Pension fund investment in private equity funds

Pensions are not like other classes of financial investment, where investors select part of their surplus income to make a bet. Pensions are meant to guarantee a minimum income level that allows the retiree to maintain a certain quality of life. The investors in pension funds are the middle classes and, in the more developed countries, the workers, and their future incomes should not be the result of the kind of market games played by private equity funds or hedge funds.

Fernando J. Cardim de Carvalho[1]

The rise of the pension fund industry

Most social security systems suffered deeply with the fall in rates of economic growth that followed the so-called golden era of capitalism from the end of the Second World War until the late 1960s. Even in countries where the benefits offered by official retirement schemes were not particularly generous, as in the United States, social security ran into trouble when employment growth decelerated in the 1970s and afterwards. In many cases these systems had become Ponzi schemes, where benefits were paid not with the yield of past investments but with the revenues generated by new entrants.

While economies were growing rapidly and employment was expanding, new members' contributions were more than enough to pay benefits. With the end of the post-war Keynesian era and the rolling back of state economic initiatives that characterized the Reagan/Thatcher neoliberal counterrevolution, rates of growth fell and new revenues have become less and less sufficient to keep the system running.

In parallel with the accumulation of financial imbalances in social security schemes, social security systems also became the target of growing ideological criticism, which frequently pointed to the 'perverse incentives' these systems were allegedly creating. Even now conservative and neoliberal critics of social security nets insistently claim that these schemes encourage workers to remain idle, since they can earn enough to survive without having to work.

The wide and relentless attack on social security schemes, and the repeated 'reforms' to which they were submitted, made clear to most workers that they had to begin providing for their own retirement or at least to look for means to add to their expected incomes in the future when they retired.

Of course, only Chile under the Pinochet dictatorship went as far as practically eliminating official schemes and replacing them with entirely private schemes. Presented as an important 'innovation' by the financial community and those who share its views, the Chilean model could not escape criticism, however, even from publications dedicated to that very community. Thus, *Institutional Investor* magazine, for instance, could not avoid acknowledging that "the goodwill that the A[dministradoras de] F[ondos de] P[ension] reaped for their role in Chile's economic success diverted attention from some glaring flaws in the privatized pension fund system." Quoting a local authority, the magazine concludes its analysis stating that "no matter how instrumental the AFPs have been to Chile's economic development, 'they seem to have forgotten about their social welfare role, which is the main reason they were created.'"[2]

In fact, the alleged social welfare role of private pension funds – namely, to provide for retirement income levels that the official schemes were no longer capable of offering – were never the real priority, especially in the case of developing countries. The reforms that created private pension funds, or enlarged their role where they already existed, approached them mostly as promising vehicles to increase household savings and to channel them to public and private securities markets. This, again, was clearly the case of Pinochet's Chile but is also characteristic of other developing countries' experiences.

In this sense, pension funds quickly became just another class of investment funds. Their special nature, which is to provide a basic level of income in the future, was residually acknowledged in some regulatory provisions, limiting their exposure to certain riskier classes of investment. These limitations, however, have become less and less effective since financial institutions have been able to circumvent them with relative ease.

Thus, pension funds ended up being just another category of collective investment schemes, which are designed as institutional investors, meaning that it is another form of gathering investors so as to create a formal *institution*. They are managed by professional fund managers, usually trained in ordinary financial institutions, and their performance is measured by criteria that are not much different from those applied to other investment funds. Many times, in fact, management of these funds is performed by employees of large financial conglomerates, through asset management divisions.

In this scenario, the *social* role of pension funds is only remembered when a crisis hits a particular group, destroying the assets of the respective pension fund, as was the case with Enron. When this happens, one hears demands for regulation and supervision, but these tend to quickly fade away, drowned out by the counterclaims of the financial markets and their spokespeople who strive to keep the system as it is.

The shift to riskier investments

Since the early 1990s a number of important forces have combined to push pension funds even farther away from their social role toward behaving like an ordinary institutional investor. On the one hand, liquidity has been very high in national and international financial markets, lowering interest rates and the returns on financial investments. In addition, a relatively long cycle of economic expansion began in the late 1980s, which still persists. In the last almost 20 years, growth periods have prevailed and recessions have been relatively light and short-lived (with the obvious exception of countries hit by capital flight crises, as in the case of the Asian crises of 1997-1998, the Russian crisis of 1998 or the Argentine crisis of 2002). Non-performing loans have been kept at low levels so that attenuated risk factors have also contributed to the reduction of interest rates in the main financial markets of the world.

