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SPECIAL REPORT

Public Funds, Private Deals:
Evaluating State Oversight and Governance of Private Equity Investments

Back in May, Star Tribune reporters put together a good backgrounder on an underappreciated feature of Minnesota public finance: Minnesota's risk/reward tradeoff in public pension funding. At issue was the world of private markets -- investments in non-publicly traded companies outside of public stock exchanges which include real estate, real assets, private credit, and the biggest and most controversial component -- private equity.[1] As of the latest SBI performance report, private equity comprises about 72% of the private markets asset class and about $16.9 billion (17%), of the state's entire "combined funds" investment portfolio -- the assets that support the state's pension plans.

In our 2020 piece, "Banking on a Superior Form of Capitalism," we discussed the appeal and rationale behind the state's long-standing and growing commitment to this asset class. However, we observed private equity had begun to exhibit signs of struggle to create the value and continue to generate the outsized returns which had come to define the performance of this asset class for years. Since then, some new challenges have arisen at the same time the entire premise of public pension investments in private markets -- particularly private equity -- have come under increasing scrutiny. We take a closer look at developments affecting this industry, the governance and transparency concerns surrounding these investments, and Minnesota's response to them.

Problems Encountered, New Challenges Emerge, But Popularity Remains Intact

In the last few years, private equity firms have been working through what the global head of private equity for megafirm Blackstone called "the most treacherous moment." The so-called "gold rush" years of private equity featured lots of cheap debt combined with explosive investor interest driving up the prices paid for deals and making investment returns from exits more challenging. The Fed's subsequent rate hikes threw a monkey wrench into private equity economics resulting in a marked decrease in deal activity.

Despite some green shoots in specific areas, the industry as a whole appears to continue to struggle. In the twelve months leading up to June of this year, private equity firm fundraising reached a seven year low despite offering incentives like significant management fee reductions and early bird discounts to attract investors.[2] Meanwhile, firms are returning fewer proceeds to investors through exits from initial public offerings, sales to another company, sales to another private equity investor, or management buy-outs. The eleven percent of assets returned last year to investors was the lowest since 2009.[3]

The global head of private investments at Cambridge Associates, a prominent advisor for large institutional investors in private equity, has warned that the industry's challenges could take years to

[1] We focus on private equity given its relative significance of this asset class compared to other private market segments. Many of the same issues highlighted in this report also apply to these other private market asset categories.
[2] "Private Equity Slides as Sector Downturn Deepens" *Financial Times,* August 25, 2025
[3] Ibid

resolve. “There is an expectation that the wheels of the exit market will start to turn. But it doesn’t end in one year, it will take a couple of years.” Or as an unnamed large industry investor remarked, “You have a huge amount of capital that has been invested on assumptions that are no longer valid.”[4]

All this has prompted some investors in private equity to sell off shares of their portfolio at a discount to net asset value. Yale University, a pioneer and vocal champion of private equity investing, turned heads earlier this year announcing plans to sell $3-4 billion of their private equity portfolio. Goldman Sachs has reported that private equity asset sales, which historically had been done at a premium of at least 10% to the fund’s internal valuations, have in recent years been made at discounts of 10%-15%.[5]

In this challenging environment, private equity firms are employing creative ways and complex financial engineering strategies to return capital to investors such as endowments and pension plans. These include continuation funds in which a private equity firm sells a portfolio company or companies to itself by establishing a new fund to avoid a forced sale. This and “secondary market transactions” -- the sale of an existing investor's interest in a private equity fund or a portfolio company to another investor to enhance liquidity -- can add additional complexity, transparency issues, valuation and operational risks, and fee implications to an asset class that already features its fair share of such characteristics.

The lack of exits can affect both a pension fund’s liquidity and re-investment ability. This can be a particular exposure concern for older and mature state pension funds that are significantly cash flow negative -- more going out in benefits than contributions and aids coming in -- and thus increasingly dependent on investment returns. As *Governing* magazine observed, “Facing negative cash flows, an illiquidity-premium strategy can backfire in down markets. The needed cash has to come from someplace else, and that can impair overall returns.”[6] In 2024 Minnesota’s state pension fund cash flows before investment returns was a negative $2.7 billion.

Despite these recent trends there is little sign of public pensions funds losing their appetite for this asset class. According to the latest Public Pension Fund Survey from the National Association of State Retirement Administrators:

> *Allocations by public pension funds to public equities and bonds historically comprised the bulwark of public pension portfolios. This predominance has been diminished by continuous growth in allocations to alternatives and real estate: the average allocation to alternatives (chiefly private equity and hedge funds) in FY 23 is the highest in public pension fund history.*

Minnesota’s asset allocation target for private markets (including private credit, real estate, resources, as well as private equity) has increased from 10% twenty years ago to 25% today.

