PRIVATE EQUITY FOR INDIVIDUAL INVESTORS

Historical Impediments and New Opportunities

By Bob Rice

The research is clear: Private equity typically generates better returns than the public markets. The advantage, at the index or median level, typically runs to an average of 300–400 basis points per year.[1] To address their funding gaps and operational budgets, institutional investors such as endowments and defined benefit plans have made private market allocations a staple of their portfolios. But individuals and defined contribution plans remain relatively underexposed, if not altogether unallocated.

The main reason is clear enough: The illiquidity that is a hallmark of these strategies is not a hurdle for institutional investors with long time horizons, but it's a very big obstacle for most individual investors. Other factors contribute, too: high investment minimums, steep net-worth qualifications for investor participation, complex tax treatment, and even the inability to source (and access) quality opportunities, in part due to limitations on advertising private placements. But recently new product types, emerging platforms, and trading technologies, as well as key legal and regulatory changes, have made private equity (PE) a more realistic opportunity for individual investors.

All the new product options come with tradeoffs. This article provides a quick map of the ways individuals can invest in PE, along with discussion of the main benefits and drawbacks of each approach.

Private Equity—Its Benefits and Drawbacks

Let's start with illiquidity. The phrase "liquid private equity" is an oxymoron, because much of PE's value derives directly from its illiquid nature. For example, as a private form of equity, there is no public market for buyer and seller to come together and agree on a price, which is an essential characteristic of tradable liquid securities. There is no fair disclosure requirement in private markets, and the resulting information asymmetry provides an investment advantage that allows for investors with potentially superior outcomes down the road.

In addition, the purchaser of a private company may have near complete control over the entity. That control includes changes in management, pursuit of long-term operational improvements, splitting off unproductive components, expanding research and development, accelerating product development, and improving distribution, all on its own time (and dime). Such control can strongly incentivize executives to achieve certain goals, because there is no need to maintain current dividends, answer to analysts on a quarterly basis, or wage proxy battles.

In short, many of the return characteristics of PE are directly linked to its private (and therefore usually illiquid) nature. To begin to answer how to reconcile the ideas of private equity and liquidity, let's consider how classic PE funds get and deploy capital.

The Mechanics of Illiquidity: The J-Curve and Cash Drag

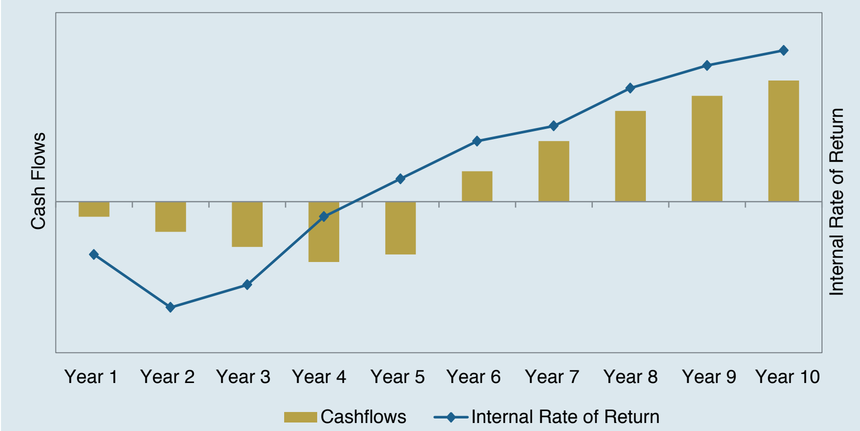
Traditional private equity funds are private partnerships in which the fund manager is the general partner and the investors are limited partners. The partnerships raise capital through private placements in which investors commit to a total funding level, but only periodically remit cash, in chunks, on demand, and over time, when capital is called by the general partner.

This system reflects the fact that private equity fund managers themselves must deploy capital slowly. Once they have capital commitments in hand, they must identify and perform diligence on private targets, select them, and then negotiate transactions on favorable terms before cash is expended. Only then will capital be called, and only the amount that can be readily spent. Note that if the manager were to raise all the investment capital up front that it wishes to deploy over several years, investors' returns would suffer as the manager sits on big piles of uninvested cash. (Conversely, a manager who doesn't have ready access to pre-committed funds can't effectively negotiate and pursue deals). So capital calls are the signature modus operandi of traditional private equity funds.

