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# Private Equity In 401(k)s: Is It Right For You?

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The Department of Labor announced on June 3rd that retail 401(k)s and other defined contribution plans would now be able to invest in private equity funds as a part of a diversified asset allocation fund, such as a target-date fund. The ruling allows for the plan fiduciary to allocate assets to a private equity component, but not a direct investment in the private equity fund at this time. Direct investments into private equity funds are typically reserved for affluent individuals or institutional firms, but this ruling opens the door for the average investor to an investment option that was not previously available. That said, just because an option is now available, doesn't necessarily mean that it's right for you. Let's take a deeper look into this alternative investment opportunity for investors.

Private equity funds seek to invest in a variety of businesses, both public and private, with the goal of providing outsized returns for their accredited investors over a long-term time horizon. These private equity funds often play the role of a financier or broker for their underlying business investments, and portfolio manager for clients who provide the firm capital for these investments. There are plenty of considerations when investing into a private equity fund, but we will focus on cost vs performance and transparency.

The fee structure for these firms may vary, but the industry standard that is often quoted has been a management fee of 2% annually and 20% of gross profits upon the sale of a company. An average fee of 2% is fairly costly, but you are paying for the best and the brightest to beat the market….right? Not necessarily, according to a State Street Private Equity Index study as of June 2019, US buyout funds returned nearly 15.5% while the public market equivalent returns of the S&P 500 came in at 15.3%. Add in the annual fees of around 2% each year and you are underperforming the market. On a 30-year time horizon, those buyout funds have seen a return of 13.1% vs 8.1% in the public market equivalent S&P 500, but many defined contribution plan participants don't have the patience or luxury of a 30-year time horizon to see their investment pan out.

As a component of a target date fund, diversification into an alternative investment such as a private equity fund may not be a bad idea. The problem is, what are you investing in? Private equity firms can invest in dozens of companies both private and public so it can be difficult to value these firms on a daily basis. The Department of Labor themselves said that fiduciaries must consider the adequacy of disclosures to plan participants and whether or not they are provided enough information to make an informed investment decision. They also make it very clear that the fund fiduciaries must have the skill to evaluate and monitor private equity instruments. Do plans want to risk that ERISA liability?

Not that it can't be done, as private equity investments have been used by defined benefit pension plans well before this ruling. The only difference is that a defined pension plan is now available in

DC  employer's contribution whereas the defined contribution comes from the employee's own pocket. The rub here is that company plan providers, who have more time and resources to dedicate themselves to vetting investment options, were on the hook for private equity investments, but now employees have to be cognizant of these inherent risks now that the option is available in their 401(k). To protect these investors, plan providers, which are also fiduciaries, must be ready to deal with increased scrutiny that comes with providing this alternative investment choice. That said, it remains to be seen how quickly, and willing, employers will be to offer alternative private equity options in their plans.

Private equity can be a solid diversifier for investors who have a strong sense of trust, long-term time horizon, and are willing to take on risk. For more conservative investors, you may find that this investment vehicle isn't right for you, and that's okay! Before looking into private equity options, make sure to consult with a fiduciary investment advisor to get a second opinion on if that vehicle is right for you.