



Amarendra Swarup **Personal view**

Private equity can become a jewel in the crown for pension fund portfolios

Once the preserve of wealthy families and viewed with deep suspicion by nearly everyone else, private equity is increasingly a valuable tool for pension schemes looking to diversify their portfolios and improve their funding positions.

Investors have been dabbling in private equity for centuries, with early well-known examples including the old Victorian merchant banks and the original JPMorgan. Today, it is a diverse field encompassing everything from venture capital investors in small start-ups, to buyout specialists looking to restructure poorly managed public companies, to distressed strategies, which hope to turnaround otherwise doomed enterprises.

In recent years, institutional investors have begun to turn their attention towards accessing this complex asset class through specialist private equity funds. The European Private Equity and Venture Capital Association estimates that 23% of the total money raised by Europe-based private equity funds between 2003 and 2007 came from pension funds, with nearly another 10% coming from insurance companies.

The rapid growth is no coincidence – private equity has shown long-term historical outperformance over publicly traded stocks across most sectors. The ability to invest in entrepreneurs and exposure to often smaller companies can also provide valuable diversification to the typical pension fund equity portfolio, and can also help improve returns without

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significantly impacting the risk profile.

There are caveats. Most private equity investments are illiquid and long-term, requiring investors to commit for five to 10 years. There is limited transparency, with few of the requirements or regulations that typify listed stocks. Every niche and industry requires a different skill set and knowledge base. These combine to make any risk assessment and valuation difficult, contributing to the suspicion of private equity held by many today.

However, as with any field of investment, it's all about understanding the unique characteristics of that asset class. This active approach is key to the creation and extraction of value from these investments, and to the superior long-term performance generated by the private equity sector.

One option is to consider external asset-liability management providers with expert knowledge, who manage the assets and liabilities for trustees on a holistic real-time basis and ensure assets are effectively diversified, with a judicious and risk-controlled allocation to private equity.

It is a complex area, but one with invaluable benefits for those pension funds willing to expand their knowledge and explore innovative ways of optimising their portfolios. The rise of experts who can partner with them means that they are not alone on this journey.

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Jargon buster

Courtesy of Aviva Investors' *Trustee Tutor*



Fat tails

A statistical reference to the idea that returns from markets may vary more than we tend to think

Fiduciary

A very high standard of behaviour. If you have a fiduciary relationship with someone, you have an obligation (over and above any contract you have with them) to act in their interests, not yours. You also have an obligation not to put yourself in a position where you have a conflict of interest. An investment manager owes fiduciary obligations to the client. A pension fund trustee has a series of fiduciary obligations to the beneficiaries (or members) of the pension trust fund

Flight to quality

When investors get nervous, they prefer to invest in less risky assets, such as cash and government bonds. The trouble is that it is quite imprecise: are pricey government bonds less risky than cheap small companies? Over what time horizon? Herd behaviour often applies.

Future

Binding agreement to do something in the future. If you buy an option, you are buying a right to do something in the future, if you want to. If you buy a future, you agree to do something in the future, even if you might not want to. Future contracts can be traded on futures exchanges, so you could pass on the buying obligation to someone else.