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Retail revolution? The democratization of private equity

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As available capital dries up for many institutional investors, some private fund sponsors have started to look elsewhere for the commitments required to continue driving their fundraises during the first prolonged down market for private markets since the 2008 financial crisis[1]. This search for new and alternative sources of capital has dovetailed with increased interest in investing in alternative asset classes from “retail” investors (i.e., individual investors that qualify as “accredited investors” under applicable securities laws).

At the same time, a rise in the use of open-ended structures for private funds and increased sophistication in the private fund secondaries market have created new avenues for liquidity outside of the traditional 10-year plus extensions term for closed-ended private funds.

These trends have the potential to revolutionize retail access to alternative asset classes and lead to significant growth for many asset managers in the years ahead.

Sidestepping barriers to entry

Participation in private funds by retail investors has historically been hampered by several factors. The first is the illiquidity of the typical closed-ended fund products offered by investment managers. While the long-hold model has the benefit of allowing private fund sponsors to avoid short termism and focus on enhancing the value of their portfolio companies over a longer period absent the fluctuations and immediate scrutiny of the public markets, it presents challenges for retail investors requiring liquidity during the life of a given fund. This is generally considered to be a particular deterrent for individual investors, whose life circumstances can trigger sudden needs for capital.

A second challenge for retail investors engaging in private funds is the relative lack of transparency as compared to the public markets and higher minimum investment thresholds of participation in alternative asset classes. Finally, regulatory requirements for individual investors to be able to participate in such illiquid asset classes (i.e., typically requiring qualification by individuals as “accredited investors” or similar concepts pursuant to applicable securities laws) have also prevented a high degree of take-up from retail investors in Canada, the United States and Europe. Although certain large cap investment sponsors are publicly traded, investing in these entities exposes retail investors to the performance of the manager’s entire balance sheet—and this generally does not provide the curated sector-by-sector access that alternative funds typically offer to their investors.

With all that being said, the strong performance of private markets over the past decade means alternative asset classes are increasingly viewed by individual investors as an attractive way to diversify their portfolios. An April 2021 report from Hamilton Lane found that over the preceding three years, private equity generated a premium of 33% over public equities, achieving that outperformance (which has otherwise been relatively consistent over the course of the past two decades) by, in many cases, continuing to achieve positive returns even during market downturns[2]. This strong performance has pushed individual investors towards diversification in private markets, particularly in light of the generally negative performance of public market equities over the past year. A recent article by Royal Bank of

Canada cited a poll indicating that 53% of alternative fund managers expect retail investors to account for a larger proportion of their assets under management over the next five years, noting also that the current retail allocation to alternatives such as private funds is only 5% (compared to 28% for pensions and 52% for endowments) and that a doubling of this retail allocation to alternative asset classes such as private funds would add an additional US$5.3 trillion to the market[3].

Trends in retail access

Driven by this strong retail interest in investing in private markets and an increased desire by fund sponsors to seek out retail investors as an alternative source of private capital, some fund sponsors and other market participants have looked at new models for raising capital from individual investors. New platforms have combined technological improvements with traditional fund structures to facilitate access by individual investors to underlying, non-affiliated private funds. These new platforms are often designed as pooling vehicles that aggregate smaller commitments by individual investors (or their personal holding companies, personal trusts, etc.) through the formation of an unaffiliated "feeder" fund that has the sole mandate of investing in one or more underlying funds of one or more investment managers. For instance, Moonfare, a recent entrant in this space based in Europe, limits itself to qualified investors but has a comparatively low minimum investment threshold (as compared to direct investment in many private funds) of £50,000 for United Kingdom-based investors[4].

In exchange for access to a curated selection of underlying private funds, these platforms will often charge an additional percentage-based management fee, which is layered on top of the more typical economics of the underlying fund (typically in a smaller amount than the underlying fund's management fee). These platforms also commonly structure their feeder vehicles such that a larger amount of the retail investors' capital is drawn down at the time a commitment is first made to help mitigate any default risk by the underlying investors in responding to capital call notices—unlike the traditional fund model where capital is called from investors as needed. For underlying fund managers, these platforms provide access for retail investors to participate in their funds without the associated administrative hassles of dealing with large numbers of individual investors.

