Pension Funds Can Only Guess at Private Equity’s Cost

By Gretchen Morgenson

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Curtis M. Loftis Jr., South Carolina’s treasurer, has pushed to learn more about private equity fees.Credit...Dale W. Ferrell for The New York Times

Partnership agreements outlining private equity firms’ practices are as closely guarded as the recipe for Coca-Cola.

Indeed, when it comes to secrecy, few industries do it better than private equity. To outsiders, the lucrative business of borrowing money, buying companies and hoping to sell them later at a profit is as impenetrable as a lockbox. Rates of return and hidden costs are difficult to identify, even for investors in these deals.

While top-line fees associated with these funds are well known — management typically charges investors 1 to 2 percent of assets and about 20 percent of portfolio gains — many charges are hidden from view. These include transaction fees, legal costs, taxes, monitoring or oversight fees, and other expenses charged to the portfolio companies held in a fund.

Those undisclosed charges are a meaningful drag on returns.

How meaningful? Very, according to a recent report by CEM Benchmarking, a Toronto-based consulting firm specializing in pension fund performance analysis.

It estimated that more than half of private equity costs charged to United States pension funds were not being disclosed.

CEM concluded that the difference between what funds reported as expenses and what they actually charged investors averaged at least two percentage points a year. For a $3 billion private equity portfolio, that would add up to $61 million.

And this estimate, CEM acknowledges, is probably low. It comes from Dutch pension fund data, and Europeans pay far less to private equity firms than pension funds in the United States typically do, investment experts say.

A 2007 academic paper that was updated in 2009 and published in The Journal of Economic Perspectives points to far larger costs in private equity funds. The paper, "Beware of Venturing Into Private Equity," by Ludovic Phalippou, a professor at the Said School of Business at Oxford, found that the average private equity buyout fund charged more than 7 percent in fees each year.

Some pension beneficiaries may find it shocking how many fees in their funds' investments are undisclosed. But it does not surprise Curtis M. Loftis Jr., the state treasurer of South Carolina. For years, Mr. Loftis has been pushing for more transparency regarding costs levied on the private equity and hedge fund investments overseen by his state's $30 billion Retirement System Investment Commission.

"It's a mammoth undertaking to understand the complexity of these costs, especially in private equity," Mr. Loftis said in an interview. "We've hired a third-party administrator to try to validate fees and expenses, and after more than a year and three months, they still don't have a handle on them all."

One reason the South Carolina pension fund's costs are so difficult to assess is that it relies more heavily than the typical pension fund on complex investments in hedge funds, real estate and private equity. According to Mr. Loftis, who is a member of the investment commission, those holdings account for 47 percent of the retirement system's assets. That's more than double the 21 percent median holding of such investments by pensions nationwide, according to the National Conference on Public Employee Retirement Systems.

Certainly, these complex and sizable holdings have raised the South Carolina pension fund's expenses. While not a complete assessment, costs identified by the state last year were $468 million, or 1.56 percent of assets. The median pension fund paid 0.57 percent of assets, by comparison.

South Carolina is far ahead of most other states, however, in trying to determine every nickel in fees that it's incurring in its private equity holdings. The state investment commission hired CEM Benchmarking to conduct an analysis; that assignment created the basis for the consulting firm's new study about disclosure failures nationwide.

Mr. Loftis said private equity firms had been able to obscure their costs partly because of fuzzy accounting rules. The Governmental Accounting Standards Board states that investment-related costs should be reported as expenses if they are "separable from investment income and the administrative expense of the pension plan." This, along with the practice of not detailing specific costs for such things as transaction expenses and monitoring fees, essentially lets funds decide which fees are separable, leaving most investors unaware.

J. J. Jelincic, a member of the California Public Employees' Retirement System board since 2010, has often raised the problem of fee transparency in the fund's private equity investments. Mr. Jelincic, who before joining the board was on the Calpers staff for 24 years, said in an interview that being in the dark on fees created problems for the overseers of the $300 billion pension fund.

"You don't think to negotiate on fees that you're not aware you're being charged," he said. "As a trustee I'm really concerned about not knowing what we're paying on private equity. We may be getting a really good deal, we may be getting a really bad deal. I just don't know."

The CEM report also notes that even those cost disclosures provided by many private equity funds are understated. After investors objected to the excessive fees associated with private equity, most firms began to offset some costs, returning a portion of them to fund holders. But such rebates only give the illusion of a fee reduction, CEM said, because those fees are also being charged to the portfolio companies in the fund, reducing the ultimate value to investors.

"There is not a broad consensus within the industry on what is a cost," said Mike Heale, a principal at CEM Benchmarking. "Clearly we think there should be disclosure and standardized reporting on everything that the investor doesn't get to keep."

The new scrutiny on secret fees in private equity is more than welcome, Mr. Loftis said. But his experience suggests that private equity firms won't open up more without a tough fight.

"South Carolina has come a long, long way," Mr. Loftis said. "But the average pension plan out there does not have a guy like me hounding them. I wish every treasurer would speak up or every investment commission would speak up. Every pension plan in the nation is paying too much, and it's being hidden."

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