KKR to Carlyle Target $3.6 Trillion in 401(k)s Accounts

By Margaret Collins & Devin Banerjee - 2013-04-04T17:47:43Z

Private-equity firms, the exclusive money managers overseeing $3 trillion worldwide for the wealthiest investors, are discovering a new type of client: ordinary people.

Carlyle Group LP (CG), Blackstone Group LP (BX) and KKR & Co. (KKR), which usually open their doors only to clients willing to commit at least $5 million, are lowering that threshold or offering investments directly to individuals, an effort to attract fresh cash amid lackluster fundraising. Their ultimate goal: a slice of the $3.57 trillion Americans have accumulated in their 401(k) retirement plans.

The firms are looking for ways to move down-market as a growing number of workers are pushed out of public and corporate pension funds, which guarantee an income after retirement, and into 401(k)-style plans, where they are responsible for investing their savings. While private-equity funds are a staple of many large pension plans, a sale to individuals poses dangers because they're hard to understand, can be illiquid and their fees are higher than those of traditional mutual funds, said David John, deputy director of the Retirement Security Project at the Brookings Institution in Washington.

"Should this start to take hold," said John, "there needs to be either a licensing, a seal of approval or some level of higher oversight so people don't find that they are investing in something that really isn't suitable for their stage of life."

Locked Up

Private-equity firms lock up investor money for about a decade with a mandate to buy companies, improve their value, and sell them with a profit. The firms use debt to finance the deals and amplify returns, typically charge an annual management fee equal to 1.5 percent to 2 percent of committed funds and keep 20 percent of profits from investments. That compares with expense ratios of 1.27 percent on average for U.S. mutual funds and 0.65 percent for exchange-traded funds, according to researcher Morningstar Inc. (MORN)

The biggest firms, seeking to evolve into broader asset managers because buyouts are less profitable than before the financial crisis, have added funds to invest in real estate, credit, hedge funds and other asset classes. Expanding their client base to include retirement savers has proved to be harder.

“We definitely would like to be part of 401(k) platforms,” Michael Gaviser, a managing director responsible for individual investor products at KKR, which oversees $76 billion, said in an interview at the firm’s New York headquarters. “We think about it every day because there’s so much demand.”

Sophisticated Products

Among the most-sophisticated investment products available, private-equity funds under U.S. rules can only be sold to accredited investors, defined as individuals with a net worth of more than $1 million or annual earnings of more than $200,000, or institutions with more than $5 million in assets. Some 401(k) plans may qualify, though employers must ensure the investments offered have fees, risk, transparency and liquidity that are appropriate for plan participants.

Defined-contribution plans such as 401(k)s let workers and employers contribute to a retirement account that’s run by the employee. The individual’s investing decisions directly affect his or her retirement income. Traditional pension plans, known as defined-benefit plans because they promise a lifetime payment, pool large amounts of money and usually have professional managers to invest it in a variety of assets.

Fundraising Woes

Traditional pensions -- the California Public Employees’ Retirement System is the largest in the U.S. -- are among the biggest investors in private equity, though they have become more selective after losses during the 2007-2009 financial crisis. Private-equity funds raised $312 billion globally last year, less than half the $669 billion gathered in 2007, according to data from London-based research firm Preqin Ltd. Fundraising closed after an average of 17 months in 2012, compared with 12 months in 2007, according to Preqin.

With traditional investors reluctant to commit new money, firms are getting more serious about accessing individual retirement plans, which have been a reliable source of growth for traditional asset managers such as Boston-based Fidelity Investments.

$5 Trillion

Assets in 401(k)-type plans will grow about 6 percent a year to $5.03 trillion by 2016, surpassing the $4.9 trillion projected for public pensions and widening their edge over private pensions, according to Boston-based research firm Cerulli Associates.

KKR last year started two debt funds for individual investors. The Alternative High Yield Fund (KHYKX), which became available in November, is an open-end fund with a $2,500 minimum investment and the option to withdraw money daily. The Alternative Corporate Opportunities Fund (XKCPX) is an unlisted closed- end fund with a minimum investment of $25,000 and quarterly liquidity. The funds, which will invest in assets such as high- yield bonds and bank loans, are the first pools managed by KKR that are structured like mutual funds.

The firm, founded in 1976 by Jerome Kohlberg and cousins Henry Kravis and George Roberts, is close to being able to add the high-yield fund to its own 401(k) plan through Fidelity, according to a person familiar with KKR's plans. KKR views that as a step toward offering the investments to other Fidelity 401(k)-plan participants, said the person, who asked not to be identified because the information isn't public.

Nicole Goodnow, a spokeswoman for Fidelity, declined to comment. Fidelity is the nation's largest provider of 401(k)s.

Blackstone ETF

"We're seeing a great level of interest by investment managers who have never worked in the defined-contribution space to find a way for their products to fit," said Lori Lucas, defined-contribution practice leader at San Francisco-based Callan Associates Inc.

Blackstone, the world's largest manager of alternative assets such as private equity, real estate and hedge funds, is seeking to develop products that would be suitable for individual investors, according to a separate person who asked not to be named because final decisions on such products haven't been made yet.

