

# The Return to Pension Funds' Direct Investments in Private Equity:

## New Evidence on the Private Equity Premium Puzzle

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### Abstract

This paper uses a novel dataset to analyze the return to direct investments in private firms. We have two key findings. First, direct investments in private firms have underperformed public equity by 392 basis points *per annum* under conservative risk adjustments. Second, initial mispricing, due to over-optimism or misperceived risk, and subsequent low capital gains seem to explain the gap in returns to private equity. Overall, these findings complement the finding of Moskowitz and Vissing-Jørgensen (2002) of low returns on entrepreneurial investments and provide new insight into the existence of what they call the *private equity premium puzzle*: Even professional investors with well-diversified portfolios like pension funds seem to get a poor risk-return tradeoff from investing directly in private equity.

JEL classification: G23; G24.

Keywords: private equity; pension funds; direct investments.

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# 1 Introduction

Asset pricing and investment theory have long studied the risk and return characteristics of public equity. As pointed out by Moskowitz and Vissing-Jørgensen (2002), the private equity market is as important as the public equity market in terms of size and growth. Despite this finding, little is known about the risk-return tradeoff in private equity investments.

A few recent papers have provided insights on the return to private equity funds. Although private equity funds have high relative performance gross of fees (Cochrane (2005)), the relative performance net of fees appears low (Kaplan and Schoar (2005); Phalippou and Gottschalg (2007)). This result suggests that the total rent captured by private equity funds is probably excessive, and raises questions about why investors allocate large amounts to this asset class given its historically poor performance.

This paper adds to this line of work by considering an alternative way to obtain exposure to private equity: through direct investments in private firms. From the existing literature we know relatively little about the scope and merits of this alternative strategy.<sup>1</sup> This is primarily because of difficulties in obtaining data, as noted by Fenn, Liang, and Prowse (1995), but partly because prior literature implicitly assumes that direct private equity investments do not occur—at least not in the United States, where the private equity market is highly developed. This assumption is invalid—particularly in a historical perspective. In fact, institutional investors appear to invest directly in private firms in most developed countries. Recent coverage in the business media reports evidence of significant direct investment by some of the largest institutional investors in Australia, Canada, Germany, the Netherlands, Switzerland, Turkey,

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<sup>1</sup>There are few studies of pension funds' direct investments in private equity. The main exception is Nielsen (2006), who shows that institutional investors mitigate the risk of minority expropriation by investing in private firms with good governance mechanisms.

United Kingdom, and the United States.<sup>2</sup> In addition, there is substantial anecdotal evidence showing that public pension funds in the United States (at least historically) have invested substantial funds directly in private firms.<sup>3</sup> In fact, Fenn, Liang and Prowse (1995) estimate that around 20 percent of U.S. institutional investments in private equity were *direct* investments in the 1990s. Moreover, a recent survey of institutional investors' private equity allocations in the Netherlands by Cumming and Johan (2007) shows that 20 percent of the average private equity portfolio in 2005 was directly held.<sup>4</sup> Although this alternative investment channel appears to be quite common, we know relatively little about it. This paper attempts to fill the gap by focusing on pension funds, which are known to be the largest contributor to private equity funds (Gompers and Lerner (2000)).

Our objective of examining the return to pension funds' direct investments and the source of these returns poses a significant challenge as data are generally not available. Pension funds rarely provide detailed insights into the return within asset classes, and in most countries, private firms are not required to provide information to the general public. This paper rises to this challenge by exploiting unique data on Danish pension funds' investments in private equity.

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<sup>2</sup>See Financial Times, November 7, 2005, "Pension Funds Bypass Private Equity Houses": FT Mandate, February 2006 Issue, "Boost for Private Route"; and the New York Times, October 8, 2006, "A New Pension Game."

<sup>3</sup>To validate this claim, I searched LexisNexis for newspaper articles on direct investments by pension funds in the United States: CalPers have historically allocated about 2 percent of their assets (\$ 1.6 billion) directly into private equity, although their current strategy relies on funds. TIAARCE has historically managed a direct investment program of similar magnitude. State Retirement Systems and Public Pension Funds in Alabama, California, Connecticut, Georgia, Kansas, New Jersey, New York, Missouri, Pennsylvania, Rhodes Island, and Virginia, among others, have all promoted in-state investment programs varying in size from 2 to 5 percent of total investment assets, or three-digit million dollar figures. These programs allocate investments to private firms within the state. Similarly, State Pension Funds in Oregon and Washington manage significant co-investment programs that invest directly in private firms alongside a private equity fund. In addition, a recent report by Technology Alliance (2007) provides an excellent catalogue of current state programs for venture capital investments. Currently, at least a handful of states have programs through which they take direct equity positions in private companies. Interestingly, these direct investment programs have received negative press in the past due to some high-profile failures, which have resulted in at least one state, Kansas, prohibiting direct investments.

<sup>4</sup>Interestingly, Cumming and Johan (2007) also show that Dutch institutional investors plan to hold 18 percent of the private equity portfolio directly in the future.

The advantage of this dataset is twofold. First, the Danish Financial Statement Act has, since 1995, obliged Danish pension funds to disclose the returns on asset classes. This creates a novel opportunity to estimate the *net* return to direct investments in private equity. We find a large negative and statistically significant abnormal return to private equity. Our most conservative risk-adjusted estimate shows that private equity has underperformed by 392 basis points *per annum*. This economically and statistically significant underperformance suggests that direct investment in private equity is a poor investment alternative. Moreover, this result complements the finding of Moskowitz and Vissing-Jørgensen (2002) of low returns on entrepreneurial investments and provides new insight into the existence of what they call the *private equity premium puzzle*. Our results show that pension funds with well-diversified portfolios also seem to accept a poor risk-return trade-off when investing in private equity.

Second, the novelty of our data allows us to examine potential explanations to this puzzle. The existing literature has listed high-risk tolerance; preference for risk; pecuniary or non-pecuniary benefits; over-optimism; misperceived risk; and politically motivated preferences as possible explanations for why investors choose private equity. Whereas these potential explanations have been discussed in the literature, they have not, to our knowledge, been subject to rigorous scrutiny.<sup>5</sup> This paper fills this gap. From pension funds' annual reports, we identify their portfolios of privately held firms. We link these to a unique dataset that comprises *all* privately held firms in Denmark. We thereby obtain data that allow us to test potential explanations to the puzzle.

Our analysis of potential explanations begins by excluding the possibility that pension funds have a high-risk tolerance, as prior research has documented that pension funds are prudent

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<sup>5</sup>This is primarily due to the difficulty of obtaining firm-level data on private equity, as noted by Fenn, Liang, and Prowse (1997).

investors (Del Guercio (1996); Gompers and Metrick (2001)). Further, we find no evidence to suggest that pension fund investments in private equity have been driven by self-interested managers, as managers are rarely appointed to the boards of portfolio companies. We thereby reject, using a very direct measure, the theory that pension fund investments to any great extent are driven by pecuniary or non-pecuniary benefits accruing to fund managers. We also reject anecdotal evidence suggesting that investments are politically motivated by showing that having a politically influenced board has no effect on the return to private equity. Finally, we distinguish whether the poor return is caused by poor economic performance or by low capital gains. We find that the portfolio companies' earnings performance is identical to a matched sample of non-portfolio companies. Thus, the poor return must be caused by low capital gains. This finding points to initial mispricing, resulting from over-optimism or misperceived risk, as the likely explanation for the poor risk-return tradeoff.

Overall, our findings suggest that the private equity premium puzzle also extends to professional investors with well-diversified portfolios like pension funds. Although it is entirely possible that these findings are specific to pension funds in Denmark, the results seem consistent with anecdotal evidence from other countries.<sup>6</sup> Given the apparent cross-country prevalence of direct investments, it is worthwhile to understand whether the private equity premium puzzle extends to professional investors as well. In that respect, this paper exploits novel data to provide an out-of-sample test that allow us to gain new evidence on the private equity premium puzzle.

This paper proceeds as follows: In the next section we survey the literature that estimates the return to private equity investments. Section 3 describes the data. Section 4 analyzes the

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<sup>6</sup>Lerner, Schoar, and Wongsunwai (2007), for instance, cite casual evidence of direct investments being abandoned by pension funds in the United States as a result of poor performance. A more concrete example is the decision by policymakers in Kansas to ban direct investments as a result of poor historic performance.

risk-return tradeoff of the pension funds' private equity investments. In Section 5, we scrutinize potential sources of the poor return and provide new insight into the private equity premium puzzle. Section 6 offers some concluding remarks.

## **2 A survey of the literature estimating return to private equity investments**

The literature estimating the return to private equity investments has primarily employed two sources of data. One has used surveys of households and consumer finance, whereas the other has used data on private equity funds from specialized agencies, such as Venture Economics. As a result, the first approach estimates the return to investments by entrepreneurs, whereas the second estimates the return to investments by equity funds with an active management role.

Using survey data on U.S. individuals, Hamilton (2000) compares the wage differential between self-employed and paid employees. He finds that the self-employed earn a significantly smaller stream of future earnings. This finding suggests that entrepreneurs are willing to sacrifice substantial earnings in exchange for non-pecuniary benefits, such as the value of "being your own boss." In a related study, Moskowitz and Vissing-Jørgensen (2002) estimate the return on investments in privately held firms by U.S. households. They find that the return to private equity is no higher than the return to public equity and that entrepreneurial investments are extremely concentrated and poorly diversified. This finding has initiated awareness of the private equity premium puzzle: why do households willingly invest substantial amounts in assets with such a poor risk-return trade-off? The private equity premium puzzle suggests that entrepreneurs receive large non-pecuniary benefits from the ownership of privately held firms; otherwise, they should invest in the public equity market.

