What can private equity offer SA pension funds?

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Now that Regulation 28 of the Pension Funds Act allows pension funds to invest 10% of their portfolio in private equity, it is worth considering what this asset class has to offer. Internationally, it is best practice to include private equity in an institutional portfolio. In the U.S., for example, both pension funds and endowment funds normally have between 10% and 30% of their portfolios invested in this category.

In South Africa, the private equity industry is well developed with over R97 billion in funds under management (SAVCA KPMG Private Equity Survey 2010) and boasts a good selection of managers with strong track records to choose from.

Strong performance

Private equity has historically enjoyed strong returns, and has outperformed the listed market over the long-term, as the following table demonstrates:

		CAGR		
Period	**Pooled IRR**	**ALSI TRI***	**FINDI TRI***	**SWIX TRI***
10 year	23.1%	14.0%	15.9%	N/A**
5 year	20.0%	7.3%	8.9%	15.9%
3 year	17.0%	16.4%	20.0%	17.9%

*Listed index returns are before fees

**SWIX only formed in 2002

***Listed indices used in the computations are total return indices before fees

This outperformance is expected as a reward to investors for choosing an illiquid investment. This illiquidity is easy for a pension fund to manage, as private equity only makes up a small part of the fund's asset allocation.

Long-term focus

Private equity managers usually look to create significant value over 5-7 years rather than aiming for short-term results. In addition, the effect of management fees and start-up costs on the relatively small capital base of a new fund means that private equity will normally show a drop in net asset value before showing any significant gains. Private equity is therefore a long-term asset class, making it a good fit with the long-term nature of pension fund liabilities.

Diversification

Typically, private equity investments show low correlation to quoted equity markets, making them a good way to increase diversification. For example, the JSE has a large exposure to resources and banks, whereas private equity offers pension funds access to companies from a much wider range of industries. In addition, listed companies tend to be more mature, whereas there is a good choice of unlisted companies with higher growth, as well as some excellent large companies such as Pepkor, Consol and Tracker.

Economic and social change

Private equity has been a part of the majority of BEE deals that have taken place in South Africa, which positions it as an important source of economic and social change. A 2009 survey carried out by the Southern African Venture Capital and Private Equity Association (SAVCA) and the Development Bank of Southern Africa (DBSA) found that private equity firms have a significant impact on improving lives and livelihoods by increasing GDP, employment and developing capital markets both in South Africa and across the continent.

The survey found over the three year period from 2005/6 to 2008/9, that private equity-backed companies achieved higher growth rates in employment, turnover and profit than the average of comparable listed firms. For example:

- Private equity-backed companies achieved annual worldwide employment growth rates of 9%, compared with JSE listed business’s growth rates of 4%.
- They accounted for 5% of South African formal sector employees, which equated to around 427 000 jobs.
- They achieved average domestic employment growth rates of 10% per annum, compared with 1% across all businesses in South Africa.
- Average turnover growth of 20%, compared to 18% for JSE businesses.
- Pre-tax profit growth of 16% per annum compared to 14% for JSE businesses.
- Growth in exports of 31% per annum, on average, compared with 24% nationally.
- Average R&D expenditure growth of 7% compared to 1% for JSE listed businesses.

Now that Reg 28 requires trustees to factor in sustainable investing (as discussed in articles **one** and**two** of this series), private equity investing is a good way of supporting this focus.

For more information on Regulation 28, **click here**.