Private Equity in 401(k)s? Why Bother?

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MarketWatch Blog by Alicia H. Munnell

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Having recently argued that **Bitcoin does not belong in 401(k) plans**, a reporter asked me my view regarding private equity. While private equity – unlike Bitcoin – passes the threshold test under **ERISA** of being a generally acceptable asset class to a broad group of investors – most importantly trustees of defined benefit plans – it is too opaque for most 401(k) fiduciaries to perform appropriate due diligence. To date, the Department of Labor (DOL) has cautioned fiduciaries but not nixed introducing private equity.

DOL has issued two letters regarding private equity in 401(k) plans. **The first**, in June 2020, was in response to an application on behalf of Pantheon Ventures and Partners Group soliciting DOL's views. After repeating – uncritically – all the applicants' arguments in favor of private equity, the agency concluded that fiduciaries would not violate their duties under ERISA solely by offering an asset fund with a private equity component, even in a default target date fund. Of course, as always, the fiduciary must confirm that the investment is prudent and made solely in the interest of beneficiaries. The letter also noted that private equity investments tend to be more complicated, with longer time horizons; are typically less liquid; and have higher fees than traditional investments. Fiduciaries must balance these considerations against opportunities for diversification and enhanced returns, and should compare funds with private equity against funds without.

Concerned that the prior administration's letter could be seen as broadly endorsing and downplaying the risks of private equity in 401(k) plans, the DOL in December 2021 issued **a statement of clarification**. The statement stresses the caution in the earlier letter regarding the fiduciary skills, knowledge, and experience required to select and monitor private equity options. It also reiterates that the DOL has not endorsed or recommended the inclusion of private equity, and fiduciaries should be wary of marketing efforts saying otherwise.

The bottom line is that, at this point, the DOL is not precluding anyone from offering private equity in 401(k) plans but rather alerting fiduciaries to the difficulties – especially for small plans – of evaluating private equity options. So, the question is why bother? As far as I can see, the only party pushing for private equity in 401(k) plans is the private equity industry.

My view is that people should invest in stuff they understand, and private equity is not a transparent investment. Moreover, it takes years for returns to be realized, and participants who leave early will have paid higher fees for nothing. Private equity simply adds unnecessary risk to retirement saving. And in most cases, 401(k) balances will be the sole addition to Social Security once workers retire.

Further, it is not apparent that private equity does produce outstanding returns in defined benefit plans. In fact, based on our **2017 study**, holding more private equity was not associated with higher returns for state and local pension plans in the initial years after the financial crisis. And our data may not have fully accounted for fees in private equity. So, private equity may have even had a dampening effect on overall portfolio returns, relative to traditional equity, during the period. Moreover, in terms of diversification, private equity did not have a statistically significant effect on volatility. Yes, the private equity guys get rich, but it's not clear that participants in retirement plans benefit. Why should fiduciaries bother to take such a big risk?