In the literature, entrepreneurial financing has been nearly synonymous with venture capital.<sup>7</sup> The initial studies of venture capital investments have used data on publicly traded funds to estimate returns. Martin and Petty (1983) provide evidence of a positive excess return to private equity, using a small sample of publicly traded venture funds in the United States., whereas Gompers and Lerner (1997) find evidence of positive excess return for a single publicly traded venture capital group. Using data on the performance of individual venture capital investments, a number of studies have attempted to build a private equity index (Peng (2001), Quigley and Woodward (2003), Woodward and Hall (2003)) or to estimate the return on individual venture capital projects (Cochrane (2005)). As Kaplan and Schoar (2005) point out, these studies are plagued by sample selection bias, as the return can be observed only if there is some sort of transaction involving the investment.<sup>8</sup> To circumvent this potential problem, other studies have focused on the cash-flow stream between private equity funds and their limited partners. Using a large sample of private equity funds between 1970 and 2001, Kaplan and Schoar (2005) find that the return, net of fees, does not exceed the return on public equity. Similarly, Jones and Rhodes-Kropf (2003) examine the effect of idiosyncratic risk on the pricing of private equity investments and find no excess return even though the average fund alpha is positive (but small).

In a recent paper, Phalippou and Gottschalg (2007) suggest that the performance results in Kaplan and Schoar (2005) are significantly biased toward winners. Adjusting for sample selection and writing off the residual value of “living dead” funds, Phalippou and Gottschalg (2007) find significant underperformance for private equity funds. Assuming that the residual value of these funds’ investments is equal to half of that reported is sufficient to reach the

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<sup>7</sup>Denis (2004) provides a comprehensive review of the literature.

<sup>8</sup>Cochrane (2005) addresses this concern by employing a maximum likelihood procedure to estimate the probability of success and finds positive excess returns gross of fees.



conclusion that private equity funds, on average, have underperformed the Standard & Poor's 500 index by as much as 3.3 percentage points per annum.

Ljungqvist and Richardson (2003) argue that prior studies do not take into account the timing of the contributions to the funds and the risk profile of the portfolio companies. Using data from a large anonymous institutional investor, they find that it takes 6 years for funds to invest more than 90 percent of committed capital, and 8 years before the internal rate of return becomes positive. Taking these measurement problems into account, Ljungqvist and Richardson (2003) find evidence of a positive risk-adjusted return to private equity investments. While this finding contrasts with the results of the prior literature, their study suffers from a relatively modest sample size. The limited sample size is of particular concern if there is persistence in fund performance over time (Kaplan and Schoar (2005); Phalippou and Gottschalg (2007)) or large heterogeneity in the performance of investor classes (Lerner, Schoar, and Wongsunwai (2007)).

Finally, Cumming and Waltz (2008) document significant systematic biases in the voluntary reporting of fund performance; they find that these biases depend on the degree of accounting conservatism and the strength of the legal environment in a country. This finding raises concern about the use of data that are voluntarily reported by private equity funds in the absence of mandatory reporting and disclosure rules.

A survey of the literature highlights three major empirical challenges: first, sample selection bias is introduced as a result of the fact that accurate returns are observable only when an exit takes place. Second, as survey and fund level data rarely give access to actual cash flows, it is difficult to account for the timing of investments and the accuracy of reported returns. Third, returns are confounded by management and advisory roles of investors. The survey

also highlights the existence of an apparent private equity premium puzzle: why do investors seemingly accept the poor risk-return tradeoff offered by private equity?

This paper seeks to uncover new evidence relating to this puzzle by scrutinizing its potential explanations. Moreover, as prior literature has focused (for data reasons) on entrepreneurial households and private equity funds, the current paper provides the first estimate of the return to investments in private equity by investors without an active management role. In addition, this study uses a new data source that is likely to be less exposed to the measurement and data problems of prior studies:<sup>9</sup> Returns to pension funds' private equity investments are reported and externally audited according to government guidelines in the Financial Statement Act, which induces fairly coherent reporting practices across funds and prevents backfilling. Finally, our data include detailed holdings information, which allows us to risk-adjust the private equity returns rather than assuming a market model with a beta equal to one (Moskowitz and Vissing-Jørgensen (2002); Kaplan and Schoar (2005); Phalippou and Gottschalg (2007); Lerner, Schoar, and Wongsunwai (2007), among others). Thus, a major contribution of this paper is to provide out-of-sample evidence of the existence of a private equity premium puzzle using data that are less plagued by the empirical challenges faced by prior literature.

One immediate limitation to the interpretation of our results is that they might be sample specific, as Lerner, Schoar, and Wongsunwai (2007) have documented large heterogeneity in the performance of investor classes. Thus, although we present additional evidence consistent with the existence of a (general) private equity premium puzzle, our analysis is insufficient to conclude that private equity as an asset class is dominated by other asset classes. Despite this

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<sup>9</sup>The use of data from surveys of households could create a negative bias with regard to the estimated return to private equity, since consumption within the firm is likely to be unreported. Similarly, data on private equity funds can suffer from survivorship bias, sample selection problems, and backfilling. To circumvent these potential measurement problems, we make use of a ten-year panel of returns to private equity investments by the *entire population* of pension funds in Denmark.

limitation, the paper does provide complementary evidence for the existence of a private equity premium puzzle. In particular, the paper provides the first estimate of the return to private equity investors who are without an active management role. Moreover, the novelty of the data provides an opportunity to perform an out-of-sample test of the disappointing return to private equity documented in prior literature.

### 3 Data on pension funds' investments in private equity

#### 3.1 Data collection

The Danish Financial Statements Act has, since its enactment in 1995, obliged Danish pension funds to state their portfolio return on individual asset classes. The act specifies six categories of assets: real estate, subsidiaries, equity, bonds, loans, and other; it also further partitions equity into public and private, and firms into domestic and foreign, subcategories. For each asset class (as well as for subcategories) pension funds must report the market value (primo and ultimo) as well as the return. The act specifies that the yearly return,  $r_T$ , should be calculated using a time- and value-weighted formula:

$$r_T = \prod_{t=1}^T (1 + r_t) - 1$$

where  $r_t$ , the value-weighted return in sub-period  $t$  within year  $T$ , is given by

$$r_t = \frac{MV_t - MV_{t-1} - CF_{t-1,t}}{MV_{t-1} + WCF_{t-1,t}}$$

and  $MV_t$  and  $MV_{t-1}$  are the market values of the asset class at time  $t$  and  $t - 1$ , respectively.  $CF_{t-1,t}$  is net cash flow within sub-period  $t$ , and  $W$  is the relative number of days each cash flow has been included in the portfolio. If multiple cash flows occur within the period, each cash flow is weighted with its own relative weight. The length of each time-period is, in principle,

determined by flows into and out of the portfolio of the particular asset. However, it is customary among pension funds to use monthly sub-periods.

The reported returns, therefore, are not biased by new investments within the year and are comparable across time and asset classes. Consequently, these returns are not subject to the criticism of Ljungqvist and Richardson (2003), since they take the timing of the investments and cash flows into account.

From exhibits in the pension funds' annual reports, we manually collect the market value of investments in public and private equity and the return on these investments for each year from 1995 to 2004.<sup>10</sup> All numbers are reported at the portfolio level, and thus, returns are aggregate.

In addition, the act obliges pension funds to provide a list in their annual reports of any investments in firms where either their cash flow or voting stake exceed 5 percent. Given that ownership of privately held firms is extremely concentrated, this list is likely to include all portfolio investments that have generated the private equity returns.<sup>11</sup> We link this data to the *population* of privately held corporations in Denmark. These data are from the firms' filing of annual account statements with the Danish Ministry of Economic and Business Affairs, which all limited liability companies in Denmark are obliged to do by law. These data includes items from income statements and balance sheets as well as the identities of the CEOs and board members. These detailed data enable us to investigate the sources of the private equity returns.

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<sup>10</sup>Throughout this paper we only use domestic investments and refer to them as public and private equity. We have chosen to exclude foreign private equity investments, since these firms are not included in our firm-level dataset. Furthermore, most foreign private equity investments by Danish pension funds took place toward the very end of the sample period.

<sup>11</sup>The within-sample mean (median) investment by individual pension funds measured by share of cash flow is 17.9 (12.5) percent, well above the 5 percent reporting cut-off level.

### 3.2 Assessment of market value of private equity

An essential part of understanding the performance of private equity relates to the use of market valuations in the reported return. Whereas market values for publicly held firms are easily observed, the “market” values of privately held firms are only observable when there is some sort of “exit”.<sup>12</sup> Thus, if no exit occurs, the market value is the pension funds’ estimate of intrinsic value. Although the Financial Statement Act requires these market values to be adjustment whenever changes are “permanent,” there is still substantial discretion left to pension fund managers. If pension fund managers are conservative in their assessment of market values, this introduces a potential bias to the reported return. The observed returns to private equity are, therefore, a mix of current and stale returns, which is a problem shared with the prior literature.<sup>13</sup> Most of the pre-existing studies attempt to overcome this problem by evaluating the return to mature investments, as valuations are typically conservative in early years. One drawback of this approach is that one might introduce sample selection bias if unsuccessful investments disappear from the sample or, alternatively, overestimate the return, if funds, as documented by Phalippou and Gottschalg (2007), do not adjust the market value of living deads.