Advantageous Opportunities in Some Treacherous Waters

While all this has been going on, the wisdom of public pension investments in private equity has come under greater scrutiny, calling into question the entire premise of investment in this asset class and even the existence of “above market” returns. The investment equivalent of Luther’s 95 theses might be a 2020 paper from a finance professor at Oxford University with the provocative title, “An Inconvenient

[4] “Private equity payouts fell 50% short in 2024” Financial Times, December 24.2024
[5] Ibid
[6] “How ‘Alternative Investments’ Are Dragging Down Pension Performance” *Governing,* July 16, 2024

Fact: Private Equity and the Billionaire Factory." Based on his analysis of over 1,800 buyout funds he concludes private equity has returned about the same as public equity indices since at least 2006 adjusted for risk. Moreover, private equity managers -- not the investors -- are the ones capturing excess returns generated by a private equity investment compared to market returns.

A study by CEM Benchmarking -- a research firm that specializes in providing comparative performance, cost, and governance analysis to institutional investors -- examined 24 large global funds with $4 trillion of assets and concluded on average, institutional asset owners report only around half of their true total investment management costs in official financial statements—meaning roughly 49–51% of costs go unreported making results look more favorable than they really are.[7] Still another study of 24 of the largest state pension funds concluded these funds underperformed passive investment over 10 years from 2010-2020 by an average of 1.4% per year due to heavy reliance on expensive active management, especially in private markets.[8]

However, other research studies continue to report average returns that beat public markets. A reexamination of an older scholarly study of 1,400 U.S. buyout and venture-capital funds published by the National Bureau of Economic Research concluded U.S. buyout funds outperformance of the S&P 500 was actually larger than the 3% per year originally reported.[9] Numerous and more recent institutional studies by investment banks and related institutions like J.P Morgan, Bain, Dimension Fund Advisors, and the American Investment Council continue to show private equity funds, on average, outperforming public markets. As might be expected, all this has prompted a vigorous and protracted debate about what is and isn't really happening in this industry.

The truth is likely contained in the words "on average." Academic and practitioner literature is very clear that who investors, like state boards of investment and pension plans, actually invest with matters -- a lot:

- A 2023 McKinsey study of 2009-2019 vintages found the top quartile funds yielded net internal rates of return nearly 3 times that of the bottom quartile funds, and the returns of the bottom quartiles were often near or even below the cost of capital.[10]

- A study by Dimension Fund Advisors examined Lifetime Total Value to Paid in Capital (distributions plus any remaining net asset value relative to contributions) for 6,000 private market funds over a 42-year period. For private equity buyout funds the 95th percentile performance was 2.85 times contributions while the 5th percentile was negative 0.73 indicating capital losses. Similar findings existed in venture capital funds, private credit, and private real estate with the 5th percentile all losing money.[11]

- The Wall Street Journal reported at the end of 2023 that $668 billion in private equity assets had reached or exceeded their fund lifespan with one-third of assets held over 8 years now worth

[7] "Asset owners report half of all costs" Top1000funds.com, November 2, 2020
[8] "Cost, Performance, and Benchmark Bias of Public Pension Funds in the United States: An Unflattering Portrait," Ennis, *The Journal of Portfolio Management* Vol 48 Issue 5, April 2022
[9] "Reassessing Private Equity: Investors in Buyout funds Have Been Earning Higher Returns than Previously Thought" University of Chicago Booth Review, 2012
[10] McKinsey Global Private Markets Review, 2023
[11] *Understanding Private Fund Performance*, Dimensional Fund Advisors, July 19,2024

less than that original investment. Adding insult to injury, in many if not most cases the funds continue to charge fees in these so called “zombie funds” despite delivering poor or negative returns.[12]

As highlighted earlier, current exit delays lock up capital elevating the importance of “choosing the right horses to ride.” Older, illiquid funds represent the greatest risk, tying up capital, underperforming, and eroding value. Based on 2024 Annual Reports, the SBI has investments representing $1.3 billion of net asset value in private equity funds that continue to operate after their intended lifecycle.[13]

In short these can be advantageous but treacherous waters to wade into using public money. Or as Dimension Fund Advisors remarked, “Private investing is inherently associated with special fund structures, minimum capital commitments, illiquidity, and relatively high fees. Like other alternatives, private funds are not for everyone.”