A typical PE fund's entire investment process occurs over four or five years. After each investment it takes substantial time to improve the underlying company through the management changes and resource injections mentioned above; and yet more time to negotiate and execute the exit, either through a sale to a strategic buyer or an initial public offering. So each investment position, once taken, may require another three to six years to ripen.

As a result, an investor's net flow of funds is usually negative for a period of years, then flattens as the last commitments are paid and

Figure 1: The J-Curve



Source: Wilshire Associates

the first deals start to be liquidated, and then accelerates towards the end of the cycle. A graph of those flows—and associated internal rates of returns (IRRs)—often looks like a tilted and gently sloping "J" (see figure 1).

As cumbersome as this process is, it is also the most economically efficient way for general partners to gather and deploy the cash. As a result, most newer products that offer alternatives to the process suffer some form of cash drag that reduces returns.

Lowering the Velvet Rope: Investor Qualification and Fund Access

This traditional fundraising process has profound implications for which kinds of investors the general partner will solicit and accept as limited partners (because it must be confident that capital calls will be met). And before the JOBS Act, which took full effect in 2016, two other factors also were at work.[2] First, the total number of investors in a partnership was restricted to just 500 limited partners (LP). So to raise a large fund, a general partner (GP) had to find a relatively small number of LPs who, together, could invest the total amount it was targeting. Second, the private placement process limited the availability of information about PE funds to a narrow set of institutional investors. As a result, almost no individual investors could join the PE club, even if they could stomach long J-curves and complete illiquidity of the investment.

But the JOBS Act made changes that should open up investment to a far greater potential audience. In addition, a new ruling from the U.S. Securities and Exchange Commission (SEC) permits a new and readily tradable type of regulated investment company (RIC) for illiquid securities. But before we review these critical developments, let's look at how else individual investors might seek out private equity-type returns.

Exploring Potential Liquid Options: A Survey of Tradable PE Proxies

A handful of PE proxies are available in the market, some of which offer far greater liquidity than traditional PE. The most obvious proxy would be for investors to buy the public securities of major private equity firms. This easy path provides complete liquidity and some indirect exposure to the success of PE funds. But it doesn't provide a simple pass-through in terms of the risk and return profile of the underlying private funds. The investor is buying into the earnings stream and distributions of a public company, an investment that correlates with public market behavior. Also, in most cases the beta of publicly listed private equity companies tends to be high, well above 1, so they tend to trade with volatility greater than that of the market.

Because the era of public companies that are PE sponsors is new, data on how well they do for investors compared with traditional PE funds is too scarce to be reliable; but it's hard to believe that the performance won't be quite different. (After all, oil company stocks historically have had only a modest correlation to oil prices.)

Another access point via the public markets could be a set of microcap companies, or even an index that purports to identify the market areas in which PE firms are active buyers. The latter is reminiscent of retail funds that attempt to track the investment proclivities of hedge funds by following the investment behavior indicated in SEC Form 13F filings.[3] But neither approach captures the core argument of PE, which includes the information advantage; the ability to buy firms at large discounts; the ability to apply direct, operational intervention to improve the fortunes of specific, owned companies; and the ability to determine the most beneficial time and approach to liquidating the investment with a sale to a strategic buyer or a move back to the public markets.

Business development companies (BDCs) are another route. Most investors think of BDCs as strictly income vehicles that pass through interest on loans made to small private companies. However, BDCs were designed as public vehicles that could funnel growth equity capital into smaller companies. Alas, that purpose has largely been lost in the race for yield, although a few BDCs operate as equity funding vehicles and can provide decent exposure to prepublic growth companies.

