Retirement News Highlights

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US pension funds are on the brink of implosion – and Wall Street is ignoring it

PRIVATE EQUITY FIRMS MANAGING MILLIONS OF AMERICANS' RETIREMENT SAVINGS MAY BE INFLATING THEIR INVESTMENTS

By David Sirota
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As public officials across America prepare to funnel even more of government workers' savings to private equity moguls, an alarm just sounded for anyone bothering to listen. It is a warning that Wall Street executives, busy skimming fees off retirement nest eggs, want you to ignore. The longer the warning goes unheeded, however, the bigger the financial time bomb may be for workers, retirees and the governments that pay them.

Earlier this month, PitchBook – the go-to news outlet of the private equity industry – declared that "private equity returns are a major threat to pension plans' ability to pay retirees in 2023".

With more than one in 10 public pension dollars invested in private equity assets – and with states continuing to keep their private equity contracts secret – PitchBook cited a new study finding that losses from the investments may be on the horizon for retirement systems that support millions of teachers, firefighters, first responders and other government employees.

"Private equity returns get reported on a lag of up to six months, and with each update in 2022 values were coming down – which means 2022 numbers were including overstated private equity asset valuations and 2023 numbers are going to incorporate those losses," noted the study from the Equable Institute.

To comprehend this timebomb, you have to understand private equity's business model.

In general, private equity firms use pension money to buy up and restructure companies to then sell them at a higher price than they were purchased. In between buying and selling, there are no transparent metrics for valuing the purchased asset – private equity firms can manufacture an alleged value to tell pension investors (and there's evidence they inflate valuations when seeking new investments).

In a story about an investor receiving two different valuations for the same company, Institutional Investor underscored the absurdity: "Everyone Wants to Know What Private Assets Are Really Worth. The Truth: It's Complicated."

Meanwhile, valuation and fee terms in contracts between private equity firms and public pensions are kept secret, exempt from open records laws.

With that in mind, the new warnings are simple: private equity firms may have told their pension officials that their assets were worth much more than they actually are, all while the firms were skimming billions of dollars of fees off retirees' money.

If write-downs now happen, it could mean that when it's time to sell the assets to pay promised retiree benefits, pension funds would have far less money available than private equity firms led them to believe. At that point, there are three painful choices: cut retirement benefits, slash social programs to fund the benefits, or raise taxes to recoup the losses.

Signs of a doomsday scenario are already evident: some of the world's largest private equity firms have been reporting big declines in earnings, and federal regulators are reportedly intensifying their scrutiny of the industry's write-downs of asset valuations. Meanwhile, one investment bank reported that in its 2021 transactions, private equity assets sold for just 86% of their stated value last year.

But while pensioners may be imperiled, Wall Street executives are protected thanks to their heads-we-win-tails-you-lose business model. While reporting asset losses for investors, some of the firms managing pensioners' money are raking in even more fees from investors and continuing to raise executives' pay.

Meanwhile, even as some sophisticated private investors rush to get out of private equity, the world's largest private equity firm, Blackstone, recently reassured Wall Street analysts that state pension officials will continue using retirees' savings to boost revenues for private equity firms, hedge funds, real estate funds and other so-called "alternative investments".

"The desire for alternatives remains very strong," the president of Blackstone, Jon Gray, said in an investor call last week. "New York's state legislature actually increased the allocation for the big three pension funds here by roughly a third."

Gray was referring to New York Democratic lawmakers passing legislation significantly increasing the amount of retiree money that pension officials can deliver to Wall Street. The bill was championed by the New York City comptroller, Brad Lander, just weeks after the Democrat won office promising he would be "reviewing the funds' positions with risky and speculative assets including hedge funds, private equity, and private real estate funds".

The New York governor, Kathy Hochul, quietly signed the legislation on the Saturday before Christmas, just weeks after the Wall Street Journal reported that analysts have started warning pension funds of looming private equity losses. New York lawmakers simultaneously rejected separate legislation that would have allowed workers and retirees to see the contracts signed between state pension officials and Wall Street firms managing their money.

The Empire State is hardly alone in continuing to use retirees' money to enrich the planet's wealthiest financial speculators – from California to Texas to Iowa, pension funds controlling hundreds of billions of dollars of workers' retirement savings are planning to dump more money into private equity, while keeping the terms of the investments secret.

While globetrotting to elite conferences in exotic locales, pension officials have defended the high-fee investments by parroting Wall Street executives' claim that private equity reliably outperforms low-fee stock index funds. At the same time, those officials continue to conceal the terms of the investments, raising the question: if the investments are so great, why are the details being hidden?

Perhaps because the investments aren't as wonderful as advertised. In a landmark study entitled An Inconvenient Fact: Private Equity Returns & the Billionaire Factory, Oxford University's Ludovic Phalippou documented that private equity funds "have returned about the same as public equity indices since at least 2006", while extracting nearly a quarter-trillion dollars in fees from public pension systems.

A 2018 Yahoo News analysis found that US pension systems had paid more than $600bn in fees for hedge fund, private equity, real estate and other alternative investments over a decade.

"The big picture is that they're getting a lot of money for what they're doing, and they're not delivering what they have promised or what they pretend they're delivering," Phalippou told the New York Times in 2021.

Even some on Wall Street admit the truth: a JP Morgan study in 2021 found that private equity has barely outperformed the stock market, but it remains unclear whether that "very thin" outperformance is worth the risk of opaque and illiquid investments whose actual value is often impossible to determine – investments that could crater when the money is most needed.

While the warnings have not halted the flood of pension cash to private equity, they have broken through in at least some corners of American politics.

The Securities and Exchange Commission is considering new rules to require private equity firms to better disclose the fees they charge.

Similarly, Ohio's state auditor, Keith Faber, just issued a report sounding an alarm about state pension officials keeping private equity contracts secret – a practice replicated in states across the country.

And following a pension corruption scandal in Pennsylvania – whose state government oversees nearly $100bn in pension money – there's a potential financial earthquake: during his first week in office, Governor Josh Shapiro promised to shift pensioners' money out of the hands of Wall Street firms.

"We need to get rid of these risky investments," Shapiro told his state's largest newspaper. "We need to move away from relying on Wall Street money managers."

Shapiro could face opposition not only from private equity moguls and their lobbyists but also from the pension boards' union-affiliated trustees. As the Philadelphia Inquirer reported: "Union members [on the boards] have mostly favored the old strategy of private investments, even when challenged by governors' reps and the last couple of state treasurers."

When investment returns were somewhat better, the unholy alliance between some unions and Wall Street firms flew under the radar, even as pension funds were ravaged by fees. But with warnings of write-downs and losses getting louder, the dynamic could change.

Better late than never – though the later it gets, the bigger the risk for millions of workers and retirees.

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