Christine Anderson, a spokeswoman for New York-based Blackstone, declined to comment on the plans.

The firm last year partnered with Boston-based State Street Corp. (STT) to create an exchange-traded fund for speculative-grade loans. The fund, SPDR Blackstone/GSO Senior Loan ETF, started trading today under the ticker SRLN.

Carlyle's Plan

Carlyle is starting a fund with New York-based investment firm Central Park Group LLC that will accept as little as $50,000 from individual investors, according to a January regulatory filing. Central Park Group will allocate money from the pool, called CPG Carlyle Private Equity Fund, to a variety of Carlyle-managed funds, with the aim of putting as much as 80 percent of the investors' capital in buyouts.

The minimum commitment to Carlyle's funds is typically $5 million to $20 million.

Carlyle, which is based in Washington and oversees $170 billion of assets across 113 funds and 67 funds-of-funds, expects its investment products may eventually reach 401(k) plans, said a person with knowledge of the firm's strategy.

Pensions have benefited from the ability to access a wider array of asset classes, said Alan Glickstein, senior retirement consultant at Towers Watson & Co. (TW), a New York-based professional-services company. Defined-benefit pension plans outperformed 401(k)-type accounts by an annual average of 93 basis points from 1995 through 2008 after adjusting for fees, according to Towers Watson's latest data. A basis point is 0.01 percentage point.

Excess Return

"A 1 percent per year difference compounds to a huge differential over a person's working and retirement lifetime," Glickstein said. A saver investing $100,000 over a decade at an annual rate of 8 percent, for instance, would earn $19,177 more than he would at a rate of 7

percent.

Private-equity funds returned an average of 14 percent from 2002 through 2012, according to Seattle-based researcher PitchBook Data Inc. U.S. stock funds gained an annualized 8.4 percent and bond funds rose 5 percent a year, according to Morningstar.

Investments that private-equity firms ultimately bring to 401(k)s may not mirror what they've offered to traditional pension plans and wealthy clients, said Laura Pavlenko Lutton, director of fund-of-funds research at Morningstar. A diluted version that fits in 401(k)s may not generate the returns that justify higher fees, she said.

Entry Point

The likely entry point for private-equity firms seeking access to 401(k)s are target-date funds, the most common default option for employees joining the plans, said Callan's Lucas. The funds usually are structured as mutual funds and hold a mix of assets that becomes more conservative as employees near retirement age.

The funds could add an alternative product -- such as a private-equity, real estate or hedge fund -- as part of the asset allocation with other sources of liquidity, Lucas said. Large employers increasingly are using formats such as collective trusts or creating customized versions, which are regulated differently from mutual funds and may allow for more illiquid investments such as private equity or real estate, she said.

Assets in target-date funds will more than double to $1.1 trillion by 2017, according to Cerulli.

Finding Returns

"As that custom target-date world continues to develop, consultants are going to want to bring more sophisticated investments to their clients," said KKR's Gaviser. "They're trying to find greater returns, but they can't access the same investments that defined-benefit plans can yet."

U.S. Senator Tom Harkin, an Iowa Democrat and chairman of the Senate Health, Education, Labor and Pensions Committee, is pursuing changes to 401(k) plans. Harkin has said he will introduce legislation this year that would create so-called USA Retirement Funds blending features of pensions and 401(k)s to improve worker outcomes.

"Because of the frequency of withdrawals, it's much harder for 401(k)s to take advantage of the types of investments that pension plans, with their long time horizons, use to diversify their holdings," Harkin said in an e-mail, citing asset classes such as real estate and private equity.

Slow Speed

Employers can take years deciding on 401(k) investment choices because they're liable under Department of Labor regulations as fiduciaries of such plans, which means they must act in the best interest of their workers and select suitable funds with reasonable fees.

The spread of alternative assets to 401(k)s will be slow because of "the nature of the market," said Kevin Chisholm, associate director at Cerulli.

BlackRock Inc. (BLK), Fidelity, T. Rowe Price Group Inc. and Vanguard Group Inc., four of the largest providers of target- date funds in 401(k)s, said they have no imminent plans to add private equity or hedge funds.

The added cost and complexity of alternatives have kept T. Rowe Price (TROW) from including them in its target-date series, said Richard Whitney, director of asset allocation at the Baltimore- based firm. Still, over time, there will be a convergence of practices seen in pensions with those in 401(k)s, he said.

“I believe in the future non-accredited investors will ultimately be able to invest in private equity,” Carlyle co- founder David Rubenstein said in a September interview. “It will be possible in the future where 401(k) check-off plans will be able to say, you can take a certain amount of your money a year and go into an illiquid private-equity fund.”

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Enlarge image

The California Public Employees' Retirement System (Calpers) in Sacramento, California. Photographer: Ken James/Bloomberg

Enlarge image

The building that houses the Carlyle Group LP headquarters stands in Washington, D.C.. Carlyle expects its investment products may eventually reach 401(k) plans. Photographer: Andrew Harrer/Bloomberg

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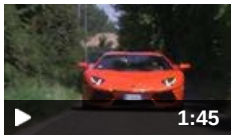

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