In response to the risks, calls for enhanced regulatory protections and transparency requirements have come from governments, pension beneficiaries, taxpayers, as well as private equity investors themselves. In 2023 the SEC adopted a sweeping new 660-page Private Fund Advisers Rule to:

> *“protect investors who directly or indirectly invest in private funds by increasing visibility into certain practices involving compensation schemes, sales practices, and conflicts of interest through disclosure; establishing requirements to address such practices that have the potential to lead to investor harm; and restricting practices that are contrary to the public interest and the protection of investors.”*
>
> Securities and Exchange Commission 17 CFR Part 275
> Release No. IA-6383; File No. S7-03-22

Among its many provisions, the new rule required:

- quarterly statements to investors;
- a detailed accounting of all fees and expenses allocated to or paid to the private fund; a detailed accounting of all portfolio investment compensation including but not limited to origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing , disposition, directors, and trustees;
- disclosure regarding the manner in which financial-related actions are calculated such as payments, rebates, offset, and allocations;
- reporting on fund performance, both gross and net of expenses “with equal prominence”; and
- prohibitions on charging certain fees and providing preferential treatment to investors.

Private market trade associations objected to the new rule arguing unnecessary duplication of existing effort, interference with contractual freedom, compliance cost and competitive harm, and harmful effects on innovation and capital formation. But opponents also argued that the SEC exceeded its legal and statutory authority under the Federal Investment Advisors Act. In June of 2024, the Fifth Circuit Court of Appeals unanimously ruled that the SEC did, in fact, overstep its authority by attempting to

[12] “*Stuck Private-Equity Deals Saddle Investors with Endless Fees*” Wall Street Journal, June 29, 2025

[13] The 2024 TRA Annual Financial Report notes “There are 43 out of 192 Private Equity funds that are over the 12-year liquidation period and represent 7.9% of the Private Equity NAV value. According to the SBI FY 2024 Annual Report, total private equity value was $16.52 billion.

regulate the internal governance structure of private funds through rules requiring disclosure to fund limited partners such as pension funds and endowments.[14] The Court vacated the rule in its entirety.

As a result, it falls to the investors themselves like the SBI -- known as "Limited Partners" in private equity -- to navigate this complexity through their negotiated limited partnership agreements and "side letters"[15] with fund managers ("General Partners") to assure their interests are aligned. In a recent report by the Chartered Financial Analyst Institute's (CFAI) Research and Policy Center entitled *Private Markets: Governance Issues Rise to the Fore*, the fundamental question regarding the wisdom of private equity investing is posed:

> *"Can institutional investors investing in private markets protect their interests and that of their own beneficiaries? Or do asymmetries of information enable private fund managers to dominate negotiations over terms of investments, the management of private funds, and the distribution of profits?"*[16]

Is SBI's Governance an Example of "Minnesota Exceptionalism"?

Minnesota appears to have a pre-existing advantage working in its favor from being one of the "first mover" states into this area of investing. This advantage should not be discounted. As Morningstar notes, "Access is highly stratified: only the largest and most sophisticated pensions are consistently admitted into top-tier funds, while others risk paying high fees for more average managers whose performance may not exceed public markets after costs."[17]

The earliest reference we could find about SBI efforts in private markets comes from its FY 1984 annual report containing a description of using alternative investment managers to gain opportunities in venture capital, resource and real estate markets. As a result, the SBI obtained access to top quartile funds and General Partners well before most other states began to pursue these investments and their demand exploded. This focus on long-term relationships with partners with proven track records and operational expertise has endured, also resulting in preferential access, treatment, and opportunities.

"Good governance" in private equity investing covers a lot of territory, but begins with a state's capabilities, expertise and infrastructure to manage and oversee these complicated investments. The work of the SBI in this area is spearheaded by a private market team within the organization. Our review of LinkedIn staff profiles indicates the individuals comprising the team collectively represent 103 years of investment experience, 43 years focused specifically in the private markets area, and include three Chartered Alternative Investment Analysts and five Chartered Financial Analysts. Per SBI annual reports, in addition to examining of the economic attractiveness of a fund's investment opportunities, these individuals are responsible for conducting related due diligence "including but not limited to

[14] The Court distinguished between the fund itself ("the client") as a separate legal entity and investors in the fund concluding that any duty to disclose extends only to the client not the limited partners. The court also drew a bright line between the regulation of private fund investors and retail customers and implying if Congress intended for these types of disclosures to be made to limited partners, it would have included specific language to that effect in laws pertaining to its anti-fraud authority.

[15] Side letters are confidential, separate agreements between a fund manager and a limited partner that grants the limited partner special rights or terms not provided to other investors in the fund.

[16] *Private Markets: Governance Issues Rise to the Fore*, CFA Institute Research and Policy Center, June 12, 2024

[17] "How Attractive is Private Equity? How Good are Your Manager Selection Skills" Morningstar.com, June 11, 2025

reference checks, database searches, the manager's approach to talent and culture, risk framework, stewardship, and governance, and -- to the extent available -- a review of the Fund's potential investor base."

