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Comments to the House Financial Services Subcommittee on Capital Markets

We provide requested comments from the committee on point (2) Whether 401(k)s and other retirement vehicles should have greater access to private markets, and if so, what safeguards should be put in place.

"Committee members also discussed whether 401(k) plans and other retirement vehicles should have greater access to private markets and what safeguards would be necessary to protect retirees' assets. For example, Congressman Lynch (D. Mass) expressed concern about potential risks associated with investing retirement assets in start-ups, citing earlier testimony about the 90% failure rate of start-ups. Overall the discussion reaffirmed that Chairman Hill is looking for ways to expand retail investor access to private markets."

Summary

This letter is to provide comments and recommendations regarding the potential inclusion of private equity investments in defined contribution pension plans, in particular, 401(k) plans and other retirement vehicles. The private equity market differs materially from public equities and other listed asset classes across many dimensions including performance, risk, reporting, valuation, fund vehicle structures, fees, and liquidity. There are unique attributes of private equity investments and structures that need to be addressed so that an individual retirement plan participant can understand the investment opportunities and risk. Further, there are several considerations for fiduciaries when contemplating the inclusion of private assets within 401(k) or similar plans, particularly as it relates to ERISA compliance.

We highlight some of the important considerations for the committee:

- Type – certain private equity investments may be unsuitable for the plan participant, including Direct private equity, individual primary funds, and secondaries.
- Pricing/Valuation – infrequent pricing of unlisted assets can lead to stale and incorrect pricing, disadvantaging the plan participant and exposing fiduciary to liability.
- Risk – perceived lower risk (volatility) of private equity is due largely to infrequent valuation.
- Returns – traditional private equity performance metrics differ materially from listed markets and may mislead plan participants.
- Benchmarks – should employ registered index built with unbiased asset level constituents and avoid use of peer group manager benchmarks that can mislead.
- Fees – full disclosure on fees including management fees, carried interest and other monitoring/transaction fees. Private Equity fee levels may expose fiduciary to risk.
- Liquidity – illiquid nature of assets at odds with potential for plan participant to change jobs, right to redeem or transfer 401(k) assets.
- Conflicts of Interest – potential for large asset managers to direct plan assets across various products within the same manager, limiting diversification and independence.

Despite the benefits of private equity in adding diversification to a portfolio, there are numerous considerations and safeguards that need to be in place to make the asset class suitable for an individual plan participant in a 401(k) or similar plan. Further, the fiduciary must be cognizant of the increased liability risk associated with an illiquid asset class, known for its high fees, infrequent and poorly disclosed valuation practices.

We frame our feedback with the understanding that The Employee Retirement Income Security Act (ERISA), a U.S. federal law that was enacted in 1974, regulates employee sponsored retirement and health plans. This includes 401(k) defined contribution plans offered by employers.

We are guided by the information letter[1] provided by the Department of Labor ("DOL") on June 3, 2020 addressing inquiries from Pantheon Ventures (US) L.P. (Pantheon) and Partners Group (USA), Inc. (Partners Group) regarding the views of the DOL on the use of private equity investments in designated investment alternatives offered to participants and beneficiaries in individual account plans such as 401(k) plans, that are subject to ERISA legislation. We also consider the supplement[2] issued by the DOL on December 21, 2021.

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[1] Information Letter 06-03-2020 | U.S. Department of Labor

[2] U.S. Department of Labor Supplement Statement on Private Equity in Defined Contribution Plan Designated Investment Alternatives | U.S. Department of Labor

Private Assets Considerations

Investing in the private equity asset class is significantly more complex and costly than investing in listed securities, mutual funds, or ETFs. Before providing recommendations, we narrow the opportunity set to help frame the discussion.

The DOL information letter and supplement dealt primarily with the potential for private equity inclusion in Asset Allocation Funds, which could be part of Target Date, Target Risk, or Balanced Funds.

The DOL did not consider the potential for direct investments in private equity but noted that, "Such direct investments in private equity investments present distinct legal and operational issues for fiduciaries of ERISA-covered individual account plans." We believe that it would be both unreasonable and impractical for an individual plan participant to invest directly in private equities (private companies). The individual and plan fiduciary lack the requisite skills to evaluate such opportunities, and it's unlikely that sufficient diversification can be achieved, or that it can be done in a cost-effective manner.

