The recent running of the Kentucky Derby marks the time of year of horse racing's prestigious Triple Crown and everything that goes along with it. Temperate spring weather, increasingly beautiful spring foliage, ostentatious hats, parties, and of course, the impressive physical prowess of the horses and the jockeys are all part of the season. It is also a reminder of another race that has been going on, albeit with considerably less pageantry: The race to fund pension plans. This is a different kind of race because it is ongoing and because there aren't distinct winners. There definitely are losers, however. It is also a race that has driven considerable interest in risky assets such as stocks and private equity. In a sense, investors are accustomed to racing because it is something of a race to fund a retirement before it happens. The reality that many people wait too long to even start the race, and often don't contribute enough money once they do start, only highlights the inherent challenges of the exercise. There is yet another factor in the retirement equation that many investors have not bargained for though: The race has gotten harder over time due to low interest rates. This makes it even harder for investors to reach their retirement objectives and has created incentives for investors to increase risk. The•*Financial Times*•reported on how the process started over ten years ago in Japan, where the demographic challenges are even more urgent:

> *"Banks today offer only token interest rates of 0.1?0.45 per cent and 'it is necessary to make money work harder', says Tomoo Sumida, senior economist at Nomura Asset Management. 'The baby-boomers will live for 20 years after they retire and there is no way they can support themselves without investing,' says Mr Hirakawa at UBS'."*

The report confirmed that "the search for higher returns has begun" with cash and bank deposits declining as a share of overall household financial assets and stocks and other investments increasing share. While the search for higher returns is understandable, it often belies the important consideration of risk. Financial assets, after all, are not utilities that consistently provide certain returns. While it is generally true that riskier assets produce higher returns than less risky assets over very long periods of time, they can also underperform for periods easily stretching to ten to twenty or more years. For many investors with comparable investment horizons, such as retirees and those nearing retirement, the historical average long-term returns of financial assets obscure the risk of falling short of their goals. A better gauge for determining expected returns for stocks over a ten- to twenty-year investment horizon is to infer the returns implied by current prices and expected cash flows. John Hussman•regularly performs this exercise and recently concluded that stock valuations "offer investors among the most offensive investment prospects in financial history." In his analysis, he also highlights an important difference between now and the tech boom in 2000 when valuations were also exceptionally high:

> *"An important aspect of current valuation extremes is that they are far broader than what was observed even at the 2000 market peak ... Strikingly, the current multiple [median price/revenue ratio of S&P 500 component stocks) is far beyond what was observed at the 2000 peak. With the exception of stocks in the very highest valuation*

decile, every other decile is more overvalued today than it was at the 2000 market peak."

In other words, not only does investing in stocks provide the bleak prospect of low to negative returns over the next several years, but unlike in 2000 when only a few stocks were significantly overvalued, now almost everything is overvalued so there is nowhere to hide. The bottom line is that the chances of hitting retirement goals by searching for higher returns in stocks is extremely low. The conditions of having under-saved for impending expenses while also confronting an interest rate environment that is adverse to accumulating wealth is one that is also starting to hit pension funds in the US hard. Even though such funds are typically managed by professional investors who can carefully evaluate risk, the reflex reaction of these institutional investors to search for higher returns has been extremely similar. The only real difference is that the search for higher returns by institutional investors is even more vigorous, which is evidenced by many of them going even further out on the risk curve by increasing allocations to private equity.•*Grants Interest Rate Observer* reports on one of the biggest players in the space in its April 5, 2019 edition:

"'So, if I could give you a one-line exact summary of this entire presentation, it would be: We need private equity, we need more of it and we need it now,' Ben Meng, GIG of the California Public Employees' Retirement System, said at the pension plans' Feb. 19 investment committee. 'So, let's talk about the first question. ***Why do we need private equity? And the answer is very simple, to increase our chance of achieving the seven-percent rate of return****'."*

Grants•describes the decision-making logic:

"What's a fiduciary to do? You can hardly meet a 7% investment hurdle with a 10- year Treasury yielding 2.5%, much less with a 10-year bund yielding negative 0.05%. The same low rates, of course, have decreased the cost of leverage and flattered the size of projected future cash flows?well and good for private equity's cosmetic appeal."