In addition, the SBI's Investment Advisory Council (IAC), which includes private and non-profit sector senior investment executives, "provides advice and independent due diligence review of the investment policy and implementation recommendations that guide the SBI's investment of assets." Proposed investment policies and actions are reviewed by the IAC before they are presented to the State Board of Investment for ratification.[18]

Even with a robust infrastructure, the true test of good governance comes in how the "asymmetries of information" as described by the CAIA and their implications are addressed. Three areas are of particular importance and relevance:

- Net Asset Value (NAV) evaluation and confirmation
- Recognition, management, and disclosure of fees and expenses
- Performance reporting and benchmarking

NAV evaluation and confirmation -- Like public equity reporting, private equity investment returns reflect unrealized gains. Unlike public equity returns, there is no market price accompanying these unrealized gains. Instead, quarterly and annual private equity returns return reporting reflect changes in net asset value (NAV) -- the estimated fair value of the fund's assets minus liabilities at a specific point in time from one period to another. It is an accounting estimate. Questions and concerns about these valuations can arise in particular circumstances such as during big changes in market conditions, fundraising cycles, and when assets are "stuck" and remain in funds exceeding their liquidation periods without an exit.

Valuations are reported by the funds themselves. Concerns may arise about the development of these valuations based on assumptions which can be manipulated or overly optimistic. Different methodologies employed can yield different NAV calculations. Moreover, multiple month lag times in NAV calculations routinely exist causing NAVs to appear stable even when real market values may be falling. This delayed recognition of declining performance as a result of more difficult economic circumstances facing portfolio businesses has a "smoothing effect" on reported returns (otherwise known as "volatility laundering" which is an underappreciated reason for the popularity of this asset class in public pension funds.) As the CEO of one global asset management firm recently stated, "A healthy skepticism of PE's reported NAV and volatility is necessary to understand the true risk of these funds' portfolios."[19]

Private equity firms typically provide annual audited financial statements for their Limited Partners which include valuations of portfolio companies and assumptions used. However, some have called into question the reliability of third-party audits from auditors who may not have the portfolio company industry understanding or background to assess the reasonableness of the assumptions behind the

[18] Contrary to what some have implied, the SBI Board, comprised of the states' constitutional officers per Article XI, Section 8 of the state's constitution, are not "making the calls" on investments. Rather, the duties and powers to "plan, direct, coordinate, and execute administrative and investment functions" are delegated to the executive director of SBI per Minn. Stat. § 11A.07 (2024).
[19] "New Analysis Suggests PE Funds Are More Volatile Than We Think" Institutional Investor, July 23, 2025

estimate. There is also concern about potential conflict of interest and regulatory capture.[20] The Government Accounting Standards Board (GASB) does not require third-party audits of NAV estimates.

For quarterly reporting, SBI contracts with State Street Bank and its "Private Edge" platform, a specialized cloud-based software solution developed to help institutional investors manage and oversee their private markets investments. Fund managers submit their quarterly NAV report and all supporting documentation through the secure Private Edge portal which consolidates all NAV data into a centralized system and applies standard data templates to normalize reporting formats for comparison. The system identifies data inconsistencies, missing inputs, and flags unusual valuation changes.

As a quality control check, SBI has a second contract with an outside consultant that performs a quarterly validation of NAV using data from fund managers for all private market funds. Any variances between SSB Private Edge reported numbers and the consultant's calculated/validated numbers are brought to the attention of SBI. SBI staff examine these quarter-over-quarter valuation changes for reasonableness while also checking to ensure managers used methodologies in line with accounting standards and partnership agreements.

SBI also requires that each private equity fund undergo an annual third-party financial audit by an external public accounting firm who confirm the valuation methodology and review compliance with GASB fair value standards. As part of the SBI's annual financial statement audit, OLA examines the roll forward NAV derived from the audited financial statements of each individual fund to determine if their calculations materially reconcile with SBI numbers and investigates any significant variances thus offering another check on NAV valuation consistency. All historical OLA audit letters on the SBI website reflect unqualified clean opinions.

Recognition, management, and disclosure of fees and expenses -- Private equity is full of potential fees and related expenses, that should be netted out in reported investment returns. Fee issues have received significantly increasing investor and regulatory scrutiny in recent years. In its 2024 agency financial report, the SEC targeted the calculation and allocation of private fund adviser fees and expenses as an examination priority. In addition to management fees and performance fees otherwise known as carried interest, a wide variety of additional transaction costs in areas such as deal sourcing and execution, post-acquisition expenses, and exit-related costs reduce the NAV and cash available for distribution to investors like pension funds.

Concerning the ***recognition*** of all relevant fees, SBI is aided by the work of the Institutional Limited Partners Association (ILPA) whose membership includes the SBI. ILPA is a global organization "dedicated exclusively to advancing the interests of private equity limited partners and their beneficiaries through best-in-class education, research, advocacy, and events." The ILPA develops sets of principles, best practices, due diligence questionnaires, and standards covering the gamut of private market investment activity and circumstances to "foster transparency, governance and alignment of interests" and "cultivate best practices and improve the quality and flow of information related to private equity."