Finally, for those who can buy and hold stocks listed in Europe, some funds have listed shares there instead of going the LP route. But cash drag raises its head here. Because these funds must launch by raising most or all the funds they hope to deploy, investor returns are bruised by large sums of capital sitting idle for long periods. In addition, the trade by appointment nature of most of these listings can result in poor pricing to a seller, making the liquidity argument a bit thin.[4]

True Illiquid PE for Individual Investors

Apart from these PE proxies, there are other ways for higher-net-worth investors to approach true private equity. The different structures have different implications for liquidity, time horizons, fees, performance, investment size, diversification, practical diligence requirements, tax reporting, and even counterparty risk. Moreover, legal structures and investment strategies can overlap in different ways, which can make commonly used labels confusing.

Feeder Funds

Feeder funds are limited partnerships that typically use all their funds to invest in one specific brand-name private equity fund. Investors become LPs in the feeder fund; the feeder fund is an LP of a traditional PE fund. As a result, investors in feeders can access well-known private equity funds with much smaller minimum commitments than otherwise required (say, $250,000 or less, rather than $5 million or more—a typical account minimum for most investors going direct into a private fund). Nevertheless, most feeder funds are still offered almost exclusively to qualified purchasers (QPs or individuals with at least $5 million minimum of net worth).

Most feeder funds are sponsored by the home office of traditional wealth management wirehouses or private banks, but a number of independent firms also provide this service. In addition, a small number of PE firms create and operate feeders into their own traditional funds.

Feeder funds do offer smaller minimums, but they also have greater expenses that diminish returns. The feeder fund itself must issue capital calls to its investors when it receives a capital call from the underlying PE fund, and these capital calls incur all sorts of accounting, tax reporting, and record keeping requirements. Typically, the general partner of the feeder fund will charge 50–100 basis points to cover these activities and make its own profit.

Investors also should be aware of the potential for counterparty risk in feeder fund structures, remembering that the GP of the feeder fund is not usually the same brand-name firm that's running the fund into which the feeder invests. This is not a serious risk for feeders sponsored by major financial institutions, but as independent feeder fund platforms proliferate, it's a point to bear in mind. Investors in feeders must be comfortable that the organization serving as the GP of the feeder will discharge its duties properly and be around for the duration of the fund.

Feeder funds historically have been as illiquid as the underlying private equity fund into which they invest, but changes are afoot. For example, the Nasdaq Private Market recently announced its designation as a qualified matching service for such funds. This would permit it to operate periodic auctions for feeder fund interests, although total share transfers within a given year would be limited to 10 percent by Internal Revenue Service rules (exceeding that limit could cause the fund to be considered a publicly traded partnership and taxable as a corporation). When this service becomes available, one can imagine that some new feeders will be designed to operate on this basis, and investors in older feeders may have new opportunities for interim liquidity in their investments, depending on whether the GP of the feeder decides to participate.

> *This fee layering has contributed to a decline in FOF popularity among institutional investors (which can usually diversify on their own), but the vehicles remain a reasonable way for individuals to approach private equity.*

Fund of Funds

The phrase "fund of funds" (FOF) refers to a general partner that invests in a range of underlying PE funds (as opposed to feeders, which usually invest in just one). For smaller investors, this approach can be extremely attractive, because these vehicles can provide far greater diversification across vintage years, styles, and geographies—something that is extremely difficult to achieve with any single investment in PE. In addition, FOFs often offer smaller minimum investments than the PE funds into which they invest. However, they are typically open only to QPs, and their illiquidity is often greater than single PE funds, because the underlying funds all have different investment periods and separate market cycles to navigate.

Also of note, FOFs charge their own fees on top of those charged by the underlying PE funds. Feeders usually charge only an annual administration fee, but FOFs usually charge both an annual fee and an incentive performance fee, as much as 10 percent of the investment returns achieved over a given hurdle rate. This fee layering has contributed to a decline in FOF popularity among institutional investors (which can usually diversify on their own), but the vehicles remain a reasonable way for individuals to approach private equity.