Under these conditions, practically every institutional investor, including pension funds, began searching for alternative investments that could offer higher returns. These higher returns could be found, naturally, in riskier investments, such as high-yield bonds (formerly known as 'junk bonds', a definitely less attractive denomination), or emerging country securities. To participate in these markets, institutional investors usually invest in hedge funds[3] or in private equity funds.

Since fund managers' performance is usually evaluated relative to the average performance of their class, there is a strong tendency for a kind of herd behaviour to emerge. Thus, once some funds begin participating in riskier markets and do enjoy higher earnings as a result, the managers of other funds have little choice but to follow the leaders, to try to emulate their earnings. Once a sufficiently large number of pension funds have taken this path, following it becomes conventional wisdom for the remaining fund managers.

What is a private equity fund?

Private equity (PE) funds are partnerships between investors, called limited partners, and fund managers, called general partners, specializing

1 Fernando J. Cardim de Carvalho is a full professor at the Institute of Economics of the Federal University of Rio de Janeiro and a consultant at Ibase, the reference group for Social Watch Brazil.

2 "Chile: The Empire Strikes Back", *Institutional Investor*, April 2007, p. 96, 99.

3 For more information on hedge funds, see the article by Aldo Caliari in this Report.

in venture capital investments or in buyout investments (Phalippou and Zollo, 2005). They are not new actors in financial markets, but their importance has increased dramatically in recent years. *The Economist* recently quoted a research group's estimate that PE funds raised USD 240 billion in the first six months of 2007 alone.[4] Researchers from the University of Pennsylvania's Wharton School estimate that PE funds manage approximately USD 1 trillion of capital.

PE funds, like hedge funds, boost their returns by heavily leveraging their capital. This means that these funds invest much more than their own capital. In fact, their own capital is used mostly to obtain loans that allow them to buy assets that will in turn be used as collateral to obtain still more loans, and so on and so on.

According to one source, two thirds of those trillion dollars under the control of PE funds are managed by buyout funds. These funds buy public companies – that is, corporations whose stock is traded on stock exchanges; turn them 'private' – that is, take them out of public view; and restructure them with a view to increasing their market value in order to resell them at a profit.

'Restructuring' in this context may mean a lot of things. PE fund apologists argue that the value of a company is increased by cutting unnecessary expenses, streamlining the company by getting rid of less productive divisions, introducing better management methods, and more efficiently aligning the interests of managers and shareholders. If this is true, companies emerge fitter and more efficient from this process, and it is the ability to engage in this restructuring that generates the profits made by the funds.

Critics of PE funds, on the other hand, point out that the value of acquired companies tends to increase mostly because of debt piling up.[5] Firms managed by PE funds borrow heavily to increase their return on equity (ROE), at the cost, of course, of making them much more vulnerable to adverse changes in financial markets. Since the early 1990s, as already observed, it has been easy to borrow at low interest rates, making the PE funds' strategy easier.

However, when this excess market liquidity begins to dry up, as it necessarily will at some point, and interest rates begin to rise, heavily indebted firms may suffer dramatic losses. Under these conditions, as observed by *The Economist*: "A bigger role for private equity might make the economy more vulnerable. Historically, recessions have often occurred when rising interest rates have cut into corporate profits, causing firms to slash employment and capital expenditure. In a world where most companies carried private-equity-style debt levels, companies would be much more vulnerable and recessions might become much more frequent."[6]

4 "The business of making money", *The Economist*, 7 July 2007.

5 "Private Illusions", *Institutional Investor*, January 2007, p. 99/100.

6 *The Economist*, *op. cit.*, p. 70.

Nevertheless, as long as interest rates remain low, stock exchanges remain active, and stock prices continue rising, PE investments are likely to remain very attractive. As has been amply noted by analysts of financial market behaviour, rising asset prices tend to blind market participants to risks, and the lure of profit opportunities is too strong to resist in the absence of regulatory limits.

In fact, even if a disaster like a full-scale financial crisis does not actually take place, the legacy of PE funds is an increase of debt that is likely to reduce the ability of firms to make productive investments. The increased risk of default attached to highly indebted firms increases the cost of capital and raises the minimum required profitability of capital to allow new investments. It may take a long time for these firms to rebalance their capital structure to allow them to operate normally again.