Our data allow us to use a portfolio approach, as the reported returns cover a ten-year window of portfolio returns. The benefit of this approach is that the potential bias from conservative valuations is likely to net out as the portfolio at any given time will consist of a mix of old and new investments. Figure 1 provides a simple illustration of this effect, focusing on

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<sup>12</sup>In the event that a privately held firm goes public, the IPO price will be recorded as the exit price for the private equity investment, and as the entry price for the “new” public equity investment. Thus, any gain from going public will rightfully count as a private equity return.

<sup>13</sup>Gompers and Lerner (2001) underscore that venture capitalists often refrain from marking portfolio company values to market to present a conservative assessment of the portfolio valuation. Similarly, Woodward (2004, p. 11) emphasizes that the return to venture capital funds are a mix of current and stale returns; *Each quarter, the general partners in the VC fund report the value of each company in which the fund invests to the limited partners. These values are nearly always based on each company’s most recent round of financing.*

three underlying types of investments during the window from 1995 to 2005; “OLD” investments undertaken pre-window and unexited before 1995; “WINDOW” investments undertaken and exited within the return window; and “NEW” investments undertaken within the window and unexited ultimo 2004. If pension funds are conservative in their valuation, the average reported returns within the window will be: positively biased for OLD investments; unbiased for WINDOW investments; and negatively biased for NEW investments. However, as the observed window from 1995 to 2004 covers both OLD and NEW investments, it follows that conservativeness can only bias the average portfolio return if either the investments in private equity increased significantly over the return window (i.e., the market value of NEW is significantly larger than for OLD investments), or pension funds became more conservative during the period (i.e., negative bias for NEW investments is numerically larger than the positive bias resulting from OLD investments). Moreover, as the length of the return window increases, the ratio of unbiased WINDOW investments to total investment increases, thereby reducing the potential bias from the two sources mentioned above.

A priori, there is no reason to suspect that pension funds should have become more conservative during the evaluation period. It follows from the argument above, therefore, that the average portfolio return will be unbiased if pension funds did not drastically increase their investments in private equity toward the end of the window. Thus, by examining the development of the portfolio, we can ascertain that the results are not an artifact of conservative valuations without introducing potential selection bias to the evaluation of returns.

### **3.3 Descriptive statistics**

Table 1 shows descriptive statistics on the number and the size of pension funds in Denmark from 1995 to 2004. Market values of assets are indexed to 2000 Danish kroner. The population

of pension funds in Denmark in the sample period has consisted of between 54 and 60 funds.<sup>14</sup>

In 1995 the average pension fund had Danish kroner (DKR) 12.5 billion, or Euro (EUR) 1.7 billion, in assets, increasing by 2004 to DKR 22.8, or EUR 3.1 billion.<sup>15</sup> Funds with investments in the particular type of equity, had on average DKR 1.8 billion (EUR 240 million) invested in firms quoted on the Copenhagen Stock Exchange and DKR 210.8 (EUR 28.3) million in privately held firms in 1995. By 2004 this had risen to DKR 1.7 billion (EUR 231.9 million) and DKR 240.4 (EUR 32.3) million, respectively. In 2004, the total investment assets of pension funds in Denmark equaled DKR 1,230 (EUR 165) billion—equivalent to 92 percent of GDP. The total market value of investments in public and private equity was DKR 82.9 (EUR 11.1) billion and DKR 10.3 (EUR 1.4) billion, respectively.

Table 1 further shows the number of pension funds with investments in private equity from 1995 to 2004. The number of pension funds with private equity investments has remained fairly constant, with a slight decrease until 1999 followed by a larger increase until 2004. The pension funds' private equity investments' average share of total domestic equity investments decreased from 15.9 percent in 1995 to 8.7 percent in 2000, but then increased to 26.5 percent in 2004. Table 1 also reports the average number of private equity investments reported in pension funds' annual reports. Throughout this paper we will refer to these as *portfolio investments*. The average number of reported portfolio investments per pension fund with private equity investments is around 10. However, as the reported investments include both direct investments and indirect investments through funds, the total number of portfolio companies is higher. More important, the size and composition of the pension funds private equity investments have

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<sup>14</sup>The number of pension funds increased in 1998 and 1999 as a result of the entry of foreign-owned pension funds and the creation of two temporary public pension funds. It decreases subsequently due to mergers of funds.

<sup>15</sup>The exchange rate between Danish Kroner and Euro is fixed at 7.45 Kroner per Euro.

not changed significantly over the sample period. The average market value of the pension funds' private equity investments grew by only 14 percent from 1995 to 2004. As this increase both captures adjustments of the market value of the current portfolio (OLD and WINDOW investments) and net new investments (replacing OLD with NEW investments), the increase to net new investments is capped at 14 percent but is likely to be substantially lower.<sup>16</sup> It follows from the discussion in Section 3.2 that adjustments to the market value of OLD and WINDOW investments limit the conservativeness bias, as only net new investments can potentially bias the reported return. In addition, most of the increase occurred in 1998 and 2000, and by the end of the window the potential net new investments would have been held for 6.5 and 4.5 years, respectively. If pension funds are only conservative in the first years, the potential bias to the return on these potential net new investments is likely to be even smaller. Although we do not know the extent to which pension funds are conservative in their valuation of private firms, these insights allow us to assess the maximum effect of the conservative valuation bias on our results. If pension funds are extremely conservative, they will never adjust the market value of their portfolio and will, thereby, report zero return until they exit the investment. The maximum effect of conservative valuation is capped, therefore, by the weight of the zero-biased return in the reported return. As potential net new investments over the period has a maximum portfolio weight of 12 percent ( $0.14/1.14 = 0.12$ ), these insights allow us to adjust the average reported return to private equity and ascertain that our results are unlikely to be explained by conservative valuations.

Table 2 reports descriptive statistics on the composition of pension funds' private equity

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<sup>16</sup>Net new investments can only increase by 14 percent in the case where pension funds never adjust the market value of the private equity portfolio. If pension funds make small adjustments of market values over time, net new investment is likely to become substantially lower.



portfolios. We identify the private equity funds among the reported portfolio investments and utilize our rich firm-level data to identify each fund's portfolio. When we include fund investments in the pension funds' private equity portfolios, the total number of portfolio companies increases substantially. In 1995, the average pension fund portfolio consisted of 24 companies (12 direct and 12 indirect investments through 1 private equity fund), whereas the median pension fund portfolio included only 13 companies.

Perhaps more interestingly, Table 2 reveals that the bulk of investments by pension funds in Denmark are directly rather than indirectly held through funds. Direct investments are defined as direct ownership in private firms, whereas co-investments are included in indirect investments, as the pension fund often has invested in the same private equity fund. To measure the relative weight placed on direct versus indirect investments, we calculate the share of the book value of assets and book value of equity that are ultimately owned by pension funds.<sup>17</sup> Direct investment's share of private equity portfolios is surprisingly high throughout the period, although the average share of book value of assets (equity) declined from 94 (90) to 79 (76) percent between 1995 and 2004. Direct investments are even more dominant in the median portfolio, where only a small fraction is allocated into indirect investments through funds. Although the reported returns include indirect investments through funds, these account for a trivial fraction of the overall returns. In a robustness check, when we exclude pension funds with more than 10 percent in private equity funds, we find little effect on our results. Thus, the evidence provided in this paper is mainly related to direct investments.

In summary, Danish pension funds have invested substantial funds in privately held firms

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<sup>17</sup>Market values on individual investments are not reported in the data. We therefore rely on book values to assess the total value of the portfolio. We calculate the share of book value of assets (equity) by multiplying the pension fund's share of ownership with each portfolio company's book value of assets (equity). We thereby estimate the relative weights on direct versus indirect investments.

with direct investments. We proceed by evaluating the return on these investments.

## 4 The risk-return tradeoff

As private equity by nature is not publicly traded, the observed returns are partly based on a subjective assessment of market value. The fact that market values of private equity are unobservable induces a lack of synchronicity between “actual” and reported returns. Moreover, as Gompers and Lerner (2001) point out, the use of conservative valuation practices provides a negative bias to the covariance with the market portfolio, which in turn makes private equity investments appear more attractive from a portfolio perspective. Thus, the stale pricing problem makes it difficult to apply the standard techniques to risk-adjust the observed returns.

Because of these obstacles, the majority of papers in prior literature assume a market model with beta equal to one to assess abnormal performance (Moskowitz and Vissing-Jørgensen (2002); Kaplan and Schoar (2005); Phalippou and Gottschalg (2007); Lerner, Schoar, and Wongsunwai (2007), among others). Currently, only three papers attempt to risk-adjust the return on private equity:<sup>18</sup> Woodward (2004) and Jones and Rhodes-Kropf (2004) estimate fund alpha and betas by regressing returns on both contemporaneous and lagged risk factors.<sup>19</sup> In a recent paper, Dreissen, Lin, and Phalippou (2007) show that such an approach might generate large biases in both risk exposure and abnormal performance. To avoid this problem, Dreissen et al. (2007) estimate a factor pricing model by applying GMM to a set of price restrictions and find significantly negative alphas for both venture capital and buyout funds.

