EBRI ISSUE BRIEF

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CAPITAL NEEDS OF SMALL BUSINESS: CAN PENSION FUNDS HELP?

In recent years, the continuing growth of pension assets has made pension funds one of the primary sources of new investment capital.1/ There is substantial competition for these pension assets. Venture capitalists are among the competitors. Venture capitalists provide money to small businesses that hold potential for high investment returns. These investments, however, often carry a high risk. Although pension fund investors have historically shied away from venture capital, there now appears to be a growing interest in such investments. This growing interest demands closer scrutiny.

This Issue Brief discusses:

(1) U.S. small business and venture capital;

(2) pension investment in venture capital;

(3) venture capital investment trends.

U.S. SMALL BUSINESS AND VENTURE CAPITAL

What Is a Small Business?

Various organizations classify "small" differently. The U.S. Small Business Administration (SBA), for example, utilizes different size definitions for different industries. Based on SBA's small business definitions, there are 6.9 million small firms. This is nearly 99 percent of all firms in existence.2/ The White House Conference on Small Business, however, recently stated that a small business is any firm employing 500 persons or less.3/ This definition excluded only 2 percent of all businesses, or 13,000 companies in 1978.4/ Factors such as annual receipts and total assets are also considered in defining firm size categories. Businesses with fewer than 500 employees account for approximately 52 percent of the private labor force and over 51 percent of annual sales.5/

What Is a Venture Capitalist?

A venture capitalist is an individual or group of individuals investing funds in carefully selected, newly formed small businesses. In addition to financial assistance, venture capitalists usually provide management advice and close supervision to help ensure business success. Their financial investment can often be converted into equity.

While many venture capitalists invest only in high-technology and high-growth firms, others specialize in real estate, franchises, retail/wholesale trade, oil, gas and mineral exploration. These different investments entail widely varying risks, returns and investment vehicles. Thus, they attract a wide range of investors.

PENSION INVESTMENT IN VENTURE CAPITAL

Venture capital supports only a very small portion of the millions of small businesses in existence. However, this vehicle currently provides the most direct means for pension fund investment in small business. There are three ways to invest in venture capital: (1) through private venture capital companies; (2) through small business investment companies (SBICs); and (3) through corporate subsidiaries. Pension funds invest in venture capital primarily through private venture capital companies and SBICs.

Private Venture Capital Companies

Private venture capital companies usually have a few general partners and a larger group of limited partners (or investors). There were about 130 private venture capital companies in mid-1982.6/ Through these firms, insurance companies, endowment funds, individuals, corporations and pension funds have invested $2.6 billion or 45 percent of the $5.8 billion presently committed to venture capital.7/

Small Business Investment Companies

SBICs are federally regulated venture capital firms. They can be either publicly or privately held. Although they are licensed by the SBA, they are able to make independent investment decisions. There are an estimated 360 SBICs; they have invested about $1.6 billion or 27.6 percent of the funds presently committed to venture capital.8/

Corporate Subsidiaries

Some companies have set up corporate subsidiaries to invest in venture capital. Since these particular subsidiaries are generally wholly owned by the parent company, pension funds do not have access to this investment option. This group has invested $1.6 billion in venture capital.9/

VENTURE CAPITAL INVESTMENT TRENDS

Throughout the early 1970s, new venture capital commitments fell sharply; they dropped to $10 million in 1975. See Table 1. During the late 1970s, these investments rose dramatically, reaching $1.3 billion by the end of 1981. Through 1974, the pension fund share of these commitments remained fairly low. Although data are not available for 1975-1977, some decrease in pension fund investment most likely occurred with the overall reduction in venture capital investments. By 1980, however, pension assets invested in venture capital had risen dramatically; it represented nearly 30 percent of all new pension fund investments in venture capital companies. See Table 2.

The causes of venture capital investment fluctuations during the 1970s--particularly those of pension funds--cannot be easily identified. Although lack of data hinders the analysis of these trends, some general observations can be made. Economic conditions, the enactment of the 1974 Employee Retirement Income Security Act (ERISA) and the publication of ERISA regulations probably influenced the extent of pension fund investment in venture capital at various points in time.

Economic Conditions

The 1974-1975 recession affected the flow of funds to all investments because it made investing more risky. A primary objective of pension trust management is capital preservation. Thus, during the recession, pension managers shifted to lower risk investments.

Enactment of ERISA

It has been suggested that after 1974, ERISA's fiduciary conduct standard, the "prudent man rule," limited pension investment in venture capital. Thirty percent of pension fund investors who responded to one survey indicated that they prohibited venture capital investments after ERISA.10/ This occurred, however, following a period of poor economic performance and before ERISA's final regulations, which clarified prudence standards.

Publication of ERISA Regulations

Regulations for Fiduciary Responsibility: Investment of Plan Assets Under the "Prudence" Rule were issued in July 1979. These regulations provide specific detailed guidance on "appropriate consideration" of investment opportunities. They do not prohibit risky investments such as venture capital, but they state that risks must be balanced and diversified to minimize the chances of loss. Prudence is evaluated on the basis of the total portfolio--not any single investment. After these regulations were issued, pension investment in private venture capital companies almost quadrupled. They grew from $53 million in 1979 to $197 million in 1980. See Table 2.

