Bloomberg Businessweek

April 24 — April 30, 2017

Retirement

Private Equity Is Eyeing Your Nest Egg

- ▶ Funds look for ways to get into—and make money from—401(k)s
- ▶ “Fundraising is all about knocking down barriers”

Private equity firms are good at solving complex problems. One that’s been stumping them is normal people. U.S. workers have about $4.8 trillion saved in 401(k) workplace retirement plans. Many buyout funds, which are limited to wealthy individuals and institutions, would like to be able to manage a sliver of that money. Five years ago, **Carlyle Group LP** co-founder David Rubenstein predicted it would happen.

Today private equity is still off the table for many individual retirement savers. The funds, which use debt to buy private companies or take public companies private, are hard to fit into 401(k)s. Their investments are opaque and illiquid—tough factors for 401(k) participants, who invest regularly and expect to be able to move money easily. Costs tend to be high, running counter to the trend of employers shifting plans into inexpensive investments such as index funds. “There’s a lot of sensitivity to fees,” says Brooks Herman, head of data and research at BrightScope Inc., which rates retirement plans.

Another popular 401(k) trend might help private equity to break in: target-date funds. London-based **Pantheon Ventures** and **Partners Group Holding AG** of Switzerland are shopping 401(k)-eligible strategies designed to be used within such portfolios. With a target-date fund, a saver gets an all-in-one mix of stock funds, bond funds, and other investments that shift into safer assets over time. Such funds are offered by three-quarters of 401(k) plans, up from a third in 2006, according to the latest data from BrightScope. A private equity fund could be just one part of a target-date portfolio’s mix. The target-date manager, not the 401(k) saver, would decide how much to invest and when to sell.

To address liquidity concerns, Pantheon will mix private equity investments, including some managed by **KKR & Co.**, with cash and shares in an S&P 500 exchange-traded fund that can be readily sold to meet redemptions. Similarly, Partners Group will combine investments in its existing private equity fund with publicly traded shares of companies that invest in private markets, says Robert Collins, a managing director in the firm’s New York office.

> “The returns can be staggering in their difference between top quartile and bottom.” —*Brooks Herman, BrightScope*

These ideas are still works in progress. Neither company’s U.S. strategy has yet won money from a 401(k) plan, according to people with knowledge of the processes. KKR declined to comment on what it expects to earn from its partnership with Pantheon. “Fundraising is all about knocking down barriers,” says Kevin Albert, Pantheon’s global head of business development. “They say they don’t want to invest with you because of one reason, so you fix it and keep reiterating.”

One big roadblock is employers’ fear of getting sued by participants for putting them in funds with higher fees. Pantheon is trying to address this by offering performance-based pricing. The firm earns a fee when performance exceeds the S&P 500 index and returns money if it lags.

So why would an employer want to bother with all this complex maneuvering? The hope of higher returns. The private equity industry has generated 13 percent annualized returns after fees over the past 25 years, according to advisory firm Cambridge Associates’ U.S. PE index. That compares with 9.3 percent in the S&P 500 index in the same period. “There’s more and more interest because of attractive returns in private equity and disappointing returns in other areas,” says Mitchell Tanzman, the co-chief executive officer of Central Park Group, which allocates money for wealthy individuals to private equity.

Whether a new crop of investors can expect similar performance is another matter. **Blackstone Group LP** President Tony James is an advocate of a plan to allow some private investment through retirement accounts. But at an event in March, he also said that a flood of money from retirement savings would pressure firms to invest bigger volumes of capital, which could reduce returns. There’s a finite supply of underpriced companies a buyout fund can target, and the industry already manages $693 billion more in assets than it did five years ago.

Investors through 401(k)s may also have trouble getting access to the best funds. That matters a lot with private equity, where “the returns can be staggering in their difference between top quartile and bottom,” says BrightScope’s Herman. The onus will be on employers to ensure they aren’t buying into mediocre managers at high prices. “The 401(k) plan holder at the end of the day is a small investor,” says Luis Viceira, a Harvard Business School professor who teaches investment management. “It may make sense for them to have this exposure, but it has to be structured in a way that they are protected.” —*Melissa Mittelman*

The bottom line There’s almost $5 trillion saved in 401(k) retirement plans, but it’s been hard for private equity funds to reach.

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