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How the 1 Percent Got That Way

By Alan Tonelson

If *Private Equity at Work* gets the large audience it deserves, great times should be in store for America's public relations industry. Eileen Appelbaum and Rosemary Batt's exhaustive study of the private equity sector and its impact on the US economy gives these often high-flying investors the kind of black eyes that typically produce a stampede to image-makers like Kekst and Company.

Bad enough are many of the relatively familiar concerns the authors meticulously document about this part of the nation's virtually unregulated shadow banking system. Has anyone who follows the economy or finance, even as a layperson, not heard of the hits often absorbed by workers and communities when companies are bought and sold solely for short-term gains through leveraged buyouts, the dominant manifestation of private equity? And the casino-like nature of these (and many other types of) transactions often have been portrayed as a central flaw of American-style capitalism, especially with the economy still struggling to emerge from a financial crisis and recession triggered by fast-buck finance.

Much more striking, and less well known, is all the evidence presented by the authors exposing private equity as a failure even by the Darwinian standards its companies favor and indeed claim to embody. As Appelbaum and Batt make abundantly clear, the sector flunks numerous major tests of free market virtue. Private equity's overall returns for investors are sub-par. Its activities often have nothing to do with turning around floundering companies. Its operations tend to be as transparent as a burka. And a major source of returns and earnings for its own general partners and staff stem directly from favors arguably bought with Washington lobbying—most prominently, the tax code's favorable treatment of debt financing for takeover activity, and lucrative earnings from so-called "carried interest" as lightly-taxed dividend income. The carried interest discount allows financial engineers to avoid paying millions in income taxes.

The combination of humdrum performance (for sky-high fees) and opacity helps produce one of the most stunning revelations of *Private Equity at Work*: The sector's victims include not only displaced (and often blindsided) workers and ravaged local tax bases, but many of those who invest in private equity firms themselves. And inside this irony is another that the authors face squarely and admirably, given their unmistakably progressive political orientation: Public employee union pension plans are among the biggest of these private equity investors.

Since American capitalism's current priorities have shown such staying power, the most important and successful parts of *Private Equity at Work* are those detailing the sector's mediocre-at-best investment performance. The authors acknowledge that their own conclusions are anything but unassailable. The reporting requirements for private equity firms are threadbare, and the companies have almost complete control over the financial information available for scrutiny.

But it's undeniably important that the preponderance of research independent of private equity companies points to returns that don't remotely justify either the fees reaped by the sector or the risks incurred by its investors. According to Appelbaum and Batt, the average private equity fund barely performs better than the most comparable stock indices, and the median fund just barely matches them.

These results, however, are actually worse than they sound. For private equity investments are judged to be relatively risky propositions, in part, because investors usually must commit their capital for ten years. Returns of three percent are considered necessary for adequate compensation, meaning that most private equity companies qualify as financial losers. And even these numbers don't fully convey private equity's failings, since nearly all of whatever slim over-performance can be credited to the entire sector is generated by the top 10 percent of funds.

At the same time, Appelbaum and Batt clearly have a bigger target in mind than the private equity sector, which since 2000 has owned companies employing only 7.5 million Americans. (During this period, total US private sector employment has ranged between roughly 107 million and 118 million on a monthly basis). As noted above, their work strongly reinforces the proliferating claims that the US economy's dramatic financialization since the late 1970s— which produced private equity investment and so many other new dubious products and services—deserves considerable blame for the 2007-08 national and global crashes. Similarly, the authors use private equity's workings as a case study in how the economy is now structured to reward unproductive financial engineering that enriches the few over genuine value creation that fosters broader prosperity. (For a vivid account of the political and policy maneuverings that helped produced this transformation, see Hedrick Smith's 2012 book, *Who Stole the American Dream?*).

This methodology is certainly sensible. Appelbaum and Blatt correctly point out that private equity "is the financial intermediary that has the most direct effect on the management of mainstream businesses in the US economy." As their book's subtitle puts it, private equity's defining characteristic entails Wall Street managing Main Street. But the relationship between the dominance of finance and the triumph of economically counterproductive short-termism is shakier than the authors contend, and not just because of all the instances they spotlight of private equity firms that do accomplish needed corporate turnarounds and restructurings.

The most compelling evidence is the US government's data on the contributions made to the economy's growth by the major inputs to gross domestic product (GDP). If Appelbaum and Batt—and so many others—are right, and the financial deregulation waves that began more than forty years ago turned businesses shareholder value- and stock price-happy at the expense of productive investments that create longer-term, more widely distributed prosperity, then the GDP figures should show a major drop-off in what's called non-residential fixed investment.

Yet the numbers show exactly the opposite. Such spending, which includes investment in factories, machinery, research & development and the like, has been a considerably greater contributor to growth since financial deregulation took off than before. The previous bubble decade, when crackpot, short-term-focused finance supposedly ran riot, was no exception. Nor is the current economic recovery, even though companies have been anything but shy about using tactics like share buybacks to boost stock prices for reasons having little to do with the real economy's fundamentals, and when private equity investments have made a significant comeback following a post-crisis nosedive.

In fact, the GDP figures indicate another problem with the dim view of modern corporate governance and priorities held by the authors and like-minded analysts, and which *Private Equity at Work* acknowledges only cursorily: The previous era of stakeholder capitalism, in which business leaders ostensibly took a more broad-minded, socially-responsible view of their responsibilities than today's tycoons, left much to be desired. Many major American companies and entire industries were completely unprepared when Washington began opening the economy wide to ever more potent foreign competitors—a development that also dates from the late-1970s. And stakeholders, especially employees, paid a heavy price.

Because Americans rightly view free market practices as superior, many of the reforms proposed by Appelbaum and Batt for the private equity regulatory regime should command broad support. Among the most important are notably greater transparency through more detailed financial reporting requirements; and an end to compensation practices and legal arrangements that needlessly distort risk-reward relationships and thereby create moral hazard (like the carried interest loophole and protections from pension liabilities and other standard consequences of business failure). Crucially, the second set of changes would bolster the nation's financial stability, and reduce the odds of another 2008-like crisis, although the problem of dangerously perverse incentives far transcends the world of private equity.

The outlook, however, looks dimmer for that much broader, more consequential goal sought by Appelbaum, Batt, and their sympathizers. Precisely because of the free market consensus, and the shortcomings of American capitalism's previous iteration, a much stronger case still needs to be made for requiring the US economy to serve stakeholders' interests more explicitly, rather than that of the one percent.

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