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Public Pensions Challenge Private Equity Fees.

Late last month, California disclosed for the first time how much its pension system paid private equity managers in performance fees: $3.4 billion over the past 25 years. The fees, which are in addition to typical managerial fees, have come under scrutiny in recent years — and not without reason.

The California Public Employees Retirement System (CalPERS) said the fees were based on $24.2 billion in profits earned from investments in private equity funds. Performance fees, which are unique to so-called alternative investments, have been poorly reported — if at all — by pension plans. But as calls for financial transparency in all areas of government intensifies, that's starting to change.

Unlike stock market investments, pensions enter into a separate contract with each private equity fund manager. There is no standardization of those contracts or the fees charged. What's more, it's time consuming for a pension plan to flesh out how much they're paying in so-called profit sharing payments, which are essentially a cut of the earnings private equity managers take off the return on investment.

Now, CalPERS and a handful of other plans are calling for private equity managers to conform to proposed industry-wide disclosure standards. It could give investors more of a bargaining chip with private equity managers. As it stands, pension plans are unable to easily compare how expensive their managers are. "Public plans need to be able to very plainly disclose this information at a plan level for their beneficiaries, stakeholders and policymakers," said Lorelei Graye, founder of the consulting firm Leodoran Financial. "Eliminating the opaqueness eliminates the controversy and fear of unknown or hidden costs."

CalPERS, the South Carolina Retirement System Investment Commission and the Washington State Investment Board, among other private equity investors, are backing a proposed fee-reporting template. Notably, the template would require managers to make clear the performance fees they are taking off the top of investment returns. Designed by the Institutional Limited Partners Association (ILPA), the final template will likely be released in January.

A big reason fees have remained largely undisclosed is that private equity funds as an asset class are secretive about how they generate their returns and charge for their work. Pension plans invest as one of many limited partners in a fund, and the fund manager buys, builds up and sells entities — like companies — at their own discretion. Typical managerial fees for private equity managers are 2 percent of the total investment; profit-sharing fees are typically 20 percent of the earnings. By comparison, most other asset classes have managerial fees under 2 percent and no additional profit-sharing agreements.

Pension systems like private equity funds because, unlike public funds that are tied to the stock market, the success of private equity funds are detached from economic booms and busts. Instead, success hinges on the manager. In other words, it's up to pension plan investment officers to judge the manager's performance and whether their strategy fits into their broader portfolio. In their view, the higher fees for managers are justified because private equity funds have generated higher returns.

Critics, however, point out that private equity performance is only a little better than stock market performance. That's been the case in Kentucky where the system's private equity investments have performed about a half-percent better than the S&P average over the past five years, according to David Peden, the system's chief investment officer. Over the past decade, the plan's private equity has performed slightly under the stock market. Peden, who said Kentucky is "very excited to adopt whatever standards are developed" by ILPA, said the past few years of an outperforming stock market has skewed the picture. "At whatever point that spread narrows and it doesn't make sense anymore, then we won't invest in it," he said.

Another problem, according to critics, is that pension systems aren't exactly sure how much they've paid in total private equity fees. CalPERS isn't the first plan to start sniffing around: Kentucky and South Carolina's plans have hired outside consultants in recent years to investigate the performance of the investments and the performance fees.

While the consultants' reports have revealed more about the market for pensions, it's also led to increased criticism. Pressure has also been building at the federal level ever since the Securities and Exchange Commission released a report last year finding that half of the 400 private equity funds they analyzed charged investors bogus fees.

More than supporting ILPA's proposal, CalPERS has already adopted it, requiring its managers to conform to the template. That could ding CalPERS in the short term, said Graye, as private equity managers may simply choose not to work with the fund. That's why, she added, it is important to watch who adopts the final ILPA standards next year. "It's a bigger deal than some people realize," she said of CalPERS' early move. "But that's leadership and if enough limited partners [investors] push for these disclosures, the managers will come back. Collectively, the limited partners are going to shape this industry."

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