The Principal Agent Problem in Private Equity

Peter Morris has written an interesting article noting the principal-agent problem as it relates to investors in private equity. Peter spent 25 years working in financial services and is the author of a report written for the Center for the Study of Financial Innovation (CSFI) called Private Equity, Public Loss? Peter and others have pointed out the disparity between low returns earned by private equity investors and the ample compensation earned by the managers of those investments. The principal-agent problem Peter notes is not unique to private equity of course, but he makes a good case for much greater transparency around results for such investors and challenges the notion that “sophisticated” investors are well equipped to make well informed decisions in this arena. Investors in hedge funds have suffered through similarly poor results as Peter also notes, and he kindly refers to a book I have written called The Hedge Fund Mirage which explores this issue.

There are interesting public policy issues surrounding this entire area, in that public pension funds are increasingly allocating capital to alternative investment strategies in the hopes of reaching the 7-8% return targets they need to meet their obligations. Ultimately, a failure to meet those goals will have consequences for taxpayers throughout the developed world as workers retire if pension plan returns fail to met expectations.