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<sup>18</sup>Other studies have attempted to assess the risk by estimating the correlation between private and public equity returns using data that are less affected by the lack of synchronicity: Moskowitz and Vissing-Jørgensen (2002) find a correlation of 0.7 between the book equity return of public and private equity from 1963 to 1999. Similarly, Phalippou and Zollo (2005b) find that the performance of private equity funds co-varies positively with both business cycles and stock market returns.

<sup>19</sup>As the stale pricing problem is equivalent to the problem of measuring risk for thinly traded stocks, Woodward (2004) and Jones and Rhodes-Kropf (2004) apply the Scholes and Williams (1977) technique of including contemporaneous and lagged market returns.

Our time series of private equity returns share the statistical problems mentioned above. However, the novelty of our data allows us to assess the risk of every portfolio company and to subsequently assess the risk at the portfolio level.

#### 4.1 The risk of private equity investments

To open the discussion of risk, we provide descriptive statistics on the total risk of private equity as an asset class. We then document the risk-level of individual pension funds' private equity portfolios, a more relevant measure for pension fund decision-making.

Table 3 reports descriptive statistics on the return to public and private equity investments. The descriptive statistics include the total number of pension funds, the average return, the standard deviation, the 10th, 50th and 90th percentiles of the return across pension funds for both public and private equity. Interestingly, the variation in private equity returns is substantially larger than for public equity in all years. In fact, in all years, the standard deviation on yearly private equity returns is at least *twice* as high as for public equity returns. Moreover, when we (in unreported regressions) estimate the alpha and beta measures of risk using the yearly observations in Table 3, we find a beta of 0.47, whereas alpha is negative and insignificant.<sup>20</sup> Economically, the private equity alpha is quite large (-2.2 percent), even though the short sample period makes it difficult to estimate standard errors with precision.

We proceed by analyzing the risk characteristics of individual pension funds' private equity portfolios, which is more directly related to pension fund decision-making. We do this in two steps: First we estimate the pension funds' private equity portfolio beta using an industry matching approach. Second, following Daniel, Grinblatt, Titman, and Wermers (1997) we characterize the risk by estimating the average corresponding size and book-to-market quintiles of

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<sup>20</sup>Specifically, we regress the risk premium on private equity on the contemporaneous and lagged risk premium on public equity.

the private equity portfolios.

We start the assessment of the risk of private equity by estimating the average beta at the pension fund level. We assume that the risk of each private equity investment can be characterized by the industry beta. To cover all pension funds' private equity investments (i.e., industries) we estimate betas on stocks from six Northern European markets (Denmark, Germany, the Netherlands, Norway, Sweden, and the U.K.). In addition, we estimate betas for U.S. stocks (quoted on the New York Stock Exchange) as a robustness check. For each individual stock, we estimate the beta using return data from the preceding 60 months. The industry beta is then calculated as a value-weighted average of the individual betas for firms within the industry. We match the pension funds' private equity investments to the industry by using both the two-digit industry level and a best match approach. The best match approach favors the four-digit industry beta; we move to the two-digit industry beta if there are no publicly traded firms within the four- or three-digit groupings. We then average across pension funds using both equal and value weights in each year. Table 4 reports the average private equity beta from 1995 to 2004. In Panel A the reported private equity betas are calculated using equally weighted averages of each pension funds' portfolio beta, whereas Panel B reports betas based on value-weighted averages.

Panel A in Table 4 shows that the average private equity portfolio beta from 1995 to 2004 is 1.012 (1.078), using the average two-digit industry betas from Northern European (U.S.) stocks as benchmark. When we value weight in Panel B, the average betas drop to 0.86 and 1.04, respectively. We obtain betas of similar magnitude when we use the best match approach, which favors the four-digit industry beta, and move to the two-digit level if there are no publicly traded firms within the four- and three-digit groupings. In summary, pension funds' private

equity investments have average market risk with a beta around 1. Moreover, this finding seems to be robust to both the level of industry matching and geographic scope of the benchmark.

The second step in our risk assessment is to estimate the private equity portfolios' exposure to common risk factors. To do this we apply the approach developed by Daniels et al. (1997), which characterizes the risk of an investment by the corresponding quintile number in a Fama-French model. We focus on size and book-to-market factors. In order to characterize the risk of the individual pension fund portfolios, we identified the two corresponding characteristic quintile numbers for each private equity investment held by a given pension fund in a given year. To do this, we estimate the market value of equity for each portfolio company by scaling book value of assets with the median market-to-book ratio on assets at the two-digit industry level and subtract book value of debt. The book-to-market ratio is calculated as the book value of equity over the estimated market value of equity. Given the estimates of market value and book-to-market ratio, the corresponding characteristic quintile numbers were found using Northern European and U.S. stocks as benchmark, respectively.<sup>21</sup> We then computed the portfolio-weighted quintile number for each pension fund for each of the two characteristics. The portfolio characteristics were then averaged across all funds during a year using both equal and value weights. Table 5 reports the outcome of applying the risk characteristics approach by Daniel et al. (1997).

Panel A in Table 5 reports the average risk characteristic per year using equal weights. For all pension funds over the period of 1995 to 2004, the average size quintile number is 1.4 and 1.6 when we use Northern European and U.S. stocks as the benchmark, respectively.<sup>22</sup> Thus, pension funds have a high private equity portfolio weight on small firms. In addition, the average

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<sup>21</sup>Thus, essentially we sort the Northern European (U.S) stocks in each year and form Fama-French quintile portfolios. We then find the corresponding quintile number for each risk factor for each private equity investment. See Daniel et al. (1997) for a thorough explanation of the risk characteristics approach.

<sup>22</sup>Size quintile 1 (5) consists of small (large) stocks, whereas book-to-market quintile 1 (5) consists of low (high) book-to-market stocks.

book-to-market quintile number is 3.2 independent of which benchmark we use. Thus, pension funds have a slight tendency to overweight stocks with a high book-to-market value of equity. A similar conclusion emerges from Panel B, which uses a value weighted average of the individual pension funds' portfolio characteristics. Given the well-documented factor risk-premia (Fama and French, 1993) the expected return on a portfolio with high load on the size factor (small minus big) and a modest load on the book-to-market factor (high minus low) is higher than the return to the market portfolio. Moreover, such a portfolio would have higher risk than the market portfolio.

To summarize, the evidence suggests that pension fund private equity portfolios are at least as risky as their public equity portfolios.

## **4.2 The return to private equity investments**

We start the discussion of the return to private equity investments by using the standard approach in the prior literature, which assumes a market model with a beta equal to one. Moreover, as the pension funds also invest in public equity, we benchmark the private equity return to the same pension fund's public equity return. We thereby control for pension fund-invariant heterogeneity (e.g., risk attitude) as this will affect both the realized public and private equity returns. We then provide a risk-adjusted estimate of the return to private equity. As the main purpose is to document the underperformance of the pension funds' private equity investments, we deliberately use the most conservative risk assessment from our prior analysis to estimate the abnormal return. The attractiveness of this conservative choice is that our estimate then provides a lower bound on the actual abnormal return, since any alternative risk adjustment will enhance the negative abnormal return and strengthen the premise of the paper. Table 6 summarizes the estimated abnormal return to private equity.

A major concern when estimating the return to private equity is whether the sample period is sufficiently long to observe the realization of the return. Private equity investments can be long-term investments in the sense that several years may pass before *any* return is realized.<sup>23</sup> To avoid this potential bias, the analysis includes only pension funds with private equity investments for the period 1995 to 2004.<sup>24</sup>

Table 6 shows that the average annual return to private equity is 5.52 percent when we use equal weights on each pension fund. As evident from Table 1 the pension funds and their investments in private equity vary in terms of size. Thus, when we value weight, using the average reported market value of private equity within the year, the estimated average annual return to private equity increases to 8.33 percent.

More interestingly, Table 6 reports the abnormal return to private equity using three benchmarks: market return (Panel A); pension funds' public equity return (Panel B); and risk-adjusted market return (Panel C).

Panel A assumes a market model with a beta equal to one. As the market index returned 13.15 percent per year on average, the estimated annual abnormal return to private equity equals -7.63 and -4.82 percent using equal and value weights, respectively. Using a standard F-test to test whether the returns on the market index and private equity are identical, we reject the null hypothesis at the 1 percent level.<sup>25</sup> Thus, the return to private equity has been significantly *lower* than the average return to public equity.

Panel B reports the estimated abnormal return when we use the pension funds' realized

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<sup>23</sup>In particular, Table 1 shows that after the turn of the millennium, there was a small increase in the number of pension funds with private equity investments.

<sup>24</sup>In fact, the estimated abnormal return to private equity is numerically larger if we include all pension funds.

<sup>25</sup>We perform a simple F-test of comparable means. As a robustness check, the Wilcoxon rank sum test as well as a test on the equality of medians have been performed. Both non-parametric tests reject the null at the 1 percent level.

return to their public equity investments as benchmark. As pension funds realized on average a slightly higher return to public equity compared to the market index, the abnormal return to private equity decreases. Again, we strongly reject the null hypothesis of comparable means. Thus, Panel B shows that pension funds realized a significantly lower return from their private equity investments. This raises the bar for potential explanations to the private equity premium puzzle, as the acceptance of the poor risk-return tradeoff cannot be explained by pension fund-invariant heterogeneity.

