PODCAST

The benefits of private equity in pension fund portfolios

The outbreak of the Covid-19 pandemic, in which stock markets have seen increased volatility, combined with global low interest rates has led to alternative asset classes rising in popularity. Private equity is one of the top runners in this category, and for good reason.

In this podcast, Munich Private Equity Partners Managing Director, Christopher Bär, **chats to European Pensions Editor,** Natalie Tuck, **about the benefits private equity investments can bring to pension fund portfolios and the best approach to take**

How has the private equity industry evolved in recent years particularly during the Covid-19 pandemic?

Alternative asset classes have become more attractive in recent years due to persistently low interest rates; private equity has been one of the top runners because it has delivered attractive returns for investors. Private equity funds have historically yielded, on average, better long-term returns than public equities and other asset classes within the alternative space.

At the beginning of the Covid-19 pandemic, private equity finance companies were just as affected by contact restrictions, supply shortages and other constraints like their listed counterparts. However, the advantage for private equity-backed companies is that operationally strong private equity fund managers can play to their strengths in such a situation and provide their portfolio companies with support and liquidity. There is a crucial difference between public and private equity that allows for private equity to contribute significantly to reducing overall portfolio volatility. Private equity funds value and report only quarterly and that leads to smoother valuations and less short-term volatility. In terms of performance, the private equity asset class has been very attractive. I can only speak for our own private equity programmes, which have weathered the Covid-19 storm extremely well and have been a stabilising factor in our investors' portfolios.

Why should pension funds invest in private equity?

There are many good reasons but first, pension funds often target annual returns of 3-5 per cent, roughly. Low-interest rates and volatility in traditional asset classes have led to a shift to alternatives, such as private equity, infrastructure, and private debt. Private equity has an attractive risk / return profile, and, in our opinion, it is therefore a suitable addition to the portfolio. With a thoughtfully constructed private equity portfolio, diversified across a variety of fund managers, investments regions, vintages and sectors, the asset class fits the profile sought by many pension funds.

How can pension funds access private equity?

There are several ways to invest in private equity, the most important avenues being, direct investment in private companies, co-investments, secondaries, single fund investments and fund of funds. If we set adequate diversification as the goal, there are then only three main ways to add private equity to your portfolio. The first one being creating your own private equity portfolio with an in-house team; secondly investing in a fund of fund programme of a specialised fund of fund manager and, lastly, to cooperate with a specialist manager to establish a managed account for your organisation.

Creating your own portfolio is often considered the ideal method of investing in private equity. Doing so at least promises the most attractive returns while also limiting costs since additional fees from outsourcing are avoided. But to successfully execute this a pension fund needs specific capacities and the specific know-how and network in-house to access the most promising funds.

With regards to fund of funds, they give pension funds access to a diversified portfolio with a single capital commitment. The money is then pooled with the capital of other investors and is invested in multiple private equity funds. Then, depending on the strategy, the capital will be deployed across various geographical regions, over several vintage years and in different industry sectors. Experienced fund of fund managers provide access to the best-in-class and most sought-after private equity funds because they have already proven themselves to be experts and reliable partners by successfully cooperating with those managers in previous fund generations and they are capable of building strong long-term relationships over many years. This is one of the crucial advantages for partnering with an experienced fund of fund manager.

Lastly, managed accounts are kind of an individually designed investment programme. They are typically set up for a single investor and often combine an individualised concept with some advantage of a fund of fund as well, like diversification, access to excellent funds and outsourced portfolio management. The difference to a fund of fund is that the investor can quickly set or influence investment strategy decisions, fund selection and some other aspects if they wish to do so. Both fund of funds and managed accounts create an additional layer of fees for investors, and this has led many to believe that returns with those avenues generally are lower than returns from one's own implementation of a portfolio. However, this calculation should not ignore the significant costs of highly qualified internal personnel when private equity fund investments and the whole administration are conducted entirely in house.

What is crucial for success in private equity investments?

We believe that identifying the proper private equity funds only constitutes half of the battle. Access to the best funds is crucial for success; there are huge differences in returns between successful and average funds and even below average private equity fund managers. Those are significantly larger return differences than you would see in public market stock funds. Unfortunately, the best private equity funds are often almost completely inaccessible to new investors and this trend should continue given that the amount of capital allocated to the private equity market further increases. Fund managers who can master the field of valuation and quickly set their portfolio companies' business models for success are in extreme demand. Those fund managers have a virtually unlimited demand given their successes but finite fund sizes.

What should schemes look for when selecting a fund of funds manager?

What they should look at is the access to outstanding fund managers and this, in my opinion, is the most important selection criteria. Pension funds should focus on this as the access to outstanding fund managers ultimately determines the performance of the programme. If you can identify such a fund of fund manager, you gain access to fund generations of exceptional managers. You benefit from the expertise and capacities of the fund of fund manager who also takes care of the key areas such as professional due diligence, portfolio management and the often underestimated and quite frankly burdensome, administration. Of course, track record and the respected investment strategies of the fund of funds are very relevant when you select a fund of fund manager. At Munich Private Equity Partners, we focus on best-in-class and those most sought after fund managers in the mid-cap buyout segment but only within the established markets of Europe and North America.

Why do you think this segment is attractive?

Firstly, we at Munich Private Equity Partners are pursuing a conservative investment approach as we're committed to building thoughtfully diversified portfolios of high-quality buyout funds. In addition, we only partner with established and proven fund management teams that are targeting only mature companies with proven business models and then only mature economies, such as North America and Europe. In our opinion, the mid-market buyout offers the most attractive risk/reward profile, and the four main characteristics that would support this are: first, there is a favourable ratio of private equity capital to potential target companies; secondly in the mid-market compared to the large and mega cap markets you have relatively low entry prices and prudent leverage and that adds to an attractive risk / reward profile. Most importantly, mid-market companies offer a very broad spectrum of value creation opportunities investors can ultimately benefit from. Finally, the mid-cap buyout segment offers multiple attributes for those companies due to a large universe of strategic and financial buyers and then possibly the opportunity to potentially initial public offering (IPO) a company as well. ■

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