The relative importance of PE funds as a source of finance is still relatively small but growing fast. Moreover, these funds are extending their reach even to markets that used to be considered protected against their influence, such as the financial markets themselves. They are also expanding into the real estate business.[7]

PE funds are usually favoured by the lighter tax treatment of capital gains as compared to income earnings, which most countries tended to adopt after the Reagan/Thatcher counterrevolution. They are also favoured by the so far long-lasting context of an excess supply of loans, which has allowed what is currently known as a 'covenant-lite' loan structure. This means that lenders are so numerous at this point that they do not feel they can impose conditions on the use of their loans, giving much more freedom to borrowers like PE fund managers.[8]

Of course, there may very well be an element of truth in the arguments of both supporters and critics of PE funds. Their benefits may be more visible in the case of venture capital, where the funds help to finance nascent firms, than in the case of buyout funds, where restructuring may very well be, as *Institutional Investor* suggested, merely "sleight of hand," a trick allowing fund managers to increase the appearance of profitability of companies to sell them back in public markets. In fact, the jury is still out on the PE strategy as such, although it is increasingly clear to almost anybody that the tax incentive represented by the favourable treatment of capital gains should be eliminated and that regulation should be beefed up in this market segment.[9]

7 "Private Property", *Institutional Investor*, December 2006.

8 "Taking a Plunge on Univision", *Institutional Investor*, April 2007.

9 In fact, PE funds themselves may be bracing up to face at least some of these changes. A recent document issued by the British financial regulator, FSA, noted that "the industry has asked Sir David Walker to chair a high-level working group to assess the adequacy of disclosure arrangements and the clarity and consistency of valuations and returns employed by UK private equity firms. *The intention is to establish a voluntary code of compliance in these areas.*" (FSA, 2007, p. 4, emphasis by the author). PE funds seem to be trying to preempt more hostile forms of *official* regulation by offering to restrain their own behavior through *self-regulation*.

Risks and benefits for pension funds

If the macroeconomic or social benefits of the operation of PE funds may still be difficult to ascertain, there may also be less than meets the eye when this investment alternative is investigated more closely. As in the case of hedge funds, there is a widespread view that there should be no attempt to curb these types of investment, because they are so profitable that market actors would always find a way to circumvent the barriers. If PE investments are really that profitable, preventing pension funds from enjoying the promised high returns, even if at the cost of some degree of risk exposure, could be unjustifiable or simply unenforceable.

There are several important reasons to question this assumption, however. A number of studies of the performance of private equity funds have shown that the exceedingly high returns exhibited by them in recent years may not be the whole story.

It is usually accepted that PE funds have reached yearly returns on equity of around 25%, which is, certainly, a very high figure. However, before accepting this number as a true reflection of the performance of the PE sector, some qualifications have to be made. We will focus on four of them.

The first qualification is actually very important, given the generally accepted view that this is a particularly risky industry. When analyzing industry returns, one has to adjust the available information for what is called the 'survivor's bias'. The concept is quite simple. Let us assume that two PE funds invest USD 100 each. The first succeeds and earns USD 200. The second goes under and loses its capital. When an industry survey is taken, the second fund is no longer there to respond to the questions. So what the survey is going to show is only the result of the first firm, with a 100% rate of return. In risky industries, the rate of mortality tends to be higher than average. Results therefore tend to heavily exaggerate the profitability of PE funds because only the successful survivors are actually surveyed.

A second qualification is that after a PE fund buys out a firm and makes it 'private', the value of the assets bought by the fund is difficult to ascertain. The fund may record how much it paid for the equity but there is no guarantee that it is actually worth what was paid. Some PE funds simply become inactive as an alternative to reselling equities with a loss. So when surveys measure the assets of PE funds they tend to count potentially worthless assets as still worth their original price.

A third qualification refers to risk. All financial investments offer combinations of return and risk. The higher the risk, the higher the rate of return must be to induce the investor to buy that particular asset. Accounting measures of profitability are not adjusted for risk, which is especially serious in the case of riskier investments such as PE funds.