Of particular relevance to fee and expense recognition and NAV reconciliation is the ILPA reporting "template" -- a standardized form to promote uniform and transparent reporting practices in the private equity industry. The ILPA reporting template is designed to provide a line-by-line determination and

[20] "Private Equity's Ties to Companies' Auditors Have Never Been Closer. That Worries Some Regulators." *Wall Street Journal,* October 30, 2024

reconciliation of NAV calculation with incurred fees, expenses, carried interest, and other cash flow elements.

The template provides a comprehensive picture of all fees and expenses covering management fees and expenses paid to the general partner (both gross and net of offsets, rebates and waivers), carried interest, and operating fees and expenses paid to third parties. It includes roughly 23 specific expense and fee item categories from valuation services, audits, and regulatory compliance to due diligence, broken deals, and travel/entertainment. It also provides a schedule of fees and reimbursements made by all companies in a fund's portfolio to the general partner in order to identify potential conflicts of interest where the general partner might be incentivized to charge fees to portfolio companies to benefit themselves, even if it negatively impacts the fund's overall returns.

SBI informed us the agency "was an early adopter of the ILPA fee and management disclosure template in 2016." Most importantly, the SBI requires that "all General Partners with whom we have relationships agree to its usage."

With respect ***to fee and expense management***, the SBI is not a passive player simply accepting the terms and conditions offered by private equity firms in partnership agreements. Perhaps contrary to perception, SBI Board and IAC minutes, meeting materials, and news reports indicate the SBI has long actively and successfully negotiated with private equity firms on discounts, standard carried interest percentages, step-downs, and "offsets" -- mechanisms that reduce the total fees paid.[21] As suggested earlier, the SBI's long established history and partnerships with top tier firms helps with these negotiations.

Other cost-reducing strategies employed by the SBI as reported in annual reports and meeting materials include:

- Co-investments -- in which the SBI directly invests in a target firm directly alongside the fund. This strategy of cost control bypasses traditional private equity fund economics by having low or no management fees or carried interest.
- GP Stakes -- a way to participate in the revenue streams of a general partner by acquiring a minority interest in an alternative asset manager. These "GP stakes" investments include returns from management fees, capital gains, and even a portion of the carried interest itself.
- Separately Managed Accounts (SMAs) -- customized private equity structures set up specifically for the SBI typically by agreeing to be a larger funder of a portfolio (think volume discount) but in the process also receiving fee savings while gaining more control over exposure, management, and related performance matters.

With respect to ***public disclosure*** of fee and expense influence on investments, the SBI falls considerably short of what can be considered "best practice." As in most, if not all, states, limited partnership agreements and side letters themselves related to a fund in which the SBI invests (or is considering an investment) are classified as not public data pursuant to state statute:

> *All financial, business, or proprietary data collected, created, received, or maintained by the state board in connection with investments authorized by paragraph (a), clauses (1) to (6), are nonpublic data under section 13.02, subdivision 9. As used in this paragraph, "financial, business,*

[21] "Mansco Perry beats the benchmarks at Minnesota Investment Board," *Star Tribune* November 13 , 2018

or proprietary data" means data, as determined by the responsible authority for the state board, that is of a financial, business, or proprietary nature, the release of which could cause competitive harm to the state board, the legal entity in which the state board has invested or has considered an investment, the managing entity of an investment, or a portfolio company in which the legal entity holds an interest…

Minn. Stat. §11A.24, subd. 6(c)

However, the subdivision concludes with this:

Regardless of whether they could be considered financial, business, or proprietary data, the following data received, prepared, used, or retained by the state board in connection with investments authorized by paragraph (a), clauses (1) to (6), ***are public at all times*** (emphasis ours)…

With clause (5) stating: *the state board's internal rate of return for the investment,* ***including expenditures and receipts used in the calculation of the investment's internal rate of return*** (emphasis ours).

The table below compares SBI's public reporting of these "public at all times" data elements with one of the recognized best practice states for public disclosure. Even though fees and expenses used in generating internal rates of return are deemed "public at all times," SBI does not choose to disclose them requiring a Data Practices Act request for the information.

Fund Level Public Reporting Disclosure: Private Market Investments		
	Minnesota	**California**
Commitments	x	x
Contributions	x	x
Distributions	x	x
Market Value	x	x
Net Multiple on Invested Capital	x	x
Net IRR	x	x
Vintage Year	x	x
Management Fees Paid		x
Share of Other Fees and Expenses Paid		x
Carried Interest Paid		x
Share of Portfolio Fees Paid to General Partner		x
Gross IRR		x
Realized Gains/ Losses Since Inception		x

Sources: MN SBI Private Markets Investments Asset Listing, and CalStrs Report Pursuant to California Assembly Bill 2833

Not only is fund level fee and expense detail absent from SBI public reporting, until last year the SBI Annual report did not include a sum total of its private market management fees to complement reporting on total public markets fees paid. For the first time in its 2024 Annual Report, SBI reported total private market management fee payments of $259.4 million. For reference and to illustrate the considerable additional expense associated with these investments, that $259 million is 3 times the amount of fees paid to its public market managers that constitute the other 75% of the state's Combined Funds portfolio.