TABLE 1

New Annual Venture Capital Investments--1969 to 19811/

Year	Millions
1969	$ 171
1970	97
1971	95
1972	62
1973	56
1974	57
1975	10
1976	50
1977	39
1978	570
1979	319
1980	900
1981	1,300

Source: U.S. General Accounting Office, Government-Industry Cooperation Can Enhance the Venture Capital Process (Washington, D.C.: GAO, August 1982), p. 37.

1/ Includes private and public venture capital companies, small business investment companies and corporate subsidiaries.

Regulations for Fiduciary Responsibility: Proposed Rules for Definition of Plan Assets were published in mid-1979. These Department of Labor proposed regulations would have made managers of private venture capital pools as fiduciaries. All plan fiduciaries would have become personally liable for venture capital activities. After widespread concern was expressed over the potential effect of this rule, the rule was withdrawn and reproposed. One portion of these rules--unrelated to venture capital investment--was finalized in May 1982. The portion relating to venture capital was again withdrawn, and may be reproposed this year.

The Future of Pension Investment in Small Business

The amount of pension assets directly committed to identifiable venture capital investments is relatively small--less than one-half of one percent of the $750 billion now in private and public pension plans.11/ The trend of the past two and one-half years, however, shows that despite a recessionary environment, there is increasing pension fund investment in private venture capital companies. Attractive, albeit fluctuating, rates of return on recent venture capital investments may help to prolong this trend. These returns, ranging from 10.0 to 46.7 percent annually during 1975-1980, have sometimes exceeded the returns of major corporate debt and equity issues.12/

In addition to venture capital, pension funds have provided capital to small business by purchasing new public or outstanding issues of small company stock and private debt placements. There is growing interest among pension investment managers in these vehicles.13/

TABLE 2

New Pension Fund Commitments to Private Venture Capital Firms -- 1969 to 1982

	Pension Fund Commitment (millions)	Total Commitment from All Sources (millions)	Pension Fund as Percent of Total Commitment
1969-1974	$ 63.3	$262	24.2%
1975-1977	-	-	-
1978	31.0	216	14.4
1979	53.0	170	31.2
1980	197.0	661	29.8
1981	199.0	866	23.0
1982 1/	228.0	706	32.3

Source: Venture Capital Journal, "Capital Transfusion 1981," January 1982, pp. 6-11; Venture Capital Journal, "Capital Transfusion 1982," July 1982, pp. 4-8; and Richard Zock, "Small Business Access to Capital Markets Through Pension Funds" (Washington, D.C.: Interagency Task Force on Small Business Finance, 1980), p. 21.

1/ January through June.

CONCLUSION

The limited evidence available indicates that the commitments of pension funds to small business investment are growing. Whether these commitments would increase more rapidly with legislative and regulatory changes cannot be readily determined based upon existing evidence. While anecdotal information may support this premise, additional evidence is needed. New data, based upon surveys of pension officers, may also prove beneficial in determining the validity of recent requests for changes in ERISA's prohibited transactions provisions. Proponents believe that such changes would further increase the flow of pension dollars to small business.

As this analysis indicates, recent government actions appear to have increased pension investment flexibility. The data presented here suggest that pension investment managers are taking advantage of this flexibility. Pension funds can be expected to play an increasingly significant role in financing small business if: (1) a variety of small business investment vehicles continues to be available; and (2) there continues to be reasonable rates of return adjusted for risk.

NOTES

1/ For a detailed discussion, see Sophie M. Korczyk, Retirement Income Opportunities in an Aging America: Pensions and the Economy (Washington, D.C.: EBRI, 1982).

2/ Congressional Budget Office, Federal Business Aid Programs: Issues, Effects, and Options (Washington, D.C.: CBO, 1981), p. 35.

3/ Executive Office of the President, The State of Small Business: A Report of the President (Washington, D.C.: U.S. Government Printing Office, 1982), p. 3.

4/ U.S. Small Business Administration, Annual Report on Small Business and Competition (Washington, D.C.: U.S. Government Printing Office, 1982), p. 52.

5/ U.S. General Accounting Office, Government-Industry Cooperation Can Enhance the Venture Capital Process (Washington, D.C.: GAO, August 1982), p. 4.

6/ Ibid., p. 4.

7/ Ibid., p. 5.

8/ Ibid.

9/ Ibid.

10/ David Cummins et al., The Impact of ERISA on the Investment Policies of Private Pension Funds and Capital Market Efficiency (Philadelphia, Pa.: Wharton School, University of Pennsylvania, 1979), p. 96.

11/ EBRI estimate.

12/ Lawrence Litvak, Pension Funds and Economic Renewal (Washington, D.C.: Council of State Planning Agencies, 1981), p. 66.

13/ Greenwich Research Associates, 1981 Report to Participants-Large Corporate Pension Funds (Greenwich, Conn.: GRA, 1982), pp. 36-37, 66.

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