Workers Do Not Need Private Equity in their 401(k) Plans

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MarketWatch Blog by Alicia H. Munnell

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Private equity is illiquid, has high fees, and hasn't produced high returns for state/local plans

The president just issued an **executive order** to encourage adding private equity and private credit — as well as other alternative investments — as options to 401(k) plans.

The Department of Labor (DOL) is tasked with accomplishing this goal. Some suggest the expansion could be limited to 10% to 20% of target-date funds, the default investment option in most 401(k) plans, but the goal may be broader.

My view 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. Moreover, private equity comes with numerous negatives, and our studies on the performance of state and local pension plans show that the addition of private equity has not increased the return or reduced the volatility in these plans.

To date, the DOL has issued two letters that cautioned fiduciaries but did not preclude anyone from introducing private equity into 401(k)s. **The first**, in

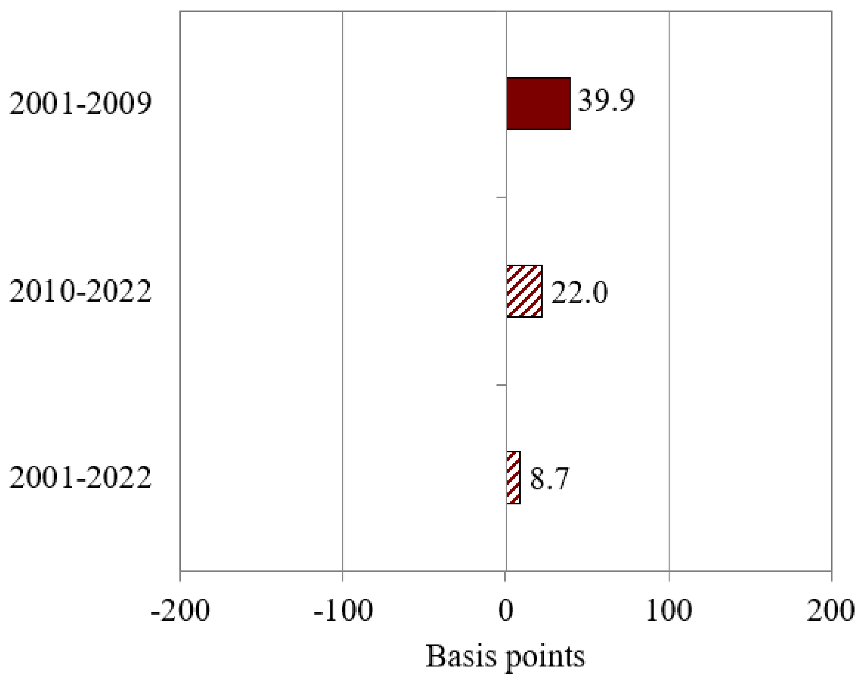
June 2020, was in response to an application on behalf of Pantheon Ventures and Partners Group soliciting DOL's views. After repeating – uncritically – all the applicants' arguments in favor of private equity, the agency did note that private equity investments tend to be more complicated, have longer time horizons, are less liquid, and have higher fees than traditional investments. Nevertheless, it concluded that fiduciaries would not violate their duties under ERISA solely by offering an asset fund with a private equity component.

One year later, concerned that the prior administration's letter could be seen as broadly endorsing private equity in 401(k) plans, the agency issued **a statement of clarification**. This letter stressed the caution in the earlier letter regarding the fiduciary skills, knowledge, and experience required to select and monitor private equity options. It also reiterated that the DOL had not endorsed or recommended the inclusion of private equity, and fiduciaries should be wary of marketing efforts saying otherwise. Why change positions now?

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.

