Private Equity Set for Best Returns in Next Decade

By Shanny Basar | New York

U.S. and global private equity is the only asset class predicted to achieve double-digit annual returns over the next 10 years, which could leave many pension struggling to achieve their targets, according to new research from BNY Mellon.

(This story also appears in Private Equity News, a U.K.-based publication of Dow Jones & Co.)

U.S. private equity is expected to return 11.75% and global private equity 10.5%, the only double-digit returns in the "10-Year capital market return assumptions" from BNY Mellon Investment Strategy and Solutions Group and BNY Mellon Wealth Management.

BNY Mellon said low fixed-income returns and single-digit equities returns will make it difficult for pension funds to meet their target returns of between 7% and 8%.

Jeffrey Saef, managing director for BNY Mellon and head of the Investment Strategy and Solutions Group, said that the private equity returns do not include fees and were modelled against public equity returns with assumptions for illiquidity and risk. "They are an average return but in this asset class manager selection is also very important."

Expected returns for alternative assets range from the highest for private equity to a low of 2.5% for both commodities and absolute return strategies.

In equities, expected returns are 7% for U.S. large-cap stocks over the 10-year period, with risk-adjusted annual returns for U.S. small- and mid-cap stocks likely to reach a similar level. The returns assume real earnings growth of 2% per year, which is below consensus forecasts of 6%, and dividend yields of 2.25% a year and developed market inflation of 2.5%.

Fixed income returns are expected to be weaker than historical norms due to rising interest rates. The report assumes that real cash rates will rise to 1% in the U.S. in 10 years with inflation at 2.5% and 10-year Treasury yields at 3.5%. This will cause 10-year Treasuries to return -0.25% over the next decade, the only negative return in the report. The highest fixed income return is expected from emerging markets sovereign local currency debt at 6%.

Mr. Saef said that corporate and public pension plans are expected to respond differently to extremely low fixed-income returns and single-digit equities returns. "Corporate plans are extremely focused on matching their asset and liabilities and removing the volatility of pension funding from their earnings. They are more likely to continue to invest in long duration fixed income assets."

This month The Wall Street Journal reported that corporates are making increased contributions to their pension plans due to the low rate environment. Ford Motor Co. expects to spend $5 billion this year shoring up its pension while Verizon Communications Inc. contributed $1.7 billion in the fourth quarter of last year.

In contrast, public pension plans are focussed on boosting returns and so are likely to increase allocations to international equities and alternatives, according to Saef.

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