The case for private equity has more than just cosmetic appeal. The environment in which institutional funds make allocation decisions is culturally amenable to the strategy as Rusty Guinn reveals in a piece entitled, "Deals are my art form":

"But if you want to understand, by and large, how big pools of capital make big decisions about how much of their plan will be allocated to private equity, venture capital, private real estate, hedge funds, alternative premia (and everything else), you must focus on the interactions that take place between the CIO office, the consultants and the board. Asset owner boards are dominated by politicians, lawyers and businesspeople. Deal people. People for whom ? like the Donald ? The Deal is their art. Understanding the decision-making process of large pools of capital means understanding the deals! meme."

In the challenging context of relatively high required returns, Guinn illustrates how the proclivity towards deal-making at the highest levels of institutional decision-making manifests itself:

"Consultants and some CIO offices that are targeting higher necessary returns are increasingly anchored to the asset classes that these assumption-driven models like. Why? Because every strategic asset allocation meeting for the last 5 years began, and every strategic asset allocation meeting for the next 10 years will begin with something akin to the following: Well, to meet our real return targets with these assumptions, we?d have to allocate 100% to either private equity or emerging markets! Ha ha ha! Of course, doing that would be imprudent, but? Yeah, ?but.? Because by this time, the

conversation has been framed. And in hundreds of rooms filled with truly smart, truly ethical, truly honest and well-meaning people infected with the deals! meme, private assets will not just feel like the understandable and straightforward strategy, they will look like the right and sensible and prudent thing to do as fiduciaries."

While the high level of interest in private equity can be explained by the deal! meme and its cultural amenability, something else is going on to compel institutional investors to overcome its obvious shortcomings. And the critiques of private equity are widespread, harsh, and compelling. For example, *Grants*•quotes Daniel Rasmussen, who has written extensively on the subject. He asks, "Why would you, in aggregate, buy disproportionately levered companies at disproportionately high prices in a very late stage of a bull market?" He answers, "That doesn't seem like a very good idea. But when you call it private equity and take away the mark to market, suddenly it is a thing that everybody wants." James S. Chanos, founder and managing partner of Kynikos Associates, L.P., also speaks out against private equity in *Grants.*•He thinks the value proposition of private equity will start undergoing the same kind of scrutiny that has been applied to hedge funds the last five to ten years. Specifically, Chanos thinks asset allocators will start to question why they are increasing allocations to an asset class *"that over the long run seems to be matching at best public-market indexes with reduced liquidity, higher fees after a monstrous rise in corporate valuations and a once-in-a-generation drop in interest rates."* AQR Capital Management also recently published its own evaluation of private equity and also found the approach lacking in merit. The AQR report assesses,•"Our estimates [of returns on private equity] display a decreasing trend over time, which does not seem to have slowed the institutional demand for private equity." They too suspect that the "return-smoothing properties of illiquid assets in general" may be part of the appeal to certain investors. John Dizard summarizes the value proposition of private equity in the *Financial Times:*

"If stock volatility is scary, lever up the portfolio with borrowed money, stop marking to market, and call it 'private equity'. Problem solved."

Whether it is individual investors increasing exposure to stocks or institutional investors increasing exposure to private equity, it is clear that the search for higher returns has evolved into a heated competition. The competition though, is based on a fallacy. When Guinn describes the pension conversation as being "framed", he means that it is unduly and artificially constrained in its consideration of possible solutions. Ben Inker from GMO elaborates on exactly this scenario by noting, "Risk is not merely a function of the volatility of the investment portfolio but also of the relationships between the investment portfolio, the liability, and the nonportfolio assets." While changes can be made to the liability variable by renegotiating retirement benefits, Inker focuses on the importance of considering contributions:

"But most pension fund managers tend to stop there, failing to fully take into account the assets outside of the portfolio that are relevant to the overall problem ? the potential of the fund sponsor to make additional contributions to the pension portfolio when needed."

