desirability. The income they generate "is predictable," he says. What's more, they have little or no competition. Electric utilities are local monopolies. Some infrastructure endeavors are privately run government concessions, such as toll roads, or private enterprises with long-term contracts—cell towers, for instance. But they all "have visibility" about their financial conditions and built-in price increases, to the benefit of investors, Wittwer adds.

While these infra categories do different things, they have a common thread: They serve ongoing needs. People won't stop requiring water, electricity, transportation, etc., even in the harshest recession. Given demographic trends, humanity will require more of what these kinds of organizations are selling. Plus, for investors, risk is low. "These are tangible services that are resilient to downturns," notes Steve Farrell, co-CIO of Summit Global Investments, an investment adviser.

The momentum for infra is mounting. The giant infra bill that Congress passed in 2021 will devote $1.2 billion to building out or repairing the nation's physical plant, ranging from roads to sewers to transit. Lots of non-government capital from institutional investors is expected to follow. The World Pensions Council, a research group, predicts that U.S. pension programs will surpass the federal government's outlay in coming years, by a 2-to-1 margin. A lot has to be done. The U.S. began constructing the interstate highway system in 1955, and now those vital arteries are in dire need of an overhaul. Funding is likely to come from many sources, including institutional investors, states, localities and the federal government.

And does this alternative investment ever have fans. Take the New Mexico State Investment Council, which began amassing a position in infrastructure in 2017. As the fund explained in its latest investment plan, infra and other real assets such as farmland "are expected to be advantaged over equities and bonds in an economic and financial market environment where growth is a little slower than average and inflation and interest rates are rising."

"We really like the cash flow of infrastructure," says NMSIC CIO Robert "Vince" Smith. The NMSIC owns 48 infra funds, totaling around $3 billion, according to Infrastructure Investor's database. That's around 8% of the New Mexico program's assets under management. Its biggest commitment is to Brookfield Asset Management funds (seven), worth some $775 million. Returns range from 8% to 11%, Smith indicates.

Allocators also like that toll roads, for instance, generate about 10% yearly. The California Public Employees' Retirement System in 2016 bought a 10% portion of the Indiana East-West Toll Road, known as "the Main Street of the Midwest," that links Chicago with the Ohio Turnpike.

Institutional investors' interest in infrastructure is hardly new. What's different is a widespread perception that stocks and bonds won't deliver in the future as they have in the past. With that in mind, physical assets with solid, dependable cash flows look like a very enticing alternative.

Public or Private Investments?

A lot of the best opportunities for appreciation are in non-publicly-traded partnerships, such as the funds Brookfield and its ilk run. They are immune from market gyrations, and while they often take on lots of debt, projected cash flow seldom has any problem servicing the interest costs. Reassuringly, most of the debt is investment-grade. Meanwhile, these funds tend to pay investors handsome dividends over their terms, which can stretch to seven years or more.

The infra companies with stocks have suffered in price terms along with the rest of the world's equity issuers recently; in fact, even more so, as the early pandemic hit them especially hard—and then sexy tech stocks shot up (for a while), leaving boring infrastructure stocks in the dirt.

The S&P Global Infrastructure Index is down 0.23% for 2023 through March 24, as compared with the broader market index, which has gained just less than 3%. Over 10 years, the infra benchmark has gained 2.7% annually, while the S&P 500 has advanced 11.7%. Electric utilities, of course, are habitual slow growers. And the fortunes of energy—a big chunk of infra—have been volatile. On the plus side, public infrastructure stocks' beta is 0.5, which means they are not very sensitive to the general market's gyrations.

For investors, public infra offerings make up for this shortfall partly by delivering lush dividends. Example: Enterprise Products Partners, a pipeline company specializing in natural gas and oil, has seen its price grow very little in recent years. A master limited partnership (i.e., it is publicly traded), EPP sports a 7.7% annual dividend. (The S&P 500's average payout is 1.74%.) "It's low-risk, like a utility," says Jay Hatfield, CEO of Infrastructure Capital Advisors asset managers.

The pipeline company, which has generated expanding revenue for years, has increased its dividends more than 75 times since going public in 1998. EPP recently unveiled an initiative to ship carbon dioxide through its pipelines, from wellheads to permanent storage sites, so this greenhouse gas does not escape into the atmosphere.

So what pays the best, publicly or privately listed infra investments?

They are close, according to a study by real assets investment manager Cohen & Steers. From 2004 through 2021, public infra returned 9.8% and private 9.4%.

Inflation, certainly, is the enemy of traditional asset classes, with fixed income suffering more than equities. The same study found that infrastructure holdings, whether public or private, actually gained a little amid inflation surges. From January 1979 through September 2022, inflation spikes saw infra returns improving an average of 1.08%, while stocks lost 0.24% and bonds lost 2.58%.

What to Invest In, From Water to Wattage

A growing world demands more infrastructure—that's the abiding philosophy of investors in this space. For instance, electricity use will increase in coming years as more and more electric vehicles take to the road, says Cliff Corso, president and CIO of Advisors Asset Management.

Electricity from renewable sources, in particular, appears to have a bright future, both for established companies and newbies in solar- and wind-power generation. Among the old guard utilities that should do well, analysts say, is Duke Energy, which mostly serves the growing Southeast region of the U.S. and has ambitious energy transition initiatives, such as a 50% carbon reduction by 2030. With annual stock growth averaging around 4% over the past five years, its is a slow and steady investment, with a nice 4% dividend.

Sure, public utilities can run into trouble. Witness the hard times the Pacific Gas and Electric Co. has endured, as it took the blame for several California wildfires since 2017 and paid out millions in damages to people whose homes were lost. Over the past five years, PG&E shed three-quarters of its valuation and went through bankruptcy, exiting Chapter 11 in 2020. This company is an outlier among large utilities, though.

Other opportunities: Clean water will be in large demand as once-impoverished nations develop, so overseas water investments stand to do well, goes the argument. Still, good investment targets exist for this space domestically. American Water Works, the largest U.S. water utility, which has been on an acquisition binge of smaller operators, has regularly beaten analysts' estimates on revenue and earnings.

Rapid growth is the story for more newfangled infrastructure. Wireless communications offer a case in point. By BCC Research's estimate revenue of $65.2 billion in 2021 will expand to $130.6 billion by 2026, growing around 15% yearly.

In the U.S., a duopoly of American Tower and Crown Castle control much of the action. Whatever company has the franchise for a municipality usually has zero competition. Local governments don't want a plethora of cell towers in town, so carriers on the order of Verizon and T-Mobile will share a single tower, explains Duff & Phelps' Wittwer. The result, he adds: Cell tower investment "returns are in the high teens."

There are different stages of site development for infrastructure organizations; thus, investors should assess timetables for new expansions. The most risky stage is what infra folks call "greenfield." That's when a project is being planned and construction started. Local political or environmentally minded opposition can erupt at this phase, delaying or ending the project. The "brownfield" stage, when a project is up and running—and generating revenue—is far less risky.

To no surprise, greenfield backers, who take the highest risk, stand to reap the richest rewards, in the 20% to 30% return bracket, versus low to high teens for brownfield investors, Advisors Asset Management's Corso says.

"TINA is retired," Corso declares, referring to the erstwhile slogan "there is no alternative" to stocks. The same could be said about bonds, which used to be the refuge of choice, until they weren't. Enter infrastructure to claim the latest rounds of investment dollars.

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