Now Playing: Private Equity for Everyone

By Bob Rice
“Wait, did you say Vanguard?” That was the main question in the investment industry after that company’s February 2020 announcement that it is developing private equity products. A couple months later, the question became, “What, the DOL?” when the U.S. Department of Labor released Information Letter 06-03-2020 and effectively endorsed the use of private equity investments by defined contribution plans.

When staid organizations such as Vanguard and the DOL act atypically and synchronously, you’re probably witnessing a sea change. And so we are: A wave of private-market products from industry stalwarts is arriving, aiming squarely at the mass market. The initial targets are accredited investors (investors with a minimum net worth of $1 million) and their $40 trillion in wealth; the longer-term targets are everyone else, via their retirement plans.

For advisors, this is welcome news. Private-market products can offer fundamental diversification and risk-return benefits to standard liquid portfolios. And they will not be available through any passive product or automated investment system; in a world of fee compression, that helps prove out an advisor’s value proposition.

Fundamentally, these developments could help advisors to expand their practices. Traditionally, the most attractive private-market investments have been available to individuals almost exclusively through feeder funds, but those generally are open only to qualified purchasers (QPs) with a minimum net worth of $5 million. Meanwhile, accredited investors who are not also QPs account for about 9 percent of the population. They have the appetite to invest in the same types of underlying funds and managers as the wealthier cohort, but so far they have been confined mostly to the same investment options as true retail clients. The new generation of products could help put those investors into play.

There have been previous efforts to reach the sub-QP market with private-market exposures, but the coming wave is fundamentally different. First, it features classic institutional fiduciaries as allocators, building portfolios just as they do for their current clients (i.e., “best ideas” portfolios that are not limited to single managers, styles, or stages). Second, the product wrappers now have liquidity features that eliminate gates, minimize cash drag, and operate more frequently than tender and interval funds. And third, they’re being brought to market by traditional financial manufacturers with the full marketing support and extensive educational programs that advisors will need for successful implementation into their practices.

So why is all this happening now? One reason is obvious: The growing recognition by regulators and investment professionals that private equity (PE) and related asset classes can significantly improve the return and risk metrics of standard liquid portfolios, and that those benefits should no longer be available only to the wealthiest investors.

Another reason is subtle but crucial: The motivations of the most prestigious firms in the field are finally aligning. Top-tier private-market allocators, who had been resistant to lowering fees to run mass market products—especially for some of the most desirable strategies—have started to perceive that the broad market opportunity may justify the trade-off (obviously, the DOL letter has greatly improved those odds). Meantime, manufacturers and intermediaries are anxious to respond to the passive investment tidal wave and are willing to invest in the required product development, marketing, and education efforts.

At the same time, legal changes and new market technologies are enabling product innovation and easing the path to broad distribution. The Securities and Exchange Commission (SEC) has, for example, approved innovations such as auction funds, which are aimed at addressing the liquidity limitations of their interval and tender offer fund predecessors. It has also made “general solicitation” (i.e., advertising) of private placements radically easier, expanded the “accredited investor” definition, and removed other barriers to success.

Below, we’ll tour the major private-market asset classes and investment characteristics, review key business and legal developments, discuss distinguishing product features of new PE products that advisors may wish to consider, and describe the theory and practice of integrating these investments into standard liquid portfolios.

PRIVATE-MARKET ASSET CLASSES—PERFORMANCE AND RISK CHARACTERISTICS

Before we start, though, let’s ask a fundamental question: Are the private
versions of equity, debt, and real-asset investments really so critically important to average investors, given how well their traded cousins have performed over the past many years?

The answer is a straightforward “yes.” And one does not need a CPWA® certification to appreciate why: It’s because these asset classes provide radically broader diversification along with historically higher (both absolute and risk-adjusted) returns.

In the United States, for example, four times as many private companies as publicly listed companies deliver returns to investors via private equity and venture funds.

The private credit and private real-asset opportunity sets offer public investors similar kinds of diversification benefits.

Let’s look more closely at the three major private-market categories—private equity, private credit, and private real assets.

**PRIVATE EQUITY [BUYOUTS, VENTURE, AND GROWTH]**

The granddaddy of the space is private equity, a term that for years was taken to encompass all of the private markets but now typically refers more narrowly to investments in operating companies, typically through buyout, venture capital, and growth equity approaches.

Buyouts are the most popular single strategy in all of the private markets. They often are described as the corporate version of house-flipping. A fund acquires a company and sets up improvements in some or all aspects: products, distribution, management, technology, scale (including by industry roll-up), etc. With larger funds pursuing larger companies, the acquisition usually utilizes as much debt and as little equity as possible—the classic leveraged buyout—so that the resulting value accretion is captured by the relatively small equity investment (again, like a house-flipper).

However, many smaller and specialty-focused funds complete their acquisitions with little or no debt, so as to free up the acquired company from having to dedicate cash to interest payments. These managers focus more on operational improvements than financial engineering to achieve their profits.

Table 1 shows that the returns on these strategies have been remarkable and remarkably consistent, even at the level of the average manager. Top-tier managers have performed significantly better, an important point because performance persistence is meaningful.

As one would imagine, then, adding these exposures to a traditional liquid portfolio tends to improve its Sharpe ratio significantly. Obviously, how much improvement depends on numerous factors. At a 2020 Investments & Wealth Institute event, however, Wilshire Associates representatives estimated that integrating a 20-percentage allocation to average-performing private-market funds (10 percent to private equity and 5 percent each to private credit and private real assets) into a generic 60/40 portfolio could produce a 17-percentage improvement in expected returns with no increase in expected risk.3

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**Table 1**

**PRIVATE EQUITY 20-YEAR HISTORICAL PERFORMANCE**

| Global Private Equity1 |  |
|---|---|---|---|
| Strategy | Average [Mean] | Standard Deviation | Sharpe Ratio |
| Buyout | 16.7% | 20.4% | 0.7 |
| Venture Capital | 15.4% | 34.7% | 0.4 |
| Growth Equity | 15.8% | 22.7% | 0.6 |

| Public Equity |  |
|---|---|---|---|
| Strategy | Total Return | Standard Deviation | Sharpe Ratio |
| S&P 500* | 6.8% | 14.8% | 0.4 |
| MSCI World** | 5.5% | 15.3% | 0.3 |

3 Source: Prequin
in the space. As a result, there is significant competition among investors to access the top managers—a key reason that it’s a plus for the allocator of any retail product to be an established institutional investor with the heft to command investing capacity into the best-performing funds.

Many suggest that these