From its 2024 Annual Report, SBI's explanation is that "until recently it was not practicable for the SBI to separate private market management fees from investment income within the timeframe required for inclusion in the fiscal year audit." It's an explanation that's partially plausible but also a head-scratcher. On the one hand, as discussed earlier, lag times of months can exist in private markets NAV and fee reporting and may conflict with audit deadlines. On the other hand, other state investment boards and pension plans have been doing this for years, and SBI's use of ILPA reporting templates would seem to make this much easier. Even if not audit-ready, SBI has quarterly or annual fee totals from invoices and capital account statements to be able to report at least a reasonable estimate, perhaps subject to later "true-ups" to address transparency concerns.

Nor does the SBI report gross IRR for its funds which, when compared to net IRR, allows a rough approximation of "fee drag" on these investments. Comparability complications, public interpretation concerns,[22] and General Partner sensitivity to these disclosures likely explains reticence to public disclosure of gross IRR. Nevertheless, both the ILPA and Pew recommend publishing both gross and net IRR to improve public transparency of these investments.[23]

All this is a curious and disconcerting look for the SBI. "Not practicable" sounds much more like "not prioritized." The justification may be a belief that transparency interests are adequately and responsibly served by its Combined Funds total returns report net of fees. It's also not unreasonable to assume that SBI is also concerned that making unfamiliar data and details available to the public can generate the opposite of transparency and understanding -- a fertile environment for misinterpretation, confusion, misuse, and erroneous conclusions.

Importantly, and regardless of the SBI's rationale, the failure to publicly disclose does not mean a failure to recognize and incorporate. SBI articulates in all its performance reporting that "performance and investment income have historically been reported net of investment management fees and any profit-sharing arrangements and that practice continues through the entirety of the report."

Performance reporting and benchmarking -- To put it bluntly, private equity investing significantly complicates pension fund public return reporting and benchmarking. Return reporting is fundamentally different for public markets and private equity. Public market investing uses familiar time-weighted rates of return (TWR) measuring how an investment grows over time, ignoring the effect of when money is put in or taken it out. This is ideal for benchmarking against public indices and evaluating the performance of investment managers who don't control investment cash flows. In stark contrast private equity features very large and very irregular cash flows that managers ***do*** directly control. This demands

[22] Gross IRR doesn't reflect what the fund actually earned nor is it simply "net IRR plus fees and expenses" – gross cash flows also have to be incorporated into this calculation.
[23] "Transparency in Investment Disclosures Helps Promote Effective Public Pension Administration" Pew, October 31, 2023

money-weighted Internal Rate of Return (IRR) reporting, which is an annualized rate of return on the actual cash invested.[24] Public market TWRs and private equity IRRs are apples and oranges -- they can't be directly compared with each other. The exact same investment with the exact same timing of cash flows can yield very different reported time-weighted and IRR results. For that reason, SBI reports internal rates of returns for its private equity funds separately.

However, lawmakers, pension beneficiaries, and the public understandably want a one number "scorecard" to evaluate total Combined Fund performance against a composite benchmark index that reflect all the fund's different asset policy allocations. As a result, the SBI constructs a TWR return series from its private equity NAVs and cash flows as a proxy for private equity performance and makes that a part of its Total Combined Funds Performance Report. This report provides a seemingly simple and straightforward scorecard about whether "excess returns" have been achieved or not through active management.

Performance (Net of Fees)

The Combined Funds' performance is evaluated relative to a composite of public market index and private market investment returns. The Composite performance is calculated by multiplying the beginning of month Composite weights and the monthly returns of the asset class benchmarks.

	QTR	FYTD	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr	30 Yr
Combined Funds	0.1%	4.5%	6.3%	5.3%	11.6%	8.3%	8.1%	8.6%
Combined Funds-Composite Index	0.4%	4.7%	6.4%	5.1%	11.2%	8.1%	7.9%	8.3%
Excess	-0.3%	-0.2%	-0.1%	0.2%	0.5%	0.2%	0.2%	0.3%

Source: SBI Combined Funds Performance Report, March 2025

As might be expected, things are not as simple as they may superficially appear to be. In this performance report the public market holdings are benchmarked against appropriate public indexes. However the SBI includes actual time weighted private market returns in the composite index. That is because no investable, generally accepted index exists for private markets including private equity. The practice is GASB compliant for this very reason.