The most likely avenue for investing in private equity will be through fund partnerships ("Primary" investments). This is the path chosen by most defined benefit (DB) and public sector pension plans. However, these institutions typically have built in-house teams that have the skills to evaluate private equity managers and funds, including the past performance, fund structure, terms, and portfolio construction. For similar reasons made against investing in direct private equities, we think it would be inappropriate for a plan participant or fiduciary to pick individual funds. Further, it is unlikely that one could build a diversified set of funds through this approach as it's likely that just a small subset of the overall private equity market would be made available to the 401(k) market. Currently, only the largest private equity managers offer access to the private wealth or retail market via "Evergreen" funds, reflecting only a small component of the overall private equity market.

As a result, the most appropriate method to invest in the private equity market will likely be through a "fund of funds" offering or an Evergreen structure that can build a diversified portfolio of fund relationships across independent managers strategies. Given the costs associated with such a strategy, one may question if they outweigh the benefits for the individual retirement account.

Case for Private Assets in Defined Contribution Plans

Private Assets have grown in scale over the last 25 years and represent a significant portion of assets within defined benefit and public sector pension plans portfolios. Private assets include private equities and private equity funds, infrastructure equities and debt, venture capital, and private credit. For the purpose of this letter, we will focus on private equities and private equity funds, though many of the comments and issues apply to all private asset classes.

The argument usually follows that DC plans should offer similar asset allocation as their DB counterparts, which would include significant private asset allocations. The counter argument is that DB plans are uniquely set up to take on highly illiquid assets. An individual 401(k) plan participant does not have the same ability to manage longer duration, highly illiquid investments and investment funds.

The main benefit of investing in private equity and other private markets asset classes is diversification, as the correlation with listed markets is typically less than one. This has the potential to provide a more optimal return vs risk profile for the investor relative to their existing portfolio.

Higher returns are often cited as a reason for investing in private equity, but we note that over the last several years, private equity returns have trailed those of listed markets. We think it is inappropriate to refer to the private equity returns of 10+ years ago, or over longer periods, as the market has matured and become much more competitive. The market dynamics today are very different, expected returns have declined, and the assets and number of players have grown tremendously. Furthermore, as we will discuss in the section on returns, there are material differences in calculation of returns between private equity and public equity such that the comparisons often are not meaningful.

Finally, the listed equity markets do not represent the full global market as many companies remain private. In the US, 87% of companies with revenues exceeding 100 million remain private[3]. To access the full breadth of the economy, private equity exposure may be desirable.

Types of Private Assets Envisaged

The disclosures and guidance thus far provide limited insight into the types and structure of private capital investments that would be permissible in 401(k) and other retirement plans. For example, there is no commentary regarding whether all of venture capital, private equity (buyouts), private credit, and infrastructure debt and equities would be included. We note that many Evergreen funds that target the individual wealth or retail channel have strategies that permit them to invest across primary funds, secondaries, and direct or co-investment transactions. This is often permitted to minimize the "J-Curve" effect, which can be a drag on returns during the early years of a primary fund investment due to the payment of management fees with limited realizations and distributions during a funds investment period. However, it can also introduce conflicts of interest[4]. Further, it is unlikely that an individual plan participant would be able to navigate the nuances of these various strategies.

We note that in a recent Secondary Markets report by Campbell Lutyens[5], it was disclosed that Evergreen funds tend to pay higher prices (lower discounts) for Secondary transactions than Fund Managers back by institutional investors. One must consider the possibility that DC participants may be providing liquidity to DB corporate and other large pension plans, at

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[3] CFA Institute. CapitalIQ

[4] https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf

[5] https://campbell-lutyens.com/news-insights/publications/2025/fy2024-secondary-market-overview/

premiums to other market participants. In considering acceptable investment offerings, one should ensure that plan participants are not treated as "2nd class citizens" and are investing on the same terms and conditions as institutional players. With the potential for significant 401(k) capital to be channelled into the secondary market, this conflict of interest needs to be closely monitored. Additionally, there is the possibility of bad or underperforming assets being offloaded to the retail channel through such vehicles.

