Why Pensions' Private Equity Returns Could Be a 'Red Flag'

An independent analysis and projection of several prominent portfolios suggests those pensions with higher private equity allocations could have a rocky road ahead.

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Public pensions with sizable allocations to private equity tended to weather the last year's market volatility better than their peers, but that could change in coming months, according to new projections from a top data analytics firm.

Markov Processes International's new "transparency lab" analyzes the publicly reported returns of institutional investors to provide a better understanding of what the actual holdings are.

The firm, called MPI, reports that the three best-performing public pension investors as of June 30, 2022, were the Oregon Public Employees Retirement Fund, the Washington State Investment Board, and the Pennsylvania Public School Employees' Retirement System, or Psers, which returned 6.3%, 5.4% and 2.3%, respectively. Psers reported that return at 2.2%, according to the system's website, but MPI used a preliminary figure released last year, the firm said.

These funds' private equity allocations made an outsized contribution to their outperformance compared to peers, according to MPI's analysis. Oregon's private equity portfolio contributed 8.5% to its total fund return, while Washington's contributed 10%, and Psers' 5.6%, MPI's analysis found.

Oregon's one-year private equity return as of June 30, 2022 was 24.2%, according to documents on its website. However, that return is lagged by a quarter, meaning the number reported for Sept. 30, 5.2%, is the actual value for that date. Washington's one-year private equity return as of the same date was 19.9% and Psers' was 8.3%, according to documents on their respective websites.

These pensions all have large private equity allocations relative to their peers. A recent report from the National Conference on Public Employees Retirement Systems, or Ncpers, looked at 195 public retirement systems and found an average private equity allocation of 12.5%, as reported. By comparison, as of Jan. 31, Oregon's private equity allocation was 26.5%; as of Dec. 31, 2022, Washington's was 28.2%; and as of Sept. 30, 2022, Psers' was 17.9%, according to their respective websites.

MPI uses a proprietary process called "dynamic style analysis," to reverse engineer an institution's portfolio holdings based upon its publicly reported returns, said Michael Markov, the firm's chairman and chief executive.

This process “creates a dynamic portfolio of factors, or asset classes, or different strategies that mimics the performance of a … given returns stream,” Markov said. This creates “a model portfolio that you can use to better understand the strategy, [and] the value added.”

Whenever returns appear to be coming out of nowhere, that is a warning sign, Markov added.

“If there’s a lot of unexplained return, it’s a huge red flag,” he said.

As volatility roiled public markets last year, private equity valuations stayed firm, but public pensions have seen weaker returns from private equity in recent quarters, as reported.

MPI’s projections for fiscal year 2023 show Oregon, Washington and Psers with the lowest returns of all the pensions it tracks, losing 1.4%, 1.5% and 1.5%, respectively.

MPI’s website includes a disclaimer that says the firm “makes no warranties or guarantees as to the accuracy of this statistical analysis,” and does not “know or insinuate what the actual strategy, positions or holdings of the funds are, nor are we commenting on the quality or merits of the strategies.”

Psers has no comment on MPI’s 2023 estimates and methodology, spokesperson Steve Esack said in an email.

“The future is unknown,” he added. “Psers believes the best way to achieve its long-term objectives is to maintain a diversified portfolio across market cycles.”

Washington considers itself a “long-term investor,” and is not concerned with “shorter-term return forecasts,” spokesperson James Aber told FundFire in an email.

“We believe private equity will continue to provide attractive returns in the coming years,” he wrote.

Oregon declined to comment for this story, but has expressed confidence in its private equity program despite the volatile environment, as reported.

Private equity and venture capital assets have a “staleness premium” due to outdated valuations, Markov said, echoing other analysts. His estimates of this premium as of the end of last year’s third quarter are 20% for private equity and 35% for venture capital, and will effect future returns.

As of Sept. 30 last year, the S&P 500 had lost 15.5%, while private equity strategies returned 7% and venture capital lost 4.9%, according to a recent Pitchbook report covering the major publicly traded private equity firms.

Private equity valuations are “generally accurate across most industry sectors,” alternatives consultant Hamilton Lane wrote in a recent report. While private market valuations began 2022 “at a significant discount to comparable traded assets,” the “valuation multiples” for public and private equities “converged” as the year went on, the firm said in a press release.

The firm’s data shows that managers tended to exit deals “at a premium,” suggesting that, “at the current time, there is not any blanket over- or under-valuation of private assets,” the spokesperson said. The firm declined to provide the entire report.

Private equity is a “tale of two cities,” with venture capital funds likely to be overvalued while buyout funds did well in the last two quarters of last year, said Steven Kaplan, a professor at the University of Chicago Booth School of Business.

“It is less clear [buyouts holdings] are misvalued going forward because their companies did well on an operating basis,” Kaplan said in an email. “Their headwind is higher interest costs.”

Private equity valuations “don’t pass the smell test” following 2022, said Jeffrey Hooke, a senior lecturer at Johns Hopkins University and author of the book The Myth of Private Equity. The wide gap between public markets performance and reported private markets returns is “something out of a fairy tale,” Hooke said.

“The pension funds don’t want to know the truth … because then the pension funds managers who have been rubber stamping these [private equity] investments over the years might look bad,” he said. “The investment consultants … don’t want to know it either, they’ve been pushing private equity for the last 15 years, so they’ll look bad as well.”

Back to top