At face value using actual returns also in the benchmark index itself may seem self referential and disingenuous. But by doing so the SBI is able to show total plan performance relative to its policy targets without introducing potentially misleading proxies. It essentially informs the question, "did the SBI, as managed, beat or lag the mix of assets our investment policy dictates we should hold?" This is a clean presentation of aggregate performance that keeps the Combined Funds accountable to the state's stated asset allocation policies.

[24] IRR is complemented by other metrics including Net Multiple on Invested Capital, Distributions to Paid in Capital, and Total Value to Paid in Capital which are used to compare performance within and across private equity funds.

One important implication is this: because private market returns are also included in the composite benchmark itself, ***SBI's private market investing contributes nothing to SBI's reported "excess return" numbers***. All SBI's reported "excess returns" come exclusively from public market manager outperformance and SBI's tactical public market investment shifts (e.g. overweighting an opportunistic business sector or shifting more into international public equities).

However, this reporting does not provide answers to two other questions that are likely of no less interest to lawmakers, pension beneficiaries, and taxpayers -- especially given the considerably greater fees and expenses accompanying these investments:

- Are private equity investments beating investment returns available in public markets without the extra cost?
- How much wealth was created or lost by investing in private equity instead of public markets?

Time-weighted proxy returns for private equity are a useful way to compare performance on paper with other parts of a portfolio. However, they cannot show whether private equity investing is really beating returns from public markets or convey how much actual wealth is created or lost by doing so. That is because private equity draws capital gradually and pays out irregularly over many years. Time-weighted return reporting makes it look like all the capital was invested evenly and assumes distributions could be reinvested instantly at the same rate, which isn't true in reality. TWR proxies for private equity do not reflect the true economic returns of the asset class. As a result, comparing these proxies to public market indexes as a measure of whether private equity has outperformed or underperformed the public markets introduces distortion and leads to misleading conclusions.

To answer questions of how private equity returns compare to what what was available in public markets, two approaches are used. The first is to simply compare private equity returns to some public index benchmark with an added "illiquidity premium" -- the additional return that investors demand for holding assets that are difficult to sell quickly or without a significant loss in value (e.g. Russell 3000 index plus 3%). It offers some perspective on whether private equity investments have beaten an investment hurdle available in public markets. The problem is the "apples and oranges" comparison problem of IRR and TWR still exists, and conversion of private IRRs to a TWR proxy doesn't fix the problem for reasons discussed above. In addition, the choice of the best index(es) and illiquidity premium are inherently subjective potentially yielding very different "findings" for whatever is selected.

A superior approach is a supplemental analysis called Private Market Equivalent (PME). The basic idea of PME is to simulate the timing of the fund's actual private equity cash flows into public markets. Grossly simplified, each private equity contribution is treated as a purchase of the public index. Each distribution is treated as a sale. At the end, the value of this "hypothetical public investment" is compared to the actual value of the private equity fund (NAV + distributions). A variation on this general idea called Direct Alpha translates the comparison into an annualized excess return figure between private equity and public markets.

A highly simplifed example of PME analysis:

Assume a pension fund's investment in a private equity fund has the following cash flows

2018: Contribute $100
2019: Contribute $50
2020: Distribution of $30
2021: Distribution of $60
2022: Distribution of $120

Step 1 is to pick an public index. Assume the following index levels over these 5 years

2018: 1,000
2019: 1,100
2020: 1,000
2021: 1,200
2022: 1,300

Step 2 is to "Invest" private equity cash flows in the chosen index. Each contribution and distribution is tracked as if it happened in the index:

2018 contribution ($100 at index 1,000): Buy 0.10 "shares" of index.
2019 contribution ($50 at index 1,100): Buy 0.0455 shares of index
Total index holdings = 0.1455 shares.

2020 distribution ($30 at index 1,000): Sell 0.03 shares. Remaining = 0.1155 shares.
2021 distribution ($60 at index 1,200): Sell 0.05 shares. Remaining = 0.0655 shares.
2022 distribution ($120 at index 1,300)
Sell 0.0923 shares but only 0.0655 shares actually remain for sale. So 0.0655 × 1,300 = $85.

So the total hypothetical public index proceeds is $30 + $60 + $85 = $175.

Step 3: Compare to actual private equity performance
Actual private equity distributions = $210.
PME distributions earned in the index = $175.

A PME > 1.0 means private equity outperformed the public market alternative; <1.0 underperformed

PME in this example: $210 ÷ $175 = 1.20. (A Direct Alpha analysis of this same example would report the private equity investment outperformed the hypothetical public index investment by 3.6% annually.)

This suggests over this five year period, private equity outperformed the public market equivalent by 20% in absolute dollar terms, or by 3.6% per year in annualized terms.

In the most recent 2024 SBI annual report, no information is provided on how the SBI compares its private equity performance to what is available in public markets. Rather, the report states SBI "reviews the performance of its private market investments over longer time periods relative to public market investments and expects that private market investments in aggregate will be accretive to other investments in the Combined Funds." Taken at face value that implies "adding value to the fund" rather than "outperformance of public markets" is the prime evaluation consideration of its private equity investments.

