

There was no shortage of criticisms launched against private equity and hedge funds in 2014.

From the high profile decision in September by the California Public Employees Retirement System - known to its friends as “CalPERS” - to walk away from hedge funds, to the continued debate over whether to tax the share of profits landing in the hands of private equity professionals as capital gains or ordinary income, these alternative investment funds were never too far away from the public attentions over the past twelve month.

Financial regulators in many leading industrial countries, including Australia, also wrestled with the question of precisely to what extent should mom-and-pop retail investors be allowed to invest in these high-risk, high-return vehicles.

To some, private equity and hedge funds are simply examples of the excesses that under-regulated financial markets routinely produce. They allow a handful of in-the-know speculators to generate outsized profits without generating any meaningful benefit for the rest of society. And so on and so on...

As with any media-friendly narrative, we saw a sort of momentum build as more critics attempted to pile on the anti-private equity, anti-hedge fund campaign.

In response to CalPERS announcement that it would liquidate its hedge fund investments and pursue high investment returns elsewhere, New York Governor Andrew Cuomo vetoed a law that would have allowed his states beleaguered pension plans to allocate more money to alternative investments. State law already permits such funds to account for up to 25% of a pension plans portfolio. The vetoed bill would have lifted the number to 30%.

Meanwhile, commentators such as the New York Times’ James B Stewart continued to argue in favor of scrapping the so-called “carried interest loophole.” By assembling the usual suspects of American law professors and high-ranking Democratic politicians, Stewart laid out the best arguments in favor of increasing the taxes paid by private equity firms in a typically erudite and proficient manner.

Unfortunately, these arguments do not hold up under scrutiny.

Despite the fact that the forecasted revenue to be generated by this change is merely a drop in the bucket when compared to the staggering federal debt that has built up over the past several years, on closer inspection there is a more fundamental problem that must be overcome by critics of carried interest – namely, that there is no such thing as a “carried interest loophole.” In fact, what we have is over a century of partnership law which clearly lays out how partners are to be taxed, and the simple fact that for roughly the same period of time there has been a bi-partisan consensus that capital gains should be taxed at a lower rate than ordinary income.

That’s it – no backroom earmark or last minute legislative maneuvering. The simple application of very fundamental rules that have been around for ages.

Indeed, if there is a meaningful philosophical debate to be engaged in, then perhaps it is whether there should even be two different tax rates at all. However, there seems to be very little interest among private equity’s critics to touch that sacred cow.

The simple fact that has allowed private equity and hedge funds to survive and thrive over the past decade, despite the increasing efforts of their critics to campaign against them, is that US public pension plans are at least \$1 trillion short. This represents the gap between the assets they have and the amount of money that they need to pay out to continue to service the gold-plated final-salary pension schemes that their beneficiaries are entitled to.

It is as a result of this gap that hundreds of billions of dollars are funneled into private equity and hedge funds every year. The ability of some – clearly not all – fund managers to deliver eye-wateringly high returns will continue to cause these funds to grow in 2015.

Of course, there are valid questions to be asked about whether these firms are in full compliance with the laws and regulations that ensure, as much as possible, that the financial markets are a level playing field for all participants. But the best approaches to ensure that these funds operate in a manner that supports the wider goals of economic growth will be based on a thorough understanding of how these funds actually operate on a daily basis, rather than simple rhetoric and scaremongering.

Private Equity, Hedge Funds Survive And Thrive Despite Criticisms

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