Challenges for the Individual Plan Participant

Despite the benefits of investing in private equity, the individual participant of a 401(k) or similar retirement plan will face a myriad of difficulties investing in this asset class. Further, the fiduciary faces risk as the illiquidity, high fee structure, and pricing/valuation lags may expose the fiduciary to some legal risk. We discuss some of the concerns we have and potential recommendations below:

Fund Level Risk Exposure

Investors in private equity funds face several risks, including:

- Market Risk – market risk exposure to the underlying private equities market
- Liquidity Risk – closed end fund investment with no inability to redeem funds. Can only sell via a secondary transaction, often at a discount to NAV
- Cash Flow Risk – managing capital calls and distributions over life of fund

The individual 401(k) participant is ill-equipped to understand and manage these risks that are particular to the private asset industry. The plan fiduciary or asset allocation fund manager would need to have the knowledge and skills to manage these risks and effectively communicate them to plan participants.

We note from the DOL letter, "The stakeholders also observed that retirement savers may often need to liquidate or transfer these assets at an earlier stage than many long-term investors, especially workers that frequently change jobs." Managing liquidity risk will be a challenge for individual plan participants as well as asset allocation fund managers.

Market Risk

Standard risk metrics such as return volatility and risk adjusted performance metrics such as the Sharpe ratio can provide misleading results when presented by private equity managers or consultants. Less frequent valuations and return smoothing is a problem in the industry and often understates the risk of private equities, implying a much better return/risk (Sharpe ratio) than listed equities.

How will plan participants understand the risk in the underlying PE investments? Certain private equities investment vehicles targeting the retail and wealth channel often advertise their products as having significantly less volatility than listed equities. For example, we highlight the Partners Group Global Value SICAV[6]. This fund, which has been in operation since

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[6] Partners Group GlobalValue SICAV

2010, claims to have an annualized volatility of 5.8%, which is approximately 1/3 of what is observed in listed equities such as the S&P 500 or Russell 2000. This lower reported volatility is in part attributable to the less frequent valuations and smoothing of valuations (e.g., Jenkinson et al., 2013) giving the impression of lower risk. This lower volatility also implies that the private equities market is less correlated with the public equities market, potentially overstating the diversification benefits. While there are diversification benefits, using a more appropriate volatility metric from a private equities index would provide the investor with a better understanding of the risk. We refer you to the following paper that shows private equities and public equities have similar risk metrics (see: Paper).

Pricing/Valuation

Related to the prior point on market risk, the lack of frequent pricing in private equity means that a plan participant will not know how their private equity investments are performing in real time. Listed assets price daily and the 401(k) plan participant can see daily the value of their portfolio. But private equity valuations may be stale or incorrect, leaving the plan participant with limited information regarding their holdings. This creates risk for the fiduciary as the plan participant may not be receiving timely and accurate information regarding the value, performance, and risk of their holdings. Further, this creates a risk for the fiduciary upon entry and exit of the private equity investments, as there may be legal risk if the plan participant is buying/selling at a valuation or NAV that is stale or incorrect.

The private equity fund managers will be required to satisfy ASC 820 and ERISA disclosures about current value. This means that the pricing/valuation will have to reflect the fair value as if the company were sold on that date to arms length third parties.

We recommend that participating fund managers be required to adopt a more frequent valuation policy (daily or weekly) and employ a factor model calibrated from real transaction data to understand how each factor impacts the multiple or valuation, rather than accepting multiples or other valuation approaches at face value. This can permit daily or weekly pricing of assets and holdings and facilitate entry/exit at latest pricing, rather than at stale or incorrect values.

Returns

Returns data calculations are regulated and standardized with registered investment companies in listed markets, such as mutual funds. Mutual Funds and other funds invested in listed companies are required to present 1, 5-, and 10-year time weighted return[7] details to prospective plan participants/beneficiaries. The Private Equity industry uses performance metrics that are not often observed in other asset classes. This includes the use of money weighted Internal Rate of Return ("IRR") and Total Value to Paid-In Capital ("TVPI") calculations[8] that are not directly comparable to the commonly observed public equity time weighted

[7] https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/dol-transparent-401k-fees-fact-sheet.pdf

[8] https://blogs.cfainstitute.org/investor/2024/11/08/the-tyranny-of-irr-a-reality-check-on-private-market-returns/

returns, obfuscating the comparisons among the various investment alternatives (e.g., Phalippou, 2009; McKinsey & Co, 2004).

How will performance and return information be presented to plan participants?
Large corporate Defined Benefit plans or public pension plans often have the staff and expertise to evaluate the performance, but it is unlikely that in individual plan participant would be capable of analysing and comparing performance across public and private equities. For example, a 15% IRR reported by a private equity fund is not necessarily equivalent to a 15%-time weighted return.