In a recent Canadian example, Bank of Montreal recently entered into an arrangement with Georgian Partners Growth LP (Georgian) to allow its accredited investor clients to invest in Georgian's portfolio of privately held North American tech companies. Establishing a feeder vehicle that will allow these retail investors to participate indirectly in Georgian's privately held fund investments is viewed as creating a win-win-win for all parties involved: i) retail investors are provided with a new opportunity to diversify their investment portfolios with a private fund sponsor; ii) Georgian taps into an expanded base of investor capital; and iii) Bank of Montreal gains access to a new source of fee income by establishing the feeder vehicle and facilitating access for their accredited investor clients. Similarly, Mackenzie Financial Corporation, Brookfield Corporation and Wealthsimple Inc. have all recently begun offering access to qualifying Canadian retail investors to private funds[5].

Given the clear benefits to these structures for a variety of market participants, we expect to see similar feeder vehicles established over the coming years by Canadian financial institutions and fintech platforms, a self-reinforcing trend that will continue to drive expanded growth in retail access to alternatives in Canada, the United States and abroad.

Read more commentary on retail investors in our article "Retail investors and access funds: 'hey, we want to invest in private funds, too!'"

Seeking liquidity through semi-liquid funds

Another recent trend in retail access to private funds is the development of "semi-liquid" funds, which are designed as open-ended or "evergreen" funds with no set term and which generally permit redemptions by investors on an ongoing basis. These redemptions remain subject to limitations in the underlying fund documents, which typically provide for mechanics such as withdrawal limits or "gates" to help manage demands for liquidity.

Open-ended funds, relative to the closed-ended fund structure, have the benefit of minimizing the liquidity issue that many retail investors run into when exploring private funds as an asset class (given the ability to redeem on an ongoing basis) and have traditionally worked well when combined with longer hold assets such as real estate, infrastructure and credit products. There has also been a relatively recent rise of open-ended funds in the private equity buyout context, in part as a reaction to increased demand from investors.

Read our three-part commentary on open-ended funds, starting with our article "Open-ended funds: a new way forward for private market funds".

Secondary sale options for retail investors

Another interesting recent development, in the context of the establishment of retail feeder vehicles by financial institutions and fintech platforms in the closed-ended space, is the interaction of the secondaries market with such products and the resulting creation of new markets for investor liquidity. For example, Moonfare has partnered with a U.S.-based secondaries fund sponsor to allow retail investors a semi-annual right to participate in an auction through which they can buy and sell fund interests on the secondary market.

The potential need for individual investors to access such liquidity is clear: according to a recent poll, 82% of mid- to high-net-worth investors tried to seek liquidity for their alternative assets over the previous five years[6]. In such a sale process, a price is typically set by the buyers on the market (either institutional investors or individual retail investors seeking to upsize their position in a given fund product) with reference to the net asset value provided by the underlying fund managers in respect of the interests. Sellers can then choose whether to sell their interests at that price in exchange for a secondary markets fee.

Although liquidity is not guaranteed on the secondary market, this option provides the potential for sellers to cash out early in respect of well-performing fund interests or to achieve liquidity if changes in circumstance dictate such need at any point (even if the sale is ultimately at a discount to the interests' net asset value at such time) and for buyers to aggregate individual fund interests and accumulate larger stakes. Similarly, we expect to see more Canadian financial institutions and fintech platforms partnering with Canadian secondaries fund managers to provide access to liquidity for retail investors in respect of their own closed-ended fund products aimed at individuals.

Read our take in "How the secondaries market can unlock PE liquidity in a recessionary environment".

Regulatory reform and the future of retail growth

The ongoing demand for access to private funds by retail investors has led to regulatory change in Europe and the United States. In Europe, the European Commission has explored providing retail investors with access to long duration private funds which can invest in alternative assets. In the United States, the Securities and Exchange Commission has recently expanded the definition of "accredited investor" pursuant to which investors can qualify to participate in private fund offerings, and the Department of Labor has expanded access for 401k retirement plans to participate in private equity funds[7]. Meanwhile, in Canada, securities regulators are expanding eligibility criteria for prospectus-exempt offerings (such as the self-certified investor exemption) and have granted exemptive relief to facilitate the operation of resale markets for private issuers, including funds.

These regulatory changes and the increased supply of new products and fintech platforms in the space suggest that retail investors' demand for alternative assets such as private funds is growing and that regulators have taken notice. As noted earlier, even a modest expansion of these markets has the potential to unlock significant new value for retail investors, financial institutions and fund sponsors alike. We also expect that technological innovation in the fintech sector will continue to drive growth in this space in the years to come. These trends point to an exciting near-future where private fund investing becomes significantly more widespread among individuals, benefitting both fund sponsors and retail investors alike.

FOOTNOTES

To discuss these issues, please contact the author(s).

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