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On

The Power of Pensions: Building a Strong Middle Class and Strong Economy

Before the Senate Committee on Health, Education, Labor and Pensions

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Mr. Chairman, Senator Enzi and Members of the Committee:

Thank you very much for the opportunity to testify on the very important subject of the role that pension funds play in the U.S. economy. I also want to thank the Chairman and Ranking Member for approaching this important subject in a bipartisan manner.

The Carlyle Group is a global alternative asset management firm with approximately $150 billion in assets under management. We care deeply about the subject of this hearing because our mandate as a firm is to generate attractive returns for our investors, the largest groups of which are public and private pension funds.

I would like to focus on four points today:

1. First, authoritative research demonstrates that pension funds provide essential liquidity that helps make U.S. financial markets function effectively and efficiently.

2. Second, defined benefit plans tend to out-perform defined contribution plans, particularly where individual, non-professional investors make investment decisions.

3. Third, pension funds are critical drivers of growth and economic activity in the United States because they are one of the only significant sources of long-term, patient capital. As such, they are able to invest in longer-term, less liquid asset classes, and those asset classes tend to create jobs and generate efficiencies in the U.S. economy.

4. Finally, pension funds provide the bulk of funding for venture and growth capital, real estate and private equity investments, and those investments in turn create

millions of jobs, and more efficient companies, driving innovation in the U.S. economy.

The bottom line is that private and public pension funds create jobs and drive economic growth in the United States at a time when we desperately need more growth and lower unemployment.

1. Pension Funds are An Important Driver of Liquidity in the U.S. economy

The size and scale of pension funds have helped to drive the development of the U.S. financial system. Defined benefit pension systems depend on asset accumulation to pay benefits, which increases demand for new investments and accelerates securities market development. World Bank researchers have established a causal relationship between pension funds' asset accumulation and stock market development in many countries.[1] In other words, the larger and more developed a country's pension funds, the larger and more developed a country's stock market. Stock market growth obviously creates growth in income and national wealth.

Pension funds also help stimulate the development of non-bank finance channels, including the issuance of corporate bonds and commercial paper that reduce businesses' external financing costs relative to bank loans.

At the end of the first quarter of 2011, U.S. private pensions held $6.27 trillion in total assets, while state and local government employee pension funds held more than $3.03 trillion in assets.[2] Of this $9 trillion of total assets, $4 trillion was invested directly in corporate equities, with an additional $2.4 trillion invested in mutual funds that invest in corporate securities. In total, private and public pension funds accounted for about one-third of the total market capitalization of domestic corporations, which the Fed estimates at $18.2 trillion. Pension funds play a key role providing liquidity for initial public offerings, private placements of equity and debt securities, and large block securities trades. Without a large and strong pension fund sector in the United States, the cost of capital to businesses would increase, slowing growth.

Defined benefit pension funds also provide large benefits to investors. By pooling savings and risks across beneficiaries, pension plans create economies of scale, which results in lower average costs for investors. These economies of scale also enable defined benefit funds to invest in large investment opportunities, including large-scale natural resource development and other types of project finance that would otherwise be unable to attract competitive financing.

2. Defined Benefit (DB) Plans Out-Perform Defined Contribution (DC) Plans

DB plans' economies of scale and wide range of investment opportunities translate directly to higher returns than other forms of savings, including DC plans and individual

[1] World Bank Policy Research Working Paper No. 2421.
[2] Federal Reserve, Flow of Funds, June 2011.

retirement accounts (IRAs). By out-performing other forms of savings, DB plans reduce the amount of resources that need to be set aside today to fund a given level of future retirement income. In other words, for the same level of savings today, DB plans can generate sufficient future investment balances to provide higher levels of retirement income. The economy benefits because higher returns create more consumer demand, which in turn creates more rapid economic growth.

Two authoritative studies published in the last five years show that DB plans achieved higher returns than both DC plans and IRAs. A 2006 paper published by the Center for Retirement Research at Boston College found that DB plans out-performed DC plans by 1% per year between 1988 and 2004. This finding was confirmed by research from Watson Wyatt, a leading retirement consulting firm. Watson Wyatt also observed a 1.09% per year return differential between 1995 and 2006. The Watson Wyatt study analyzed corporate DB plans and 401(k)s in both bull and bear markets and found that larger DB plans out performed 401(k)s in part because larger plans "generally have access to a wider variety of investment options and economies of scale and, in the case of DB plans, more investment expertise." That study concluded the following:

> "Trustees for DB plans have a fiduciary responsibility for investment performance. They or the professionals they hire also usually have considerable financial education, experience, discipline and access to sophisticated investment tools — advantages not typically shared by individual participants in 401(k) plans. These advantages help DB plan investors maximize their returns and maintain well-diversified portfolios, so they can generally ride out market fluctuations more smoothly than 401(k) plan participants."

