Is Private Equity a Safe Bet for CalPERS?

by Daniel Synge

CalPERS invests a lot of its assets in private equity, which leads to two obvious questions: First, what is private equity?; Second, is it a good idea for CalPERS to invest so much money in it? The answer to the first question is fairly straightforward, though the second one is harder to say.

Most of the time, when individuals or institutions like CalPERS invest in "equities" (a fancy word for stocks), they do it by buying shares on the stock market. However, some businesses aren't "publicly" traded on stock markets. In this sense they are "private." When these businesses are bought and sold, usually almost all their stock changes hands at once from one owner to another. This is a private equity transaction. If a person buys a restaurant, they are engaging in a private equity transaction, though they typically don't think of it that way. CalPERS doesn't buy individual restaurants of course. Instead, they hire private equity firms who pool money from CalPERS and a bunch of other institutional investors to buy, manage, and sell a whole group of large private businesses on their behalf.

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Private equity started as a niche part of the CalPERS portfolio but has grown to dominate it in terms of impact on returns and the portfolio's overall risk. In the late 1980s, when CalPERS began investing in private equity, it comprised just 1 percent of CalPERS' portfolio, but over time, that allocation has grown to about 20 percent. Again, the question worth asking is whether this dramatic bet on private equity is a good idea at this point?

During the early years of the private equity program, industry data supported CalPERS' conclusion that private equity was a smart investment, delivering excess returns compared to public markets. Back then, data also suggested it was possible for CalPERS to identify which private equity firms would likely outperform. This belief justified the program's early expansion. However, the investment landscape has changed dramatically since the 2008 financial crisis. Recent data indicates that private equity no longer consistently outperforms other asset classes on average. Additionally, even the top-performing, private-equity managers cannot be reliably identified in advance, making the quest for higher returns more of a gamble than a strategy.

One concerning factor is that private equity funds take a decade or more to show their true results. This extended timeline means that CalPERS management can avoid accountability for their investment decisions for long periods, as the actual outcomes of their choices may not be fully known until many years later. This lack of timely feedback can create incentives for CalPERS management to continue favoring private equity, even when there is evidence suggesting it may not be in the best interests of beneficiaries. That is not to say that anyone is making an ethically compromised decision. But we need to be clear-eyed about the conflicts of interest faced by CalPERS employees.

Moreover, private equity managers engage in practices that CalPERS and other institutions have fought to limit in the public markets, yet they seem willing to overlook when dealing with private equity. For example, private equity firms charge very high fees, use aggressive leverage, and extract additional payments for themselves from the companies they own on CalPERS' behalf. These practices can significantly affect the profitability of investments, yet they receive far less scrutiny from CalPERS than similar practices in the stock market. CalPERS' tolerance of these behaviors raises questions about whether private equity investments are being managed with the same rigor and standards as other parts of the fund.

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As former government employees, we should also be sensitive to the political influence peddling that private equity frequently involves. The CalPERS CEO who went to prison was bribed by a private equity firm. An elected state comptroller of New York and the elected treasurer of Connecticut were also both convicted of bribery by private equity firms and jailed. Four of the five last U.S. Treasury secretaries went to work for private equity firms immediately after leaving office.

As beneficiaries, it's essential to understand these dynamics. While private equity may promise high returns, the risks and lack of transparency involved call for greater scrutiny and accountability. RPEA will be closely monitoring CalPERS' approach to private equity to ensure that it serves the long-term interests of its members and does not expose the pension fund to unnecessary risk