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The Myth of Private Equity: An Inside Look at Wall Street's Transformative Investments

Jeffrey C. Hooke. New York: Columbia University Press, 2021. 240 pages. Cloth $35.00. ISBN: 9780231198820

There is an abundance of literature, written in plain, accessible language, that provides clear explication of the financial sector's various and never-ending misdeeds. Whether offering case studies of malfeasance or outright criminality, or analyzing more systemic misallocation or misappropriation of capital, its careful marshalling of evidence and application of logic amount to a substantial body of evidence that would, in an "efficient" market of the kind beloved of orthodox economists and finance theorists, result in the rapid overthrow of the status quo (for example, see Martin 2011; Schultz 2011; Kelly 2014; Foroohar 2016).

A recent and important critical intervention is Jeffrey Hooke's *The Myth of Private Equity*, a patient and methodical analysis of the leveraged buyout sector and its unjustified reputation for outperforming the market. The book concludes as it begins, with a resigned acknowledgment of the apparent futility of even suggesting, let alone expecting, meaningful reform. This is partially hedged by Hooke's invocation of the financial sector's vulnerability to "the irrationality that grips Wall Street from time to time" (186) and the implied "correction" that must eventually follow, as evidence of buyout funds' underperformance accumulates (unlike the savings of their presumed beneficiaries). However, the contrast between publicly-traded mortgage-backed securities or dot.com stocks and buyout funds' "rates of return, fees, and diversification attributes" means that "a self-perpetuating feedback loop allows the industry to operate in a parallel universe where the laws of financial

physics do not apply" (188). The "one key underpinning" of this feedback loop is the fact that "everyone makes money except the beneficiaries" (190).

How can this be? One of the key selling points of private equity is its supposedly proven ability to beat the market repeatedly and decisively. Testimonials to this effect proliferate. Occasionally an otherwise often acquiescent financial press will acknowledge that "using fair public market comparisons, private equity hasn't been delivering vastly superior returns despite its leverage advantage. In more recent vintages of funds, it has basically matched public market performance" (Ford 2019b). This is not as easy to detect as it should be, however: "Private equity firms are notoriously parsimonious about sharing their data. What they want us to see as members of the public (or of pension schemes) are bulk anonymized numbers from which industry associations and tame consultants compile illustrative performance data" (Ford 2019a). This might actually be precisely what institutional investors pay for, given the lofty promises made to their beneficiaries and their vulnerability to critical scrutiny in a more transparent environment (Ford 2020a). Even worse, trustees are being advised to choose buyout fund investments by consultants who are predisposed to provide such guidance due to financial incentives (Jenkinson, Jones, and Martinez 2016). In extreme cases, they might even "succumb to a type of Stockholm syndrome" that is rationalized on the basis that everyone else is doing it (Ford 2020b), in what Hooke describes as "pied piper confirmism" (194).

All of these points are raised in this concise but comprehensive guide. Now a senior lecturer in finance at Johns Hopkins University's Carey Business School, Hooke puts his inside knowledge of investment banking and private equity to excellent use, in what may be a particularly timely intervention. The book begins with a chapter portraying the management of the state of Maryland's

employee pension fund, highlighting the various conflicts of interest and institutionalized obstacles to proper accountability that facilitate persistent investment underperformance.

Nevertheless, venal politicians and their appointees are only a small part of the story. Chapter by chapter, Hooke presents the various elements comprising the structures and practices of the buyout industry, its client base, its regulatory environment, and the supporting cast of actors who enable it and champion its performance, all evidence to the contrary notwithstanding. The reader finishes a relatively short book with a thorough comprehension of a relatively poorly understood sector that encapsulates the depiction of financial sector profits more generally as "an appropriation from the rest of the economy" (Tabb 2012: 41–42).

Following his introductory presentation of Maryland's state pension plan governance, Hooke provides a general overview of private equity (PE) as a whole. The focus of the book is the leveraged buyout (LBO) sector, which accounts for approximately 65 percent of PE, the other main categories being growth capital (15 percent, where PE firms typically take a minority stake in established but growing companies that require capital but prefer not to go public) and venture capital (also 15 percent). There follows a chapter describing the typical practices of a buyout fund, before the core issue of investment performance is addressed.