However, some evidence exists to indicate SBI does employ its consultants to conduct PME analysis to get a bettter sense of the opportunity costs associated with private equity investments. [25] Likely reasons for not publically disclosing such findings include the risk of alienating general partners; the inherent complexity, confusion, and difficulty of explaining potential contradictions between official Combined Fund performance reports and the true economic contribution of private equity; challenges of justifying periods of private equity underperformance; and political risk accompanying all of the above.

Worthy of a Closer Look

Looking at the totality of Minnesota's governance of its private equity investments there is much to appreciate:

- Minnesota's pension investment structure is a multi-tiered fiduciary structure with the investment responsibilities and their oversight managed by the SBI's experienced, professional staff and further supported by an Investment Advisory Council which includes senior investment executives from the private and foundation communities. This is in contrast to public pension plans elsewhere where investments are overseen by pension boards comprised predominantly of active and retired beneficiaries.

- Minnesota's long history and selectivity has resulted in long-term relationships with partners with proven track records and operational expertise.

- Reasonableness of NAV valuations are run through a specialized software system flagging data inconsistencies, missing inputs, and unusual valuation changes and reviewed internally; subsequentially receiving a quarterly quality control check from an outside consultant; and ultimately reconciled with financial statements as part of the annual financial statement audit.

- SBI employs best practices in the recognition and incorporation of fees and expenses in net return calculations through the use of the ILPA reporting template, and no less importantly requires that all General Partners with whom it has relationships agree to its usage. Moreover, the state is an active negotiator on fees, expenses, and other cost matters and actively pursues co-investment strategies and other investment arrangements avoiding the higher cost structures of traditional private equity arrangements.

[25] We found a reference to private equity PME analysis in a 2019 report by the State Board of Investment to the Legislative Reference Library on investment consultant activities that is required by state statute. At time of publication, we had not heard back from the SBI on its current practices/disclosures regarding PME or related cash flow-based comparisons.

- SBI provides a perspective on total combined fund composite performance by creating and incorporating a time weighted proxy for its private equity investments. This gives the public and lawmakers a consistent, "apples-to-apples" performance number across all asset classes and makes it easier to evaluate whether the fund as managed kept pace with its stated policy mix.

However, given a private equity environment marked by weaker exits, slower distributions, NAV discounts, and growing questions about whether the significantly higher fees and expenses are justified, greater public disclosure of private equity performance deserves attention. Pension fund investors like the SBI face mounting pressure nationally to show not just headline performance returns relative to asset holding policies, but to justify the continued merits and benefits of investing in this asset class.

By requiring more transparent fee reporting at the fund level and employing cash-flow-based performance analysis at the portfolio level, SBI can provide the lawmakers, beneficiaries, and the general public with a clearer cost/benefit picture of its private equity investments. Such an effort would include:

- Greater disclosure of information on expenses and fees paid -- disaggregated information at the fund level on fees and carried interest (per ILPA and Pew recommendations.)

- Analysis and metrics that report whether these investments are delivering value and earning their fees compared to far less expensive public markets. A "public friendly" private equity portfolio performance summary (for rolling multi-year periods to accommodate the inherent lumpiness of cash flows and the volatility noise that individual years can show) comprised of the items below could signal private equity is being assessed rigorously without triggering general partner disclosure concerns.

    - Total private equity committments ($)
    - Distributed to paid-in capital ratio (how much cash the private equity portfolio has returned to investors compared with how much those investors have contributed)
    - Residual NAV ($)
    - Public Market Equivalent (PME) for the entire private equity portfolio (excess returns over public markets expressed as a wealth mutiple)
    - Direct Alpha for the entire private equity portfolio (excess returns over public markets expressed as a percentage return)

- Much more narrative information to help stakeholders better understand this complex area of investment and properly interpret the information and metrics that are already provided.

SBI faces a difficult balancing act when it comes to private equity. On the one hand, there is a strong and deserving public interest in greater transparency, since these funds are managing taxpayer-backed retirement savings and must demonstrate that these significantly more costly investments justify the expense. On the other hand, private equity operates in an environment where a degree of opacity is the price of admission. Deal terms, portfolio company performance, and negotiated fees are often guarded to protect competitive advantage and maintain relationships with managers. This tension creates a transparency gap: citizens and policymakers deserving clear reporting on costs, risks, and outcomes, but too much disclosure can jeopardize access to top-tier funds or expose sensitive financial details.

The result is an ongoing struggle to strike the right balance between accountability and the practical realities of investing in a market built on discretion. The state would be well served with Legisative Commission on Pensions and Retirement hearings on this topic and an assessment of public transparency needs and practices in the 2026 legislatve session.