Finally, Panel C provides a risk-adjusted estimate of the performance of private equity. To provide a conservative estimate of the abnormal return to private equity, we risk-adjust using the most conservative assessment of risk from the analysis in the prior section, which is the estimated private equity portfolio betas from Table 4. Thus, the risk of the public equity benchmark in Panel C is assumed to be equivalent to the estimated risk of the private equity portfolio for each individual pension fund. Among the four estimations of beta in Table 4, we use the one with the lowest average risk assessment of the private equity portfolios, which is the value-weighted portfolio beta using Northern European stocks and industry matching on the 2-digit industry level. Consistently, the average equal-weighted (value-weighted) expected return decreases to 12.14 (12.25) percent per year. However, the risk-adjusted gap in returns between private and public equity is still economically and statistically significant: Using equal weights, pension funds' private equity returns lag as much as 6.62 percentage points per year, whereas with value weights the gap in returns equals 3.92 percentage points per year. These differences are statistically significant at the 1-percent level. Moreover, any alternative risk-adjustment using either betas or the risk characteristics from Table 5 would enhance the negative abnormal return to private equity. Thus, our most conservative estimate shows that pension funds have received



a negative abnormal return of 392 basis points per year over 10 years.

To ascertain that these results are not driven by conservative valuation one can adjust the reported returns for this potential bias by taking the extreme position that pension funds never adjust the market value of their investments. In such cases, the reported returns are zero-biased by the increase in net new investments of 14 percent over the sample period. This increase translates into a portfolio weight of 12 percent on the zero-biased return in the reported return.<sup>26</sup> Adjusting the reported return for the effect of the bias the equal and value-weighted unbiased returns equal 6.91 percent and 9.30 percent, respectively. Thus, it follows that the maximum bias resulting from conservative valuations has a relatively small effect on our results as the underperformance equals around 3 percent per year. As an additional test, in (unreported) regressions of the return gap (public equity return-private equity return) on the increase to the reported market value of private equity we find a negative but insignificant correlation between increasing market value and the return gap. Thus, pension funds with the largest increases in the reported market value also reported the highest return, which is the opposite of what we should find if the results are driven by conservative valuation bias. Moreover, the intercept equals 8.46 percent and is statistically significant at the 1 percent level. Thus, the return gap persists after controlling for potential bias due to the potential increase in net investments.

Another important caveat to the estimated abnormal return on private equity is that the data covers a window of 10 years. Short time series is a problem shared with most of the literature on private equity returns. In our case, the length of the window is determined by the implementation of the mandatory reporting of returns by the government in 1995. Prior

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<sup>26</sup>Because pension funds under this assumption never adjust the market value of OLD and WINDOW investments, the increase of 14 percent in reported market values in Table 1 is entirely a consequence of net new investments (replacing OLD with NEW investments). The portfolio weight on the zero-biased investments is equal to 12 percent as  $0.14/1.14 = 0.12$ .

to 1995, pension funds reported the return on private and public equity collectively. However, two pension funds have voluntarily reported the return on private equity for a substantially longer time period. Although voluntarily reported returns might be biased toward successful investments, this potential bias will make it harder to establish the performance gap.

Interestingly, these two pension funds are among the largest investors in private equity. The first pension fund, Lønmodtagernes Dyrtdsfond (LD), is by far the largest and most experienced private equity investor, with more than 300 investments to date.<sup>27</sup> LD reports the return for both private and public equity from 1980 to 2004, and over this period, the return on private equity lagged as much as 8.8 percentage points *per year*. Similarly, *Pensionskassen for Magistre og Psykologer* (MP Pension), reports an underperformance of 3.6 percentage points per year over the fifteen-year period from 1990 to 2004. Although we cannot provide systematic evidence of the documented underperformance using a longer time series, the two examples highlight the puzzling finding that even professional investors such as pension funds seem to get a poor risk-return tradeoff from investing in private equity. In addition, the sheer size of the documented underperformance reduces the likelihood that the results are driven by the length of the sample period.

In summary, we provide strong evidence that the return to private equity investments has been significantly lower than the return to public equity within the ten-year period of 1995 to 2004. The difference is large both economically and statistically. Our most conservative risk-adjusted estimate shows that private equity investments have provided a 392-basis-point negative abnormal return *per annum*.

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<sup>27</sup>In the sample period, LD accounts for between 13 and 19 percent of the market value of all private equity investments. Moreover, despite Denmark's relative small size, LD is among the 300-largest pension funds in the World (Watson Wyatt, 2006).

## 5 New evidence on the private equity premium puzzle

This section exploits our novel data on pension funds' private equity holdings to test the potential explanations for why pension funds invest in private equity despite the poor risk-return tradeoff. Moreover, as the pension funds realized a poor return relative to their own public equity investments, any potential explanation for why pension funds invest in private equity should explain this relative difference as well.

In their seminal paper, Moskowitz and Vissing-Jørgensen (2002) list a number of potential explanations for why entrepreneurs willingly invest a substantial fraction of their wealth in a single private firm: Entrepreneurs might have a high risk tolerance (i.e., low risk aversion), which will reduce the disutility from poor diversification. Likewise, entrepreneurs might have a preference for skewed returns and, therefore, accept a lower mean return in exchange for the large potential upside; in this respect, entrepreneurs can be characterized as participating in a tournament. Entrepreneurial activity could also be encouraged by the ability to derive pecuniary and non-pecuniary benefits. Pecuniary benefits take the form of consumption through the firm (e.g., perks), whereas non-pecuniary benefits are prestige, reputation, and the value of being your own boss, among others. Finally, Moskowitz and Vissing-Jørgensen point to over-optimism and misperceived risk as explanations for entrepreneurial investments in private equity. In addition to this list, we consider a number of other explanations related to pension funds, including relationship-building and politically motivated investments.

### A. Risk tolerance and preference for skewness

Prior research on institutional investors and their investment preferences has shown that institutions, and in particular pension funds, tend to be prudent (see Del Guercio (1996), and Gompers

and Metrick (2001), among others). Prudent investors invest in less risky stocks, which is inconsistent with having a high risk tolerance and/or a preference for skewed returns. Thus, unlike entrepreneurs and individuals, pension funds are unlikely to have a high risk tolerance or a preference for skewed returns.

## **B. Pecuniary and non-pecuniary benefits to pension fund managers**

Pecuniary and non-pecuniary benefits have been suggested by both Hamilton (2000) and Moskowitz and Vissing-Jørgensen (2002) as explanations for why people become entrepreneurs. Pecuniary benefits usually take the form of consumption through the firm. In essence, these benefits are measurement errors when we evaluate the return to private equity using survey data, since these benefits are unreported. Non-pecuniary benefits, on the other hand, include prestige, reputation, and the value of 'being your own boss', which are difficult to quantify.

Although it seems reasonable to argue that pension funds are less likely than individuals to obtain pecuniary or non-pecuniary benefits from their investments in private equity, pension funds are run by managers who might be self-interested. To address this potential explanation, we examine whether pension fund managers get elected to the board; we posit that, as directorship positions are paid and prestigious, accumulation of board seats capture both pecuniary and non-pecuniary benefits accruing to fund managers.

Our rich data allow us to investigate the relationship between the managers of a pension fund and the appointment of new board members in portfolio companies subsequent to investment. Within the period of 1995 to 2004, 39 pension funds reported having at least 1 investment in a private firm where either the cash flow or the voting stake exceeded 5 percent. In the course of this ten-year period, pension funds invested directly in 333 portfolio companies and indirectly in 749 companies through 33 private equity funds. To complete the analysis, we

identify new board members in both portfolio companies and private equity funds. In total, the sample consists of 4,355 firm-year observations, and with this dataset, we identify all new board members subsequent to an investment by a pension fund. We then check whether the board members are managers or directors of the investing pension fund, using the social security number as identifier.

Table 7 shows that a total of 2,514 new board members were appointed in portfolio companies and private equity funds subsequent to an investment by a pension fund. Of these 2,514 new board members, only 26 (1 percent) were directors in the pension fund at the time that the investment decision was taken. Similarly, 24 (less than 1 percent) of the newly appointed board members were members of the board of the investing pension fund. Table 7 conditions on the timing of the appointment of new board members. Evidently, most appointments to portfolio company boards of managers of the investing pension funds took place while the pension fund was an owner. The lack of a significant accumulation of board seats by the management of pension funds is inconsistent with the idea that these investments are driven by self-interested managers. Thus, using a very direct measure of pecuniary and non-pecuniary benefits, we do not find significant evidence of this as the driving force behind the investments.

Arguably, there are many more indirect ways to obtain private benefit from portfolio companies than by joining the board. These are difficult to quantify and to measure. We argue that if private benefits are important to the management of pension funds, one of the most likely manifestations would be board representation. We base this belief on the positive motive for board representation—monitoring of the investment. Monitoring of portfolio companies might provide a perfect blind for managers to join a board and, at the same time, to receive private benefits. Still, we find little evidence backing this explanation for pension fund investment in

private equity.

### **C. Over-optimism and misperceived risk**

In this section, we scrutinize the source of the low private equity return. We make use of our detailed firm-level data to distinguish whether poor performance of the underlying portfolio of privately held firms, missing capital gains, or both are the driving forces behind the low returns.

