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NEWS & ANALYSIS

Is private equity ready for a retail revolution?

An influx of retail capital could change the future of private equity, bringing with it growth opportunities and operational implications.

The might of the world's stock markets is waning. From 1996 to 2018, the number of listed companies in the US almost halved, according to the World Bank. In the UK, meanwhile, analysis by law firm Pinsent Masons found that take-privates soared by 40 percent last year alone. Private equity returns have also persistently outstripped public market indices in recent decades. And yet, much of the world's population is prevented from benefiting from this outperformance.

In the US, 98 percent of households are prohibited from investing in private funds, according to a 2018 review by the Committee on Capital Markets Regulation, and 401(k) retirement plans generally cannot invest in them either. Access is restricted to institutions and individuals that are somewhat arbitrarily defined as accredited investors.

The rules, of course, are designed to protect retail investors from being burnt by risky strategies. And the spectacular fall from grace of star UK fund manager Neil Woodford last year would seem to support that premise. However, research suggests such restrictions are misguided. A 2017 study by Voya Investment Management, for example, found that private equity investment reduces risk through diversification.

Indeed, the Securities and Exchange Commission is now seriously contemplating a change in the rules that would give retail investors widespread access to the asset class for the first time. A huge boon to the fundraising market, certainly, but opening the floodgates would also fundamentally change the nature of private equity.

The pros…

"If the SEC can find a way to give 401(k) retirement money access to private equity, that would mean a significant influx of capital," says Michael Doherty, asset management partner at Ropes & Gray, which has been in discussions with SEC staff to determine how this market liberalisation could take effect.

For GPs, the addition of retail investors to the fundraising pool certainly has its advantages. "I believe the key attraction to the private equity industry is the sheer size of the opportunity compared to traditional institutional channels," says Doug Keller, head of private wealth at Pantheon.

"The opportunity to provide private equity investments to retail investors is the largest long-term growth opportunity for private industry," adds Robert Collins, managing director at Partners Group. "These retail assets not only will offset the declining flows from large, historic pools of institutional capital, such as defined benefit plans, but will also provide longer-term fundamental growth.

"The unmet need within the retail market is staggering, particularly when you look at the entire landscape of retail investors including the defined contribution market. The retail market is roughly the size of the institutional market. However, retail investors are massively under-allocated to all alternatives. So, one impact that you could see is a winnowing in the industry: the long-term 'winners' will be the ones who successfully tap these retail segments."

… And cons

Not everyone thinks a surge in retail investment would be good for the asset class, however. Incumbent LPs, in particular, are far from convinced. According to Coller Capital's Global Private Equity Barometer: Winter 2019-20, three quarters of limited partners surveyed think private equity investing is not suitable for retail investors, says the firm's head of investment management Michael Schad.

"An influx of retail money to the industry could significantly increase the scale of the industry's assets under management, and structurally transform the industry's operating model – from regulatory requirements to operational management and investor services," Schad adds.

And for GPs, the challenges are commensurate with the opportunities. "Large increases in volumes of investors at lower investment sizes could strain operational and administrative teams that were not set up to service retail," says Keller.

Indeed, accepting commitments from retail investors would present risks and have operational implications, including increased compliance and anti-money laundering requirements; liquidity management issues in terms of significantly increased capital calls and distributions; an increased burden on investor relations and relationship management administration and complex operational issues arising from managing a large number of individual investors alongside institutional LPs in a fund. "Most fund managers would have to make significant investments in their investor relations services and operations departments to be able to process commitments from a large number of retail investors," says Schad.

"Furthermore, the admission of retail investors to the private equity ecosystem would undoubtedly bring added regulatory scrutiny. "Institutional investors understand the implications of making illiquid, long-term investments, but private individuals would typically have a less sophisticated understanding of the asset class and its risks," Schad explains. "And so, for their part, fund managers would need to comply with greater transparency and disclosure obligations than those currently applicable to privately owned companies and assets."

Pantheon's Keller, however, is sanguine about the prospect of such demands. "As the private equity market has grown, so too has scrutiny from external commentators and participants, which has supported an overall increase in transparency to the historically opaque asset class," he says. "But GPs have navigated increased disclosure levels before, through experience with accepting capital from investors subject to Freedom of Information Act requirements, and we would expect to see a similar dynamic play out in retail as well."

Design and distribution

Designing products and structures that are appropriate for both the target audience and the investment strategy will be key to making retail investment work. Some of the high-profile negative events that we have seen, like the Woodford fund, for example, stemmed from underlying investment strategies that did not fit the product structure – illiquid investments in a structure that promised liquidity.

Retail markets will require products significantly less complex than the traditional limited partnership used in the institutional model. "So, no capital calls, no K-1s, no finite fundraising periods, but rather fully paid-in, 1099 tax reporting and perpetually offered," Partners Group's Collins explains. "From a product development perspective, the goal should be to build something as close to a traditional regulated mutual fund as possible without sacrificing the return and diversification benefits of the underlying private equity strategies and investments."

Investor education is also critical. "Once a product is designed, it's equally important that it is sold to the investor correctly," says Keller. "Investor education means ensuring investors understand the products they are buying, from the unique product structures to the underlying portfolios. Managers that implement an education-first sales strategy will benefit in the longer term, in my view."

Indeed, private equity managers contemplating opening their doors to retail investors, must not underestimate the distribution challenge. Accessing the major distribution channels from banks and wirehouses to registered investment advisors, independent broker dealers and the defined contribution market, requires a significant investment in incremental and dedicated sales and client service resources.

"Selling to retail investors is not just about having an attractive product, it's about ensuring you have the right sales channels that have access to those retail clients," says Ropes & Gray's Doherty. "Getting your products on those platforms can be a lot of work and very expensive. However, one possibility is to partner with someone who already has that distribution capability rather than build your own."

In February, for example, Vanguard forged a partnership with HarbourVest, to provide investors with access to private equity. "If these tie-ups are seen to work, that could certainly bring a whole new range of potential entrants to the private equity market," Doherty adds.

Indeed, while the SEC is undoubtedly distracted by more pressing issues at present, an influx of retail investment to the private equity industry, at some point, now seems more likely than not. This represents an opportunity for those GPs prepared to invest heavily in their own infrastructure, or else forge innovative partnerships. But it will also radically change the environment in which some managers have operated – and thrived – for so long. ■

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