Further, it is not apparent that private equity produces outstanding returns in retirement plans. While **one study** concluded that increasing private equity holdings in 401(k)s would have boosted returns by a small amount, that analysis ended in 2020, before the run-up in the stock market. And the results of **our 2022 study** showed that holding more private equity would not have increased returns for state and local pension plans over the period 2001-2022. Yes, private equity helped before the financial crisis, but it has not had a statistically significant effect since then (see Figure 1). And given that the exercise may not have fully accounted for fees in private equity and that the stock market has soared since 2022, private equity may have even had a dampening effect on overall portfolio returns, relative to traditional equity.

Figure 1. *Estimated Effect of a 10-Percent Increase in Average Allocations to Private Equity on Returns to State/Local Pension Plans, in Basis Points*

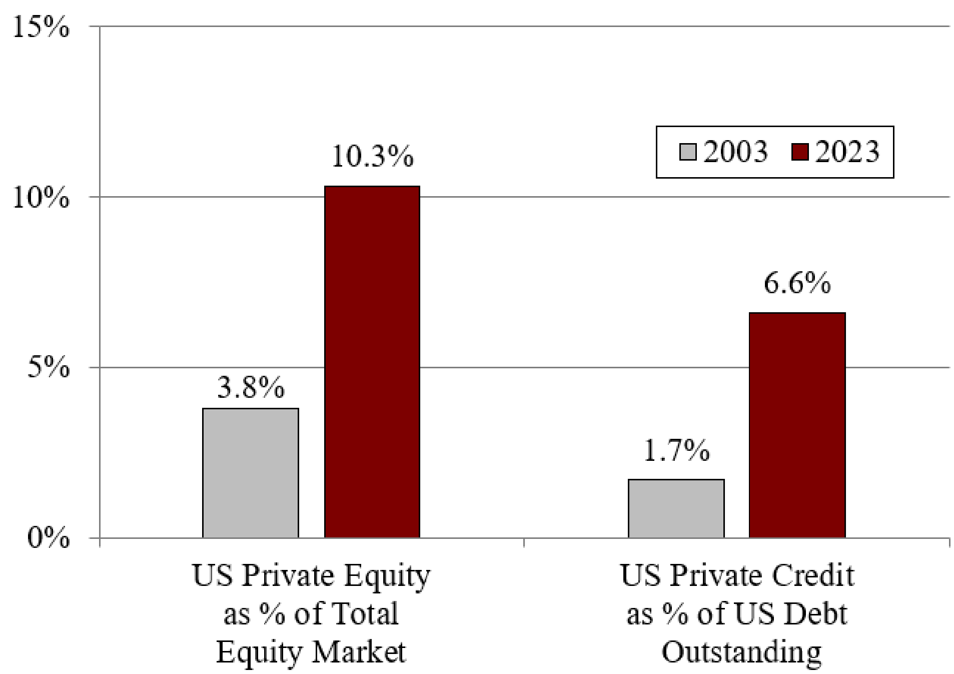


Notes: Solid bars are statistically significant. Returns are net of fees.
Source: Jean-Pierre Aubry. 2022. "Public Pension Investment Update: Have Alternatives Helped or Hurt?" *Issue Brief* 22-20. Center for Retirement Research at Boston College.

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?

One potentially persuasive argument for introducing at least a small amount of private equity in 401(k) plans is that companies are increasingly financing activities through private rather than public capital, so that plan participants have access to only a sliver of market activity. It's not easy to get numbers on the inroads made by private equity and credit, but the best estimates available suggest that in 2023 private equity accounted for around 10 percent of the equity market and private credit for about 7 percent of the private debt market (see Figure 2). My view on those numbers is that plan participants have plenty of access to equity and credit markets in the form of familiar publicly-traded stocks and bonds. Happy to talk when private equity and credit amounts to 30-40 percent of the total. Until then, in my book the risks associated with private equity far outweigh any potential gains.

Figure 2. *Private Equity and Private Credit as a Percentage of the Total Market, 2003 and 2023*



Sources: State Street Investment Management's calculations using World Federation of Exchanges, PitchBook and World Bank as of December 2023 for private equity; and Preqin, Apollo Chief Economist as of December 31, 2023 for private credit.