Our empirical strategy is, therefore, to test whether underlying performance has been lower in pension fund portfolio companies.<sup>28</sup> We use a simple matching procedure for each portfolio company to form a matched sample of non-portfolio companies. We construct matched samples using both two-digit and three-digit industry codes. The matched sample consists of the 10 (5) firms within the two-digit (three-digit) industry code with the closest proximity measured by firm size (book value of assets) to each portfolio company in each year. This match is repeated for all portfolio companies to form a fairly homogeneous sample of control firms within the period of 1995 to 2004.

Table 8 summarizes the results from regressions of return on assets (defined as EBIT over assets) on a portfolio company dummy. We run ten yearly cross-section regressions as well as a pooled regression. To provide an overview, Table 8 therefore reports the average coefficient; the average marginal effect; and the number of positive, negative, and significant coefficients for the cross-section models, whereas we report the coefficient and t-statistics for the pooled model. In all regressions we control for industry and size-specific effects by including a dummy for each portfolio company and the corresponding matched sample.<sup>29</sup> In addition, our specification includes firm age and leverage as control variables to ensure that our results are not driven by

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<sup>28</sup>Note that we only focus on portfolio companies. We therefore exclude private equity funds, as their portfolios are included in the sample of portfolio companies. See Section 3.1 for details.

<sup>29</sup>To reduce the influence of outliers, we weight the observations with book value of assets. In addition, we have performed median regressions as a robustness check and obtained results of a similar order of magnitude.

observable characteristics unrelated to industry and size.

In the left panel of Table 8, where the matching procedure is based on two-digit industry codes, the coefficient on pension funds' portfolio companies have mixed signs and significance: in 6 (4) out of 10 regressions, the coefficient is positive (negative), but only significant at the 5 percent level in 2 (1) cases. Consistently, the average coefficient across the ten yearly regressions is close to zero. This is confirmed in the pooled model, where the coefficient is positive, but insignificant. These results are robust with respect to the level of industry matching, since we find similar results when we match within three-digit industry codes. On average, pension fund portfolio companies perform no differently than a matched sample of similar firms.

Overall, we find no significant difference in the earnings performance of pension fund portfolio companies. Given the average performance, the disappointing return cannot be explained by poor selection of investments from the population of firms. The poor return has to be caused by low capital gains. Thus, low returns most likely result from initial over-optimism or misperceived risk (or both). In both cases, pension funds will initially misprice the portfolio companies, and subsequently experience low abnormal returns. Thus, the evidence points to initial over-optimism and misperceived risk as important sources of the disappointing returns. As pension funds are perceived to be professional investors, our findings might also indicate that the much cited non-pecuniary benefits do not stand alone in explaining the private equity premium puzzle for entrepreneurs and entrepreneurial households. Over-optimism and misperceived risk are likely to contribute as well.

#### **D. Other explanations related to pensions funds**

In this section, we discuss a number of other explanations for why pension funds might invest in private equity despite poor returns.

Pension funds manage large portfolios of assets; it might therefore be sensible to hold a small fraction of private equity if the return is sufficiently uncorrelated with the return on other assets. In fact, using U.S. data, Hwang, Quigley, and Woodward (2005) show that a mean-variance investor would want to invest a positive fraction in private equity despite the lack of a return premium. This result relies on two important assumptions: i) the mean-variance investor can invest in an index of private equity; and ii) a low correlation between returns to private and public equity.

Both assumptions appear highly contestable. First, in previous sections we show that pension funds have, on average, invested in approximately 15 privately held firms, representing a tiny fraction of the total private equity market. Thus, the assumption that investors can index the private equity market is not backed by the data. Second, using the same data as Hwang, Quigley, and Woodward (2005), Woodward (2004) shows that the correlation coefficient is significantly negatively biased by the stale pricing problem; as a result, the covariance between private and public equity returns triples.<sup>30</sup> In a similar vein, Moskowitz and Vissing-Jørgensen (2002) show that private equity does not appear to have particularly attractive hedging properties. Finally, it should be noted that even though Hwang, Quigley, and Woodward (2005) find a positive portfolio weight on private equity, the inclusion of private equity does not change the efficient portfolio frontier significantly. Thus, even under contestable assumptions which make private equity appear much more attractive from a portfolio perspective, the inclusion of private equity does not yield a higher portfolio return. Our data show that pension funds with private equity investments on average have allocated 2.3 percent of their total portfolio to private equity. Even though this appears to be a tiny fraction of the total portfolio, it corresponds to 17.7 percent of

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<sup>30</sup>Woodward (2004) reports that the beta of risk increases from 0.6 to 2.0 when correcting for the stale pricing problem. See section 4 for further details.



all domestic investments in equity. Thus, pension funds have allocated a significant fraction of their equity investment into private firms.

In a study of relationship banking in venture capital, Hellmann, Lindsey, and Puri (2004) suggest that banks might sacrifice returns in order to obtain future banking income from the portfolio firms. As a case in point, pension funds might diverge from maximizing the return to obtain future pension customers. However, this alternative explanation receives little support since the pension funds' portfolio firms have, on average, few employees. The average (median) number of employees in portfolio firms in 2004 is 144 (12). As the average private equity portfolio consists of few firms (see Table 2), the prospects for generating future pension fees are not large enough to cover the large gap in returns.

Another possible explanation is that pension funds might be committed to the development of the local economy and might, therefore, invest in private equity to stimulate growth and innovation. Historically, pension funds in the U.S. have been encouraged by in-state investment programs to invest directly in local private firms and fund local venture capitalists.<sup>31</sup> In Europe, pension funds have historically been influenced by unions, which suggests that investment decisions might be influenced by political preferences.<sup>32</sup> Political investments to sustain employment in unprofitable industries might have induced pension funds to invest in private equity. Again, it is hard to argue that this political preference should affect private equity investments significantly differently than it affects investments in public firms. Further, as these politically motivated investments tend to attract significant media attention, there seem to be too few examples to explain the large underperformance. Nevertheless, to quantify the influence

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<sup>31</sup>Consistently, Lerner, Schoar, and Wongsunwai (2007) find evidence that suggest that public pension funds and public universities in the United States face politically motivated pressures or constraints to invest in their local areas with unfavorable effects on performance.

<sup>32</sup>Phalippou and Zollo (2005b) cite causal evidence of this behavior among pension managers in Europe

of political investments, we use another novel feature of our data: our sample of pension funds consists of two types, one managed by labor market parties (unions and employers' organizations) and one managed by financial intermediaries. Where politics pervade investment decisions in pension funds managed by unions and employers' organizations, we should expect a lower return to private equity for this group, if political motives take precedence

Panel A in Table 9 shows the return to private equity for pension funds managed by labor market parties and those managed by financial intermediaries, respectively. On average, pension funds managed by labor market parties realized an annual return of 8.5 percent, as compared to 7.7 for funds managed by financial intermediaries. The difference of 0.7 percent is highly insignificant.

To further examine the impact of politically motivated investments, we examine election rules in the pension fund bylaws that grant board seats to political organizations (defined as unions and associations of local governments).<sup>33</sup> If political organizations are granted the right to appoint board members, they can indirectly influence pension fund investment policy. In particular, we are interested in board seats granted to unions and associations of local governments as they appoint their leaders and (local) politicians, respectively. By measuring the number of board seats granted to political organizations, we thereby obtain a measure of the political influence on pension fund investment policy.

Panel B in Table 9 shows the return to private equity for pension funds as a function of the degree of political influence on the boards. We use two measures: in Panel B (I) we divide the pension funds based on whether at least 1 board seat is granted to a political organization; in Panel B (II) we divide them based on whether the majority of board seats are granted to

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<sup>33</sup>As employers in a wide range of professions (e.g., education, child care, health care, etc.), local governments are actively involved in pension funds managed by labor market parties.

political organizations. Using both measures, we find no significant difference in the return to private equity of politically influenced boards. Thus, politically motivated investments do not seem to explain why pension funds invest in private equity despite the poor return. Otherwise, we should have found a significantly lower return to politically influenced pension funds' private equity investments.

To conclude, we acknowledge that in the case where all pension funds' investments in private equity are politically motivated, our test would fail to recognize this. Rather, we used the within-sample variation to show that the return to pension funds' private equity investments is unrelated to the organization of the pension fund and to the number of board seats granted to political organizations. We thereby find no evidence to suggest that political preferences can explain why pension funds accept the poor risk-return tradeoff.

## 6 Conclusion

Prior studies of return to private equity investments show that the return to private equity funds net of fees is disappointing. This paper makes use of a novel dataset to examine whether, alternatively, pension funds can get private equity exposure by investing directly in private firms. We show that Danish pension funds' direct investments in private equity has dramatically underperformed: our most conservative risk-adjusted estimate shows that the return to direct investments in private firms lags public equity by 3.9 percentage points per annum. To the best of our knowledge, this is the first estimate of the return to private equity by investors without an active management role.

An additional novel feature of our data is that we have access to the portfolio companies that have generated the returns and to the entire population of privately held firms. This allows us

to evaluate potential explanations for the realized return. We find that most of the potential explanations discussed in prior literature cannot explain the large gap in the pension funds' private equity returns. We disentangle the source of this underperformance to show that it is driven by missing capital gains that result, presumably, from over-optimism and misperceived risk. As pension funds are perceived to be professional investors, the importance of over-optimism and misperceived risk in explaining the private equity premium puzzle is likely to extend to entrepreneurs and entrepreneurial households as well. Overall, these findings suggest that the private equity premium puzzle raised by Moskowitz and Vissing-Jørgensen (2002) extends to professional investors with diversified portfolios.

