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CalPERS needs to upgrade its skills to succeed in private equity, CIO says

For a planned move into direct investments and large co-investments, the $353bn fund will need to learn how to select and invest in individual portfolio companies.

Dietrich Knauth | 21 Jun 2018

The $353bn **California Public Employees Retirement System** (CalPERS) needs to develop new expertise if it's going to overhaul its private equity strategy, according to CIO **Ted Eliopoulos**.

CalPERS' private equity portfolio is currently composed solely of traditional private equity funds run by general partners, and it has become quite good at vetting those partners and the opportunities they offer, Eliopoulos said at the mega fund's June meeting. But that model won't be enough to keep CalPERS near its preferred 10% allocation to private equity, which is why CalPERS is pursuing a new strategy that includes direct investments, a commitment to larger strategic partnerships and co-investments with private equity firms, and an increased focus on emerging managers. The new strategy will require substantial additions to CalPERS internal skills and resources, so that it is less reliant on its private equity managers, Eliopoulos said.

"Our private equity program, our team, our systems, our methods are really geared all towards performing this function of selecting an external general partner," Eliopoulos said. "The [new strategy] really seeks to add to this capacity the ability to select and invest in individual portfolio companies. This is a new domain."

The board has not made a decision on the new strategy, but board members generally sounded positive when discussing the new model at the meeting. The plan also received an endorsement from **University of California** professor **Ashby Monk**, who said that more public pension plans could benefit from thinking outside the box on private equity.

Institutional caution leads public pensions to invest only in general partners with great track records and avoid first-time funds, which appeals to their sense of responsibility, but creates a market with a few dominant players and shuts out new entrants that could provide pension funds with more options and better fees in the long run, Monk said.

"Innovation is incredibly challenging inside the context of a public pension plan operating inside a government," Monk said. "The truth be told, most of our public pension plans view a lack of creativity as a feature, not a bug."

CalPERS Direct, the proposed semi-independent private equity entity, seems like a reasonable step toward bringing private equity expertise in-house, Monk said. The arms-length structure will allow the new entity to take risks that CalPERS as a whole would not be able to stomach, and it would allow a way to hire private equity experts that would balk at joining a state agency, at a state government salary, Monk said.

"I would love to endorse a plan to help you internalize all your private equity dollars but I'm afraid that is not practical in the short run," Monk said. "These are people making hundreds of millions of dollars. It's hard to recruit those people even if you can really tap their heart strings to come and work for CalPERS."

Direct investments could help weaken the hold that private equity managers have on investors, who increasingly rely on private markets to capture the upside that has retreated from public markets, Monk said.

Fewer and fewer companies list themselves publicly, and when they do, they've already sold off high-value equity stakes to private investors before they reach an IPO.

But when every investor is chasing private equity, general partners are free to set the terms in a way that disadvantages large investors like CalPERS, he said.

"With this massive increase in supply, what we would call a wall of money coming at private markets, the tables have turned," Monk said. 'The asset managers we have relied on have benefited incredibly. We've all seen the high fees."

CalPERS paid $700m in private equity fees in 2017, and it hopes that bringing some of its portfolio in-house, or running it through large partnerships, would reduce those costs. A direct investment structure, focused on longer-term investments than a typical private equity fund, would also offer a chance to cut some inefficiencies in the typical private equity business model, such as fundraising costs and the types of financial engineering often to meet return targets, Monk said.

"In order to make an asset perform in such a way the private equity GP could capture their carry, they'd have to do wacky things with it like lever it up, create a bunch of different interesting structures," Monk said. "If you can remove or change the way the fee structures are defined, you can get that alignment of interest."

CalPERS could also benefit by attracting private equity professionals who dislike the cyclical churn of raising funds and selling portfolio companies in order to get paid, according to Monk.

"The people that will raise their hand to work for this are, hopefully, incredible investors who don't enjoy business of fund raising and who have a mission," Monk said. "So there is an opportunity for a vehicle like this to be a breeding ground for a new generation of investor that is thoughtful and is also incredibly commercially successful."

CalPERS' willingness to even consider direct investments puts it ahead of most of its peers, Monk added, urging the fund to move decisively once it worked out a governance structure for the new CalPERS Direct.

"Don't let great be the enemy of the good," Monk said. "Move fast. Get things built."

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California Public Employees Retirement System (CalPERS)

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