Further, at the fund level, many GPs employ financing arrangements that can augment returns while altering the LPs risk profile. GP's may use subscription lines of credit to fund capital calls, effectively borrowing against future capital calls from LPs. This can boost the IRR but ultimately lead to lower dollar returns as interest is paid to the lender. NAV financing is also often employed by borrowing at the fund level against the NAV of the entire fund portfolio. This increases risk as it adds leverage at the fund level (in addition to the leverage at the portfolio company level), accelerates distributions to LPs to improve IRR, while adding risk. There are many such complexities within private equity vehicles that challenge even sophisticated institutional investors. We think it will be impossible for the individual 401(k) holder to fully understand the return/risk characteristics of their investments.

Benchmarks
ERISA requires that historical return and benchmark information is provided to the plan participants. Specifically, 1-, 5-, and 10-year return and benchmark data are to be provided for fund managers.

What will the returns be benchmarked against? Listed equities benchmarks are typically comprised of indices made up of companies (i.e. S&P 500). We suggest employing the same approach in private equities by using an index made up of private companies, with clear disclosures surrounding methodology, pricing, and construction. Other benchmarks employed, including contributed fund manager benchmarks suffer from many issues including survivorship bias, lack of robustness (too few funds/managers to be meaningful) and mixing the performance of the underlying private equities market with manager specific performance. We note that the listed equities benchmarks do not include fund manager benchmarks, but rather, indices comprised of individual companies. This has the potential to be a source of confusion for the prospective investor and may misrepresent the true performance of the private equities market.

Examples of private equities and infrastructure equities indices are the private2000®[9] and the infra300®, respectively, which are constructed with underlying companies and price monthly.

[9] https://sipametrics.com/indices/private-market-indices/indices-benchmarks/

Fees

The fees in private asset are significantly higher than those observed in mutual funds, ETFs and other funds focused on listed assets. This presents risk to the fiduciary and impacts net returns to the plan participant.

- Management Fees
    - Management fees in private equity funds often range from 1.5-2% per annum based on committed capital, stepping down over the life of the fund as capital is deployed. If 401(k) defined contribution plans access private equity via fund of funds, there will be an additional fee layer at the fund of fund manager level. These management fees are well above what is observed in mutual funds or ETFs.
- Carried Interest
    - Carried interest is a performance fee associated with most private equity funds and typically is 20% of returns over a specified hurdle rate, usually 8%. This can add meaningfully to the overall fees paid by investors in the fund and has the impact of reducing net returns.

Outside of the management fees and carried interest, there are often company monitoring fees and transaction fees. Sometimes the transaction fees are paid to other entities within the GP. There needs to be disclosure on how these fees are offset against management fees.

Plan participants should be presented with gross and net IRR information, including detailed examples of calculations so that they fully understand the impact of the various fees on net returns.

Limits/Caps

We note that the SEC limits ETFs to holding 15% of fund assets in illiquid investments. We recommend that there be a hard cap within asset allocation funds to investing in private assets.

Liquidity

Individual plan participants are entitled to liquidity under ERISA. Many employees change jobs and have the right to either transfer or liquidate their DC plan. With listed assets or funds, this does not present a problem. However, private equity vehicles tend to be long term structures (10-12 years) that do not permit redemption. Some Evergreen products allow for limited liquidity but usually limited to 5% per quarter. Further, the Evergreen products are subject to the same liquidity risk, as the underlying funds they invest in are closed-end lockup funds.

ERISA Compliance – 25% Rule

According to ERISA, if a plan or plans under the purview of ERISA constitute 25% of the assets of an investment manager, the investment manager would be subject to ERISA. This is something that all fund managers would want to avoid.

Evergreen Funds Conflict of Interest

Many large alternative asset fund managers offer Evergreen products to the wealth and retail channel. Often these products invest across various funds and asset classes within that manager. For example, a large alternative asset manager may use the evergreen fund to invest across its private equity, infrastructure, private credit, and secondary funds. There is a potential conflict of interest if these products reach the 401(k) market as they usually are captive to one fund manager. That is to say, the investments would all be made to funds managed by the same manager, rather than diversifying across unrelated managers and strategies.

Conclusion

As we have demonstrated in this letter, there are numerous considerations for the committee to evaluate regarding the inclusion of illiquid private assets within 401(k) and other retirement plans. The private equity industry practices across multiple dimensions need to evolve substantially to be suitable for the individual plan participant. Further, current practices may expose the fiduciary to risk given the major differences between private equity and listed market offerings and how these are presented to plan participants.

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