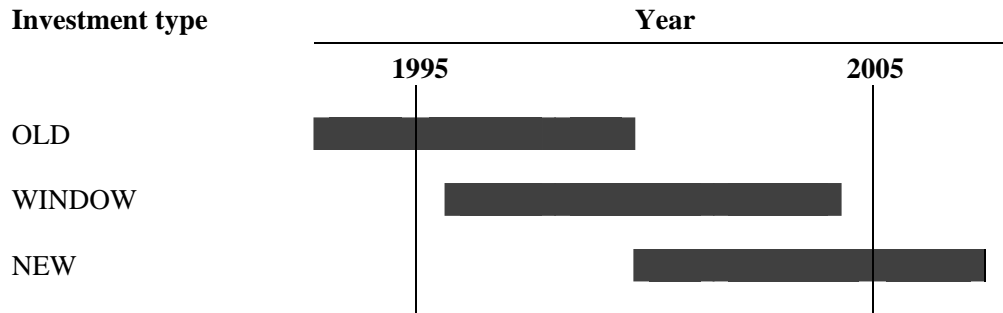
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**Figure 1. Illustration of window approach to evaluating portfolio return on private equity**

This figure classifies portfolio investments into three types: *OLD*, *WINDOW*, and *NEW* investments. *OLD* investments are undertaken pre-window and un-exited before 1995. *WINDOW* investments are undertaken and exited within the return window. *NEW* investments are undertaken within the window and un-exited ultimo 2004.



**Table 1. Pension funds' investment assets from 1995 to 2004**

This table provides descriptive statistics on the size of pension funds' investment assets. The sample consists of all pension funds in Denmark from 1995 to 2004. We report the number of pension funds and the mean and median market value of all investment assets, as well as domestic investments in public and private equity. In addition, we report the average and median share of total equity investments allocated to private equity and the number of reported portfolio investments (See Section 3.1 for details). All figures are in million 2000 Danish kroner. The exchange rate of DKR to EUR is 7.45.

Year	Pension Fund Investment Assets							
	All		Public Equity		Private Equity			
	N	Market value	N	Market value	N	Market value	% total equity allocation	Number of reported portfolio investments
Mean (Median)								
1995	55	12487.8 (3083.6)	49	1787.6 (481.2)	39	210.8 (88.6)	15.9 (13.7)	10.2 (5.0)
1996	55	13788.1 (3283.6)	51	1898.8 (509.3)	38	204.9 (94.0)	14.4 (12.1)	9.9 (4.0)
1997	55	15422.0 (3747.9)	52	2419.5 (612.1)	38	187.2 (80.3)	13.6 (9.5)	9.6 (3.0)
1998	57	16805.8 (4473.8)	56	2983.6 (737.4)	36	223.0 (100.3)	12.6 (7.2)	10.4 (5.5)
1999	60	16929.0 (4354.1)	53	3064.5 (865.1)	36	212.6 (108.0)	10.9 (6.9)	9.9 (7.0)
2000	60	18923.1 (5568.9)	53	3433.8 (959.8)	38	242.8 (72.2)	8.7 (7.5)	9.4 (7.0)
2001	60	19848.7 (6585.2)	54	3215.2 (995.7)	44	253.7 (58.7)	15.4 (8.2)	8.0 (3.5)
2002	59	19887.5 (6484.7)	54	2475.6 (799.0)	45	241.5 (83.2)	22.5 (11.0)	8.3 (4.0)
2003	58	19538.0 (6486.4)	51	1554.3 (426.3)	43	250.8 (73.8)	28.1 (16.4)	8.0 (5.0)
2004	54	22773.6 (8131.5)	48	1727.8 (521.7)	43	240.4 (88.2)	26.5 (15.4)	9.7 (5.0)



**Table 2. Pension funds' private equity portfolios from 1995 to 2004**

This table provides descriptive statistics on the size of pension funds' private equity portfolios. The sample consists of the population of pension funds with private equity investments within the period of 1995 to 2004. We distinguish between direct and indirect investment through private equity funds. We report the number of direct investments, whereas for indirect investments, we report the number of funds and number of fund investments. The total number of portfolio companies is the number of direct investments plus the number of fund investments. We measure the relative size of each type by aggregating the share of book value of assets and the share of book value equity that ultimately are owned by pension funds.

Year	Direct Investments			Indirect Investments through Private Equity Funds				Total number of portfolio companies
	Number of investments	% of total assets	% of total equity	Number of funds	Number of fund investments	% of total assets	% of total equity	
Mean (Median)								
1995	12.2 (10.5)	94.3 (100.0)	90.4 (100.0)	1.1 (0.0)	11.8 (0.0)	5.7 (0.0)	9.6 (0.0)	24.0 (13.0)
1996	11.6 (11.0)	93.4 (100.0)	89.0 (100.0)	1.1 (0.0)	14.4 (0.0)	6.6 (0.0)	11.0 (0.0)	26.0 (14.0)
1997	10.8 (8.0)	91.4 (100.0)	86.5 (100.0)	1.1 (0.0)	17.6 (0.0)	8.6 (0.0)	13.5 (0.0)	28.4 (16.0)
1998	10.2 (7.0)	89.1 (99.7)	84.0 (98.4)	1.5 (1.0)	18.3 (0.0)	10.9 (0.0)	16.0 (0.0)	28.5 (16.0)
1999	9.1 (7.0)	85.9 (98.9)	80.5 (92.6)	1.9 (2.0)	21.8 (3.0)	14.1 (0.0)	19.5 (0.1)	30.9 (16.0)
2000	9.1 (7.5)	84.3 (99.0)	77.9 (94.9)	2.3 (2.0)	22.5 (5.0)	15.7 (0.0)	22.1 (0.1)	31.6 (12.5)
2001	8.9 (7.0)	82.2 (99.2)	75.5 (95.6)	2.3 (1.0)	24.4 (9.0)	17.8 (0.8)	24.5 (4.4)	33.3 (15.0)
2002	8.5 (6.5)	80.8 (98.1)	73.8 (91.0)	2.5 (1.5)	28.8 (12.0)	19.2 (1.9)	26.2 (9.0)	37.3 (18.0)
2003	7.1 (5.0)	81.8 (98.7)	76.4 (97.2)	2.3 (1.0)	23.1 (4.0)	18.2 (1.3)	23.6 (2.8)	30.2 (14.0)
2004	8.0 (6.5)	79.2 (97.9)	75.8 (96.2)	1.8 (1.0)	20.0 (5.0)	20.8 (2.1)	24.2 (3.8)	28.0 (12.5)

**Table 3. Average yearly return on pension funds' equity investments from 1995 to 2004.**

This table summarizes the average yearly return (in percent) of pension fund equity investments from 1995 to 2004. We report the following for public and private equity investments, respectively: number of pension funds, average return, cross-fund standard deviation; the 10th (P10); the 50th (Median); and the 90th (P90) percentiles of the distribution of pension fund returns.

Year	Return to Public Equity (%)					Return to Private Equity (%)				
	N	Mean (Std. dev.)	P10	Median	P90	N	Mean (Std. dev.)	P10	Median	P90
1995	49	7.44 (3.30)	3.3	8.1	10.1	39	-0.41 (10.36)	-11.5	-1.0	10.2
1996	51	31.19 (7.13)	26.4	30.7	37.2	38	1.02 (12.05)	-14.1	1.1	12.9
1997	52	33.88 (11.07)	20.0	37.5	45.1	38	16.24 (22.436)	0.0	13.1	35.2
1998	56	-3.69 (6.17)	-9.0	-4.1	-1.5	36	12.15 (31.34)	-8.1	4.8	37.2
1999	53	22.71 (7.13)	15.3	22.8	28.7	36	1.78 (14.98)	-9.7	0.6	14.2
2000	53	20.20 (10.05)	4.3	21.5	31.7	38	27.27 (40.66)	-6.9	20.9	86.3
2001	54	-13.94 (5.78)	-20.3	-13.7	-10.7	44	-5.54 (24.85)	-24.9	-3.6	6.9
2002	54	-20.51 (6.37)	-27.2	-20.7	-14.0	45	-6.09 (14.99)	-21.2	-6.8	13.3
2003	51	30.40 (11.16)	22.0	30	36.8	43	-0.59 (19.93)	-20.0	2.1	12.0
2004	48	25.30 (5.63)	20.5	25.4	31.8	43	5.15 (9.15)	-1.6	4.1	16.5

**Table 4. Estimation of the pension funds' private equity portfolio beta**

This table shows the estimated portfolio beta on pension funds' private equity investments. Panel A uses equal weights on each investment; Panel B reports value-weighted betas. We assume that the beta on each portfolio investment can be represented by the value-weighted average of the beta on the individual stocks within the industry. We use two samples of stocks to estimate industry betas: Northern European stocks (i.e., stocks from Denmark, Germany, the Netherlands, Norway, Sweden, and the U.K.); and U.S. stocks (listed on NYSE). We estimate the beta on individual stocks using monthly returns from the preceding 60 months. We mark the investments to the market on industry level using both the 2-digit industry code and a best match approach. The best match approach matches the investment to the industry beta on the lowest possible industry level (see Section 4.1 for details).