Finally, the return to the PE fund is not the same thing as the return to the investor, because fund managers tend to charge very heavy fees from the investors. In fact, the standard structure includes a fixed fee as a percentage of the capital of the fund, a large share of the gains (usually 20% of the profits, called 'carried interest'), as well as other fees of lesser impact.

In the light of all these factors, it is not very surprising to find that PE fund managers, or general partners, are doing very well, while the investors, or limited partners, are not. Phalippou and Zollo (2005) showed that, all things considered, investors in PE funds may have earned less than they would have if they had simply bought the Standard and Poor's 500 stock basket. In other words, they earned less than the market average. A. Metrick and A. Yasuda, on the other hand, showed in an unpublished 2007 study that fund managers did very well, with buyout managers benefiting more so than venture capital managers.

Conclusion

Whatever the final word on the cost/benefit ratio of the operation of PE funds for the economy as a whole may be, the benefits of these investments for pension funds can already be judged as very doubtful, at best. In fact, risk itself should be a decisive factor to prevent pension funds from participating in these markets. Pensions are not like other classes of financial investment, where investors select part of their surplus income to make a bet. Pensions are meant to guarantee a minimum income level that allows the retiree to maintain a certain quality of life. Wealthy investors do not invest in pension funds because they usually have access to other, more profitable, opportunities. The investors in pension funds are the middle classes and, in the more developed countries, the workers, and their future incomes should not be the result of the kind of market games played by PE funds or hedge funds.

This concern is strengthened by evidence of the possibility that workers' money is simply being squandered by these funds, since their performance, when adjusted in the way suggested in the preceding section, is below par – although this does not prevent the managers of these funds from taking a large bite of whatever returns are achieved.

Stricter regulation of the investments that pension funds are allowed to make is, of course, a second-best solution. The truly appropriate solution would be, above all, to restore the primacy of full employment as a social goal, as it was in the first two decades after the end of the Second World War, since this would obviate many of the financial problems of social security systems. There is also a need to promote a broad debate with all sectors of society as to the perspectives of the social security system, in order to make it socially fair and economically sustainable. Unfortunately, the political climate is still unfavourable to such a debate, since neoliberal ideas about the virtues of the market are still strong, particularly among influential political groups. In such a situation, a second-best solution preventing pension funds from trading workers' futures for illusory short-term gains should be explored. ■

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GLOBAL TAXES FOR GLOBAL WELFARE

Andrea Baranes (Fondazione Culturale Responsabilità Etica, Social Watch Italy)

For many of the problems and challenges currently facing the international community, it is impossible for individual nations to find and apply proper solutions on their own. These challenges include global warming, the spread of global diseases, financial instability, pollution and loss of biodiversity, among many others.

At the same time, governments are facing a crisis in tax income, for a variety of reasons: recent globalization processes, new financial mechanisms, the widespread use of tax havens and corporate practices such as the abuse of transfer pricing, tax avoidance and tax evasion.

This situation has made it increasingly difficult for governments in both the South and the North to ensure fiscal justice and finance social security for their citizens. As a result, the need for innovative mechanisms to finance global welfare, enhance international cooperation and safeguard global public goods has become one of the most urgent priorities facing the planet.

From another point of view, there is a need to find adequate ways to regulate and counteract the most negative impacts of globalization, and to apply democratic and effective instruments to ensure political control over economics, trade and financial powers, which implies a profound reform of current governance mechanisms and institutions.

International taxes appear to be the best instrument to implement in the medium term to fulfil these different goals: finding new ways to finance social security and global public goods; regulating some of the negative impacts of globalization; reinforcing international cooperation among different countries; and reforming international governance.

While the primary goal of national taxes is to generate revenues, in the case of global taxation systems, the most important positive impact could be their regulation effect on some of the most adverse impacts of recent economic trends. A Tobin tax on international financial transactions, for instance, would contribute to combating financial instability, while a carbon tax would target the most polluting activities and foster the development and use of cleaner, more sustainable energy sources.

Moreover, global taxes could raise enough money to fulfil the Millennium Development Goals (MDGs) or to help finance and preserve global social security, fundamental human rights and global public goods.

The technical problems involved in the implementation of these global taxes have been resolved. In many cases, the biggest obstacle to their application is the lobbying power of the small elite that would be hit by these instruments. It is now only a matter of political will: politicians must have the intelligence and courage to move forward and implement these instruments, which would benefit the vast majority of women and men in both the North and the South. ■