Although one may question the benefit of a 1% differential, the results over time are significant. As shown in the hypothetical example below, an individual who made the median annual employee contribution of $3,000 for 35 years would realize a difference in the end-of-period balance of nearly $200,000 with just a 1% increase in annual returns.

Extrapolated Return Differentials

	Defined Benefit	Defined Contribution
Return	10.30%	9.21%
Years	35	35
Annual Contribution	$3,000	$3,000
Ending Balance	$871,256.12	$678,715.35

As a firm that invests in companies throughout the United States, we understand the challenges that companies face from a competitive position with respect to defined benefit plans. U.S. companies are facing huge competitive pressures, and the costs and uncertainties associated with escalating retirement and medical obligations have led to a trend by corporations away from DB toward DC plans. But this trend does not undermine the fact that from a macro-economic perspective, as mentioned above, DB plans make enormous contributions to the U.S. economy and tend to out-perform other forms of saving.

3. Pension funds are critical drivers of growth and economic activity in the United States

Pension funds represent long-term, patient capital – one of the only significant sources of stable capital in the United States. This approach to long-term investing is necessarily driven by their structure: DB plans have liabilities that extend 20, 30 or even 40 years, and therefore need to invest in assets that will match their long-term obligations. While pursuing long-term investment strategies is directly in pension funds' self interest, their patient approach pays huge dividends for the economy. Pension funds allow firms to issue equity and longer-dated securities, which increases capital market development and lowers the cost of capital for American businesses.

The length of time until a liability comes due helps to determine the expected return and liquidity characteristics of the investment used to fund that obligation. For example, a household with surplus cash today will choose different investment options for that savings depending on how it is expected to be used. If the money will be devoted to next month's cable bill, the household would likely choose to put the money in a savings account and accept a lower expected return in exchange for less volatility. Conversely, if that money were intended for a college tuition payment in eight years, the more appropriate investment would be one that accepts greater short-term volatility in exchange for higher expected returns. By nature of the longer time horizon, pension funds can accept less liquidity and more short-term volatility in exchange for higher expected returns.

It is widely understood that technological change drives long-term economic growth, productivity and improvement in living standards. Institutions that hold longer-dated assets are critical to financing technological change because the cash flow from new technologies is paid out in the distant future, well beyond the investment horizons of banks and other investors. For example, consider that the first microprocessor was introduced in 1971 with very uncertain commercial prospects. By 2010, computer technology had fundamentally transformed the economy and society and annual semiconductor sales had reached nearly $300 billion. Institutions unable to absorb short-term uncertainty and volatility cannot fund investments in transformative technologies that increase employment and living standards.

Consider the following: A large commercial construction project that takes ten years to develop is not likely to be funded by an institution that might need to sell its stake 18 months after groundbreaking. Similarly, the investor base of a company seeking to commercialize a new technology is not likely to be concentrated among investors subject to overnight withdrawals that might need to sell their interest in the venture during the early development stages.

4. Pension Funds Provide the Bulk of Funding for Venture and Growth Capital, Real Estate Funds and Private Equity, which in turn create millions of jobs in the United States

Pension funds are also the largest source of funding for venture, private equity and real estate funds – all of which tend to have long-term investment horizons. More specifically, public and private pensions account for 42% of all investments in venture capital, real estate, infrastructure, and later stage corporate finance.[3] Based on a prorated allocation to current invested capital totals, pension funds provide financing for more than $100 billion in venture capital investments and more than $400 billion in growth capital and later stage corporate private equity investments. In addition, according to the Real Estate Roundtable, pension funds currently provide approximately $160 billion of needed equity capital to the commercial real estate industry in the U.S. at a time when the sector has been under great pressure.

These investments contribute to a larger economy and more jobs. According to research from the World Economic Forum, productivity growth at private equity-backed companies is 2 percentage points greater than at comparable businesses, translating directly to higher wages. Private equity investment supports more than 6 million jobs in the U.S., according to 2009 data compiled by the Private Equity Growth Capital Council. An estimated 9 million jobs are generated or supported by real estate — jobs in construction, planning, architecture, environmental consultation and remediation, engineering, building maintenance and security, management, leasing, brokerage, investment and mortgage lending, accounting and legal services, interior design, landscaping, cleaning services and more. In 2010, according to the National Venture Capital Association, more than one in every ten private sector workers in the U.S. was employed by a company that had received venture capital funding at one point.