Benchmark:	Northern European stocks			U.S. stocks		
	N	Industry level		N	Industry level	
		2-digit	Best match		2-digit	Best match
<b>Panel A: Equal-weighted</b>						
1995	271	0.963	0.921	275	1.052	1.007
1996	300	0.980	0.898	304	1.056	1.026
1997	351	1.004	0.946	355	1.067	1.033
1998	372	1.002	0.955	375	1.074	1.032
1999	388	0.981	0.988	391	1.063	1.029
2000	347	0.979	0.988	350	1.072	1.056
2001	393	1.017	0.974	396	1.084	1.068
2002	414	1.041	1.014	418	1.102	1.088
2003	417	1.048	1.038	420	1.105	1.099
2004	534	1.058	1.048	537	1.103	1.101
Average 1995-2004	3787	1.012	1.004	3821	1.078	1.057
<b>Panel B: Value-weighted</b>						
1995	271	0.900	0.907	275	1.077	1.083
1996	300	0.856	0.860	304	1.036	1.039
1997	351	0.848	0.849	355	1.051	1.069
1998	372	0.836	0.846	375	1.034	1.021
1999	388	0.845	0.855	391	1.014	1.006
2000	347	0.859	0.849	350	1.045	1.047
2001	393	0.854	0.854	396	1.013	0.978
2002	414	0.838	0.866	418	1.030	1.036
2003	417	0.854	0.891	420	1.027	1.022
2004	534	0.907	0.918	537	1.075	1.073
Average 1995-2004	3787	0.860	0.869	3821	1.040	1.037

**Table 5. Risk characteristics of pension funds' private equity portfolios**

This table shows the risk characteristics of Pension Funds' Private Equity Portfolios. Following Daniel et al. (1997) we report the average size and book-to-market quintiles of the private equity portfolios using Northern European and U.S. stocks as benchmarks, respectively. To calculate the average characteristic, the quintile benchmark portfolio number (1 through 5) is identified, each year, for each private equity investment held by a pension fund for both characteristics. Size portfolio 1 consists of small stocks, whereas book-to-market portfolio 1 consists of low book-to-market stocks. The market value of equity of each private equity portfolio company is calculated as the difference between market value of assets and book value of debt. Market value of assets is estimated by multiplying the median market-to-book ratio within the 2-digit industry with the book value of assets. Book to market ratio is book value of equity over the estimated market value of equity. Finally, pension fund average benchmark portfolio numbers are averaged across all funds each year. Panel A assigns equal weight on each pension fund, whereas Panel B uses the pension fund's reported market value of private equity investment as weight. The reported average for 1995 to 2004 is the average of the time-series of average characteristics.

Benchmark:	Northern European stocks		U.S. stocks	
	Average risk factor quintile		Average risk factor quintile	
	Size	Book-to-market	Size	Book-to-market
<b>Panel A: Equal-weighted</b>				
1995	1.6	3.3	1.4	3.2
1996	1.5	3.4	1.2	3.4
1997	1.6	3.2	1.2	3.2
1998	1.6	3.6	1.3	3.1
1999	1.6	3.2	1.3	3.0
2000	1.6	3.1	1.3	3.3
2001	1.6	3.2	1.3	3.0
2002	1.8	3.2	1.6	3.2
2003	2.1	2.9	1.7	3.2
2004	1.8	3.2	1.3	3.3
Average 1995-2004	1.6	3.2	1.4	3.2
<b>Panel B: Value-weighted</b>				
1995	1.7	3.2	1.5	3.2
1996	1.7	3.4	1.3	3.3
1997	1.8	3.0	1.2	3.1
1998	1.8	3.5	1.4	3.1
1999	1.7	3.3	1.4	3.0
2000	1.7	3.2	1.4	3.4
2001	1.7	3.3	1.4	3.2
2002	1.9	3.2	1.8	3.2
2003	2.1	2.8	1.6	3.2
2004	1.8	3.1	1.2	3.2
Average 1995-2004	1.8	3.2	1.4	3.2

**Table 6. Return to private equity investments by pension funds**

This table reports the average annual abnormal return to private equity investments by pension funds in Denmark from 1995 to 2004. Panel A uses the market index as benchmark for the private equity returns by assuming a market model with a beta equal to one. Panel B uses the pension funds' realized return to public equity as benchmark, whereas Panel C reports the risk-adjusted abnormal return. Thus, Panel C reports the average market return with risk equivalent to the portfolio beta on the private equity investments. We only include pension funds with private equity investments for all years within the period. We use a standard mean comparison test to evaluate whether public and private equity provided identical returns. We report the difference and the *p*-value that emerge from the test of comparable means.

Public equity benchmark	Average Annual Return (%)					
	Public equity		Private equity		Difference	
	N	Mean (std.dev.)	N	Mean (std.dev.)		<i>P</i> -value
<b>Panel A: Market return</b>						
Equal-weighted	340	13.148 (19.55)	340	5.523 (22.74)	<b>-7.625<sup>***</sup></b>	[0.000]
Value-weighted	340	13.148 (19.55)	340	8.328 (21.32)	<b>-4.820<sup>***</sup></b>	[0.000]
<b>Panel B: Pension funds' public equity return</b>						
Equal-weighted	340	13.350 (20.20)	340	5.523 (22.74)	<b>-7.827<sup>***</sup></b>	[0.000]
Value-weighted	340	13.645 (20.39)	340	8.328 (21.32)	<b>-5.316<sup>***</sup></b>	[0.001]
<b>Panel C: Risk-adjusted market return</b>						
Equal-weighted	340	12.143 (16.45)	340	5.523 (22.74)	<b>-6.620<sup>***</sup></b>	[0.000]
Value-weighted	340	12.250 (16.70)	340	8.328 (21.32)	<b>-3.922<sup>***</sup></b>	[0.001]

**Table 7. Private benefits to the management of pension funds: Board seat accumulation in portfolio companies by management of pension funds**

This table shows the number of new board members in pension fund portfolio companies subsequent to the investment by a pension fund. We include direct investments, private equity funds, and private equity fund portfolios in the sample of portfolio companies. We report the number of new board members, and the number of managers and board members of the pension fund. We further partition based on whether the new members joined the board while the pension fund was still an owner and after the fund sold out, respectively.

	New board members in portfolio companies	Number of managers and board members of pension funds among new board members of portfolio companies			
		Pension fund managers		Pension fund board members	
		N	%	N	%
All new boards members after investment by a pension fund	2514	26	1.0	24	1.0
- New board members while pension fund is an owner	1774	22	1.2	19	1.1
- New board members after the pension fund sold out	740	4	0.5	5	0.7

**Table 8. Return on assets in pension fund portfolio companies relative to a matched sample of companies within the industry**

This table shows the operating performance of pension fund portfolio companies relative to a sample of matched firms. We construct a matched sample of similar-sized firms within the industry. On the left side of the table, the matched sample consists of the 10 firms within the 2-digit industry code with the closest proximity in firm size to the portfolio company, whereas on the right side, the matched sample consists of the 5 firms within the 3-digit industry code. We use Return on Assets, defined as EBIT over book value of assets, to measure earnings performance. We report the average coefficient, the number of positive, negative, and significant from the 10 cross-section regressions, whereas we report the coefficient and the *t*-statistics from the pooled model. Significance is based on White's robust variance estimator.

Matched control sample:	2-digit industry level			3-digit industry level		
	(1)		(2)	(3)		(4)
Model specification:	Cross-section		Pooled	Cross-section		Pooled
	Average coefficient	Number of positive / negative [significant]	Coefficient ( <i>t</i> -stat)	Average coefficient	Number of positive / negative [significant]	Coefficient ( <i>t</i> -stat)
Portfolio company dummy	-0.0014	6/4 [1/2]	0.0004 (0.29)	0.0049	6/4 [2/0]	0.0042 (2.65)
Control variables	YES		YES	YES		YES
Size and industry effects	YES		YES	YES		YES

**Table 9. Politically motivated investments and the return to private equity investments**

This table reports the value-weighted average annual return to private equity investments by pension funds with private equity investments in all years from 1995 to 2004. Panel A splits the pension funds into funds managed by labor market parties (unions and employers' organizations) and financial intermediaries, respectively. Panel B splits the pension funds according to the composition of board members: from pension fund by-laws, we identify election rules that grant board seats to political organizations (defined as unions and associations of local governments). In Panel B(I) we split the sample of pension funds on whether at least one board seat is granted to a political organization; in Panel B (II) we split the sample on whether a majority of the board seats is granted to political organizations. We use a standard mean comparison test to evaluate whether the two groups have identical returns to private equity according to the split. We report the difference and the *p*-value that emerge from the test of comparable means.

	Average Annual Return (%)			Difference	
	N	Mean	(std. dev)	<i>P</i> -value	
<b>Panel A: Organization of pension funds</b>					
Managed by labor market parties	220	8.520	(19.44)	<b>0.708</b>	[0.769]
Managed by financial intermediaries	120	7.722	(26.50)		
<b>Panel B: Board seats granted to political organizations</b>					
<b>(I)</b>					
At least one board seat granted to a political organization	250	8.107	(18.842)	<b>-1.356</b>	[0.666]
No board seats granted to political organizations	90	9.463	(31.18)		
<b>(II)</b>					
Majority of board seats granted to political organizations	160	8.512	(18.49)	<b>-0.499</b>	[0.833]
Minority of board seats granted to political organizations	180	8.003	(25.64)		