Hooke distils academic research (including his own) to show how various valuation methods are, at best, imperfect guides, and, at worst, wholly unreliable. To the latter classification belongs the internal rate of return (IRR), which is frequently quoted but vulnerable to a host of manipulations—year-on-year versus cumulative gains, lines of credit (80), valuations of unsold

investments (85)—that render its results effectively meaningless. Public market equivalent (PME) ties buyout fund returns to those of the stock market, but it "ignores the timing of cash flows," while the S&P 500 is, at best, an imperfect comparator due to the specific nature of buyout targets. Furthermore, PME ignores the illiquidity of PE, for which adjustments can be and have been made elsewhere, but have not gained wider acceptance. Nevertheless, conventional PME results "are less than stellar" (87). Total value paid in (TVPI) is the sum of cash returned to investors and the estimated value of any unsold companies on the date of measurement. Once again, however, TVPI ignores the timing of cash flows, and "fair values" of unsold assets are difficult to ascertain (88–89). Previously, in collaboration with colleagues, Hooke has developed two "mimic indices" that simulate "the attributes of those public companies taken private through buyouts" (101; see also Hooke and Barnhill 2013; Hooke and Yook 2017). These show significant deterioration in overall buyout performance since the dot.com bust. Hooke and Barnhill also offered their buyout replication index methodology for sale to various index companies, including S&P Dow Jones, to no avail: "The institutional investment community, apparently, did not want an independent benchmark to corroborate their PE investment claims" (103). This is in stark contrast with the kind of due diligence that a typical public merger or takeover must undergo with a "SWAT team of accountants, lawyers, appraisers, operations executives, and other professionals" (139).

Hooke paints a picture of a sector riddled with conflicts of interest, resulting in fiduciary neglect, regulatory torpor, and an almost complete absence of integrity, facilitated further by a 2020 U.S. Supreme Court ruling restricting the ability of beneficiaries to sue pension plan trustees for violation of fiduciary duty (136). Meanwhile, the news media's traditional role of "accountability reporting, which is costly and sometimes offensive to industry sources" has

been largely superseded by "access reporting, which is inexpensive and inoffensive" (174; see also Starkman 2015).

Hooke has since estimated that Maryland's state pension plan has spent a total of $4.5 billion on consultants over 10 years up to the end of fiscal year 2021 (Hooke 2022). This is despite the plan's failure to beat the returns of a standard 60 percent equity/40 percent bonds index. Similar stories can be told of other public sector funds, including the massive California Public Employees' Retirement System (Calpers), which in 2020 effectively doubled down on its commitment to private equity investment (187; see also Plender 2020). Meanwhile regulators' acquiescence is epitomized by the under-resourced SEC's "culture of association" with PE (166). Upon leaving the agency in December 2020, former head Jay Clayton was appointed lead independent director of Apollo Global Management, "a part time job paying half a million dollars per year," before soon becoming non-executive chair (167).

Recently the growing popularity among buyout funds to sell acquisitions to other funds within the same PE firm has attracted increasingly critical scrutiny (Thomas 2022). A major claim to PE's supposed superiority is the 10-year ownership period during which acquisitions are rendered operationally more efficient and profitable, before being sold for a healthy surplus. That aspect of buyout funds' business model has already been in doubt, given that "a quarter of new LBOs are recycled old LBOs, whereby one buyout fund sells to another buyout fund" (93). Approximately "56 percent of all deals bought by PE funds since 2006 have not been sold to follow-on buyers," a figure that jumps to 68 percent for all deals since 2009 (77). Now, via so-called "continuation funds" (also known as "GP-led secondary"), PE firms are able to extract more fees from their clients even as they calibrate asset valuations in ways that remain opaque

but that optimize net benefits in aggregate to the firms themselves (Wiggins 2022).

Book-length treatments of private equity are few and far between, so Hooke has performed a significant service to all who wish to learn more about buyout funds and their wider economic impact, not to mention the malaise that inevitably emanates from such concentrations of wealth and power. *The Myth of Private Equity* can usefully be read in conjunction with Jamie Morgan's *Private Equity Finance* (Morgan 2009). Morgan's inconclusive verdicts with respect to PE's wider economic impact are effectively corrected by Hooke, whereas Morgan's spotlight on PE's exploitation of legal and regulatory openings intended primarily for the benefit of venture capital offer additional insight regarding the manner in which buyout funds have assumed such economic and political prominence. On the latter score, interventionist noises emanating from the SEC under Gary Gensler (Wiggins 2022) almost guarantee a surge of PE-backed campaign financing for whoever wins the Republican nomination for the 2024 presidential election.

In conclusion, Hooke's resignation concerning the fate of any reform proposals appears justified. It merely confirms the rottenness at the core of our finance-dominated economies and polities.

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