The appropriate allocation of financial assets to a retirement plan depends partly on the expected returns of those assets, but only partly. It also depends on the level of retirement benefits desired and on contributions (and asset volatility and investment horizon). As a result, undue focus on returns is a false choice. The bad news is that many institutional pension plans have little or no ability to reduce benefits or increase contributions. The good news is that individuals normally have a great deal more flexibility to manage through a low return environment.

Just how little flexibility many institutions have in regard to pension funding is illuminating.•*Grants* captures this with the testimony by James P. McNaughton, assistant professor of management at the Kellogg School of Management, to a House of Representatives subcommittee dealing with the pensions crisis:

> ***?While approximately 60% of multiemployer plans are currently certified in the green zone in recent PBGC reports, that number would drop to around 7% if discount rates were based on current corporate bond yields. In other words, on an annuity purchase basis, only 7% of plans have 80% of assets needed to purchase annuities for their participants.?•***

This describes fairly clearly the predicament that pension fund managers are in. Only 7% of multiemployer plans are funded well enough to honor their promises with a very high likelihood of success. All the others are stuck between a rock and hard place: They can either try to renegotiate the promises by reducing pension benefits (which is difficult politically) or they can increase allocations to riskier assets and significantly increase the risk of losses. Such incredibly poor funding levels reveal a number of important things about the investment landscape. For one, the response by many institutions to chase returns, increase leverage, and obscure volatility has all the makings of desperation. As *Grants* points out, "If you expect big, perhaps unreasonable, things from your p.e. allocation, it's because you need them. You want to believe." It sounds more like someone down on their luck going to a loan shark than it does a high-quality decision-making process. As it happens, some private equity funds even seem to be playing the role of loan shark. The *Financial Times* reports that despite the increasingly problematic value proposition of private equity and the pressure on fees almost everywhere, some funds are actually *raising* their performance fees in what appears to be a form of surge pricing:

> *"Investors seem to have a weak hand when it comes to negotiating terms. Large institutions ? under pressure to seek yield in a low interest rate environment ? do not complain about terms because they fear being cut back or being excluded from a popular fund."*

This raises an interesting possibility that also reflects on today's investment environment. Typically, large institutional investors have been considered "smart money". As a result, other investors look to them for information content, clamoring to benefit from whatever they are doing. When institutional investors go progressively further out on the risk spectrum, it sends a signal that that might be a "smart" thing to do. But what if the "smart money" isn't so smart anymore? It's not to suggest that the people running institutional funds are any less intelligent but rather that they are more desperate. They aren't chasing returns so much because they think it is a great investment decision but because they believe they have to do something, and they don't have a choice. Insofar as this is the case, their search for higher returns signals an increasingly desperate race that is likely to end badly. It is one that should be avoided, not emulated. John Dizard sums it up well, barely containing his revulsion:

> *"Prof Siegel and his followers have been telling people what they want to hear, though he no doubt believes it himself.* ***I believe the collective opinions, policies and investment decisions based on the high equity return cult will lead to social, economic and political disaster.****"*

This suggests another important thing about the investment landscape. The pension funding crisis is a very big and interconnected issue that will affect everyone. There is already talk of legislation to rescue multiemployer pension plans that fail. Any effort to do so will set a dangerous precedent of redistributing tax income to bail out mismanaged plans. John Mauldin•expects there to be pain and describes how it will likely affect incomes: "As with the federal debt, some portion of this unfunded pension debt is going to get liquidated in some manner. Any way we do it will hurt either the pensioners or taxpayers." In a similar sense,•*Grants*•describes (in its August 10, 2018 letter) how the pension funding crisis will likely affect risk assets:

> *"The fancy prices that the p.e. firms pay for listed companies (or the neglected and undermanaged subsidiaries thereof) contribute to the lift in public-market equity averages. The returns that p.e. has earned, and?it is hoped?will earn again, support an immense structure of debt. Unwarranted expectations concerning p.e. returns raise false hopes for deeply underfunded pension funds. In short, private equity is everybody's business."*

So, this season for horse racing serves as a useful reminder that the race to fund pension plans is on but promises to be a much uglier affair. As such, it also serves as a reminder for investors to carefully align the risks of their assets with their investment horizons. Otherwise, they may end up chasing returns in a thankless race.