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What private equity can do for pensions

OVER THE PAST NINE months, the contagion of the subprime market has burst the debt bubble, resulting in widening spreads and tighter liquidity.

As a result, deal volumes have dropped from a record high of US\$410bn, and liquidity in the debt markets is currently very limited. The good news is that prices are also coming down, which mitigates the impact of the correction in the debt markets.

Buyout portfolios are unlikely to see massive value erosions found during the post venture bubble market correction. However as stock markets suffered losses, a downward correction of company values in Q1 2008 reports are likely.

In this environment, pension funds should consider three aspects: diversification, selection and investment horizon. The impact of the correction in the debt market is stronger in the large end of the market, but the mid-cap market has also been affected.

Venture investment activity is little affected, but the weakening initial public offering market will impact distributions. The distressed segment sees its opportunities rising. Thus a well-diversified portfolio will continue to generate attractive performance.

The next critical element is selection. While the long-term investment cycle in private equity makes market timing difficult, selection is a powerful way of generating returns. An

understanding of current trends and events, such as the debt market turmoil, should be used to assess which managers of a given strategy are best equipped to generate good returns despite a changed market environment in the future. As such, pension funds should review their investment processes and make sure their market analysis supports their investment decision, rather than their allocation decision.

The last element is the investment horizon. In the near future we expect returns to correct downwards to more historic levels. In the long run, however, private equity has consistently outperformed the public markets. Research has shown that private equity has outperformed the public markets by an average of 2% to 4% over the past 20 years – with good selection, this outperformance can reach 8%.

Pension funds with good visibility on their cash requirements should take advantage of their long-term investment horizon and capture the illiquidity premium that private equity provides.

Well-diversified and well-selected private equity portfolios can generate a cash-on-cash return, double that of the public markets over a 10-year timeframe. Thus for pension funds that do have a long-term investment horizon, private equity remains an attractive value proposition.