A smaller DB defined benefit pension base would directly compromise the capital markets' ability to fund these types of investments. The investment opportunities and potential employment gains would still be there, but the lack of patient capital with a sufficiently long investment horizon would make financing these projects much more difficult.

The Carlyle Group invests in small, medium and large companies, real estate, infrastructure projects and financial services firms. Whether an investment is in a small, growing company, a large infrastructure project or a real estate asset, our strategy is the same: we seek to build long-term value in a company or asset through investments, improvements in management, and efficiency enhancements. Today, we have investments in approximately 80 companies based in the United States, 77 percent of which are small or medium-size businesses (fewer than 2,500 employees), as well as about 125 real estate projects, which include commercial, residential, and health care or data centers. Combined, these companies employ more than 216,000 people in the United States in all 50 states.

[3] Preqin, 2011 Global Private Equity Report.

We invest in a variety of asset classes, most of which target long-term investments of four to seven years. Some of our funds have investment horizons as long as ten or twelve years, one of the longest investment horizons a pension fund can invest in outside of 30-year bonds.

My partners at Carlyle make the decisions when to invest, how much to invest, and how to manage the investment, but it is our investors' money, matched by a commitment of 3 - 5% of our own money, that makes an investment possible. In other words, without the long-term, patient capital provided by private and public pension funds, private equity investment would not be possible.

Allow me to give you a couple of examples of how long-term, patient capital from pension funds has helped to create jobs and economic activity in the United States.

One of Carlyle's earliest buyout funds, Carlyle Partners II, L.P., acquired Kuhlman Electric Corporation in October 1999. Public and private pension funds accounted for 45 percent of the capital committed to that fund. Kuhlman, which is based in Kentucky, was founded in 1894 and provides power transformers and related products to utility companies.

Carlyle managed our investment in Kuhlman through tough economic conditions resulting from California's energy deregulation initiative, the collapse of Enron, major reductions in customer capital spending, falling wholesale prices, and the sector's challenging credit crisis. As a result of these conditions, Carlyle valued the investment at zero.

However, Carlyle remained committed to Kuhlman. In fact, several investors and Carlyle employees personally invested additional capital to strengthen the company. Carlyle, together with management, helped turn the company around. Nearly 10 years later, in August 2008, Kuhlman was sold by Carlyle to ABB, the global power and automation technology group, earning our investors an attractive return. For the fiscal years 2005, 2006 and 2007, Kuhlman's revenue increased by approximately 26%, 26% and 45%, respectively. In 2007, Kuhlman experienced record results in all three of its operating divisions. In addition, Kuhlman's overall employment levels increased approximately 25% during Carlyle's ownership. At the time of the sale to ABB, the company had approximately 800 employees. During the downturn, Kuhlman maintained a positive relationship with its unionized workforce, and organized labor was an important part of the turnaround.

Another Carlyle fund that is focused on infrastructure investments has developed an innovative partnership with the State of Connecticut to redevelop, operate, and maintain Connecticut's 23 highway service areas across the state. Public and private pension funds contributed 42 percent of the $1.1 billion infrastructure fund that we manage.[4] In this case, Carlyle's infrastructure fund formed a 35-year public-private partnership with the State of Connecticut to finance the redevelopment and operations of highway service areas at a time when the state budget was under great stress. Carlyle and our partners plan to invest approximately $178 million in improvements and upgrades to the service areas over the next five years, investments that we estimate will create approximately 375 permanent and construction-related jobs – a 50% increase above the 750 jobs that support the service areas today. In total, the state is expected to receive nearly $500 million in economic benefit from the redevelopment effort.

Neither of these investments would have been possible without the commitment of long-term capital to Carlyle's funds by private and public pension funds in the United States. In both of these cases, private and public pension funds contributed capital for 10 years, and we are working hard to provide attractive returns to those investors who have entrusted their assets with us.

Thank you once again for the opportunity to testify.

[4] The actual amount that fund investors contribute to a particular transaction frequently varies from the level of commitment those fund investors have made to a particular fund. This differential stems from a number of factors, including the investments made by a management team or co-investors.