Registered Limited Partnerships

A promising recent development for individual investors seeking exposure to private equity is the arrival of traditional private equity LPs that have been registered under the Securities Act of 1933. This permits much broader marketing and distribution and allows an unlimited number of accredited investors into the fund—enabling it to dramatically reduce minimum investment size without using a feeder. Moreover, the latest product to market in this format features lower fees than traditional private equity funds and attempts to shorten the classic J-curve through its mix of investments. However, investors still must

Table 1: Comparing PE Investment Structures (Typical Characteristics; Exceptions and Variations Exist in Each Category)

	Single Fund Classic LP	Single Fund Feeder	Private Funds of Funds	Interval Fund—No Tax Election	Interval Fund—RIC Tax Election	33 Act Registered LP Fund	Equity Crowd-funding	Nasdaq Private Market RIC
Capital calls	yes	yes	yes	no	no	yes	no	no
Minimums	large	small	large	small	small	small	small	small
Tax reporting	K-1	K-1	K-1	1099	1099	K-1	K-1	1099
IRA eligible?	no	no	no	no	yes	no	?	yes
Liquidity	none	none	none	quarterly	quarterly	none	none	monthly
Fees (not including. Distribution costs)	200 bps+ 20% over hurdle	added admin costs	two levels	two levels	two levels	approx. 80 bps+ 1.5% over hurdle	200 bps and 20% over hurdle	two levels
Cash drag?	yes	yes	yes	yes	yes	no	no	no
Typical investors	QPs	QPs	QPs	AIs	AIs	QCs	AIs	AIs

commit to capital calls, deal with tax reporting via K-1s, and understand that the investment is fundamentally illiquid.

Private Equity Crowdfunding

Spawned by the JOBS Act, equity crowdfunding sites offer access to private investment deals to accredited (and in some cases non-accredited) investors. Typically focused on earlier stage venture deals, these sites provide for simpler access. But these platforms are new, and the track record of their underlying investments is short. Also, venture can be a particularly risky prospect (recall that only the top handful of venture capital funds capture nearly all the industry's profits), especially for platforms that do not co-invest alongside more proven venture firms or provide rigorous due diligence in their sourcing and management of their deals. And equity-crowdfunding investors are still subject to the typical illiquidity of PE, because venture deals are notoriously long-lived.

True PE for the Affluent Masses: Solving for Liquidity and Access

The high bar of investor qualification combined with long-term illiquidity is a continuous theme in any discussion of private equity. A few notable product structures attempt to solve for both—within limits.

Interval and Interval-Like Funds

Interval and interval-like funds are the primary way that accredited investors (those with a minimum net worth of $1 million, as opposed to QPs) gain access to true private equity (see sidebar). These are RICs that themselves become LPs in several classic private equity funds—thus, they are funds of funds, except investors participate through a RIC.

A core benefit of these funds is that they are continuously offered, meaning that they issue new shares whenever more capital is needed or to accommodate new investors. As a result, investors in these funds need not commit to future funding and do not face capital calls.

But probably the most touted benefit of these structures is their liquidity; they typically offer to redeem up to a stated percentage of total capital on a quarterly basis. Of late, this system has worked fairly well to provide as much liquidity as holders have desired, but there have been noteworthy failures in the past during market dislocations. This is not terribly surprising, because a fund can only hold so much cash, and its ability to quickly dispose of its core investments is very limited.

This mechanism also introduces cash drag. The cash that funds keep on hand to address redemption requests creates a direct hit to their internal rate of return (and results in relatively high management fees being paid on inactive dollars). Performance also can be adversely impacted by the cost of compliance and operations associated with quarterly tenders. But with those caveats in mind, these structures arguably may offer today's best marriage of PE and liquidity.

Nasdaq Private Market RICs

A recent and potentially important development has been the SEC's approval of Nasdaq's request to operate an auction market for a new type of private RIC. The new vehicle is designed to hold illiquid securities, be continuously offered, and trade (albeit monthly, not daily). This marks the first time this trio of features could be combined.

Only accredited investors may purchase these securities, and only financial professionals and institutions will have direct access to the Nasdaq marketplace. Auctions will be facilitated by market makers, and all buy and sell interest will be aggregated to create a single clearing price for all transactions (a handy protection for individual sellers).

Overall, the structure can be loosely thought of as a slow-motion exchange-traded fund (ETF) for PE because, although primary liquidity is through trading instead of redemptions, it also has an embedded arbitrage mechanism analogous to the one that keeps ETF prices in line with the net asset value of its basket of securities.

As a fund of funds, these structures could involve greater total investment expenses than direct investment in a classic PE limited partnership. On the other hand, they should offer a path to private equity investment that does not require capital calls, is liquid via an active marketplace, is diversified, reports via 1099s, and limits cash drag because it will not need to hold cash to meet quarterly redemptions.

Table 1 shows a comparison of the various PE investment structures discussed here.

Summary

Given today's extremely modest expected returns for stocks and bonds, as well as the basic need for broader diversification, private equity has a powerful natural appeal for affluent individual investors. A steady march of new laws and regulations, product types, and distribution platforms has finally made it a realistic option for them.

But, of course, advisors must choose among them. Despite this article's focus on structure, the most important factor is the manager(s) of the vehicles: Performance dispersion is so great (and its persistence is so significant) among PE funds that only managers with solid track records should be considered seriously. The next most-important factor is liquidity. If clients cannot certainly and comfortably hold a position and meet the required capital calls for the lengthy investment horizons required, then advisors should consider interval funds or the new Nasdaq Private Market RIC for clients. If illiquidity is not an issue, but large investment minimums are, then a registered LP interest, or feeder fund, may be suitable. If neither illiquidity nor large minimums are issues, then the traditional LP structure may be the best choice.

Acknowledgments

The author gratefully acknowledges the significant contributions of Avi Sharon, PhD, in the preparation of this article.

Bob Rice is managing partner at Tangent Capital and Rice Partners and author of The Alternative Answer *and* Three Moves Ahead. *Contact him at rer@ricepartners.com.*

Endnotes

1. See Robert S. Harris, Tim Jenkinson, and Steven N. Kaplan, "Private Equity Performance: What Do We Know?" *Journal of Finance* 6, no. 5 (October 2014): 1,851–1,882.
2. The Jumpstart Our Business Startups Act (JOBS Act) seeks to encourage funding of small businesses in the United States by easing a number of securities regulations. Title III, known as the Crowdfund Act, creates a way for companies to use Internet-based crowdfunding to issue securities, and to raise capital.
3. SEC Form 13F is a quarterly filing required of institutional investment managers with more than $100 million in qualifying assets.
4. Publicly traded closed-end funds would seem like the logical place for traded PE, but the SEC has limited such funds' ability to own most types of PE assets (aside from private debt securities). The SEC takes the view that private equity investments are inappropriate for retail investors.

CONTINUING EDUCATION
To take the CE quiz online, visit www.IMCA.org/IWMquiz

THE INS AND OUTS OF INTERVAL FUNDS

Interval funds may provide the most interesting way to translate the benefits of illiquid private markets to individual investors, but there are some key differences to appreciate among the products in the market.

One is particularly confusing: These funds are registered funds, but they might or might not be RICs. You read that right. They are all *registered* investment companies under the Investment Company Act of 1940—but they might or might not elect to be treated as *regulated* investment companies for tax purposes. The tax election version is preferable for most investors, because *regulated* investment companies report via 1099s, not K-1s. Importantly, they also automatically shield investors from unrelated business income (UBI) issues, making investment through individual retirement accounts plausible.

Another difference with important implications for investors is whether the RIC is a single-manager fund (that is, all the funds into which the RIC invests are operated by a single big-name PE manager), or a multi-manager fund. Single-manager funds carry the cachet of a famous brand, but note that the Investment Company Act does not permit the RIC to invest in affiliated funds—so these products are sponsored and advised by a group independent of the manager to which it allocates.

A subtle but crucial issue to consider in these cases, therefore, is whether the independent RIC really has all the access it desires to the best of the brand-name manager's funds and investment options. In a world where the best PE funds are constantly oversubscribed by institutional investors, some famous PE managers may not be terribly motivated to provide capacity within the best opportunities for semi-retail investors when it would mean cutting back (and maybe alienating) institutional investors with which the manager has long-term relationships. This dynamic can hinder allocations of cash on hand at the RIC into active use and accentuate cash drag.

By contrast, fund sponsors operating multi-manager RICs have better opportunities to diversify and, naturally, more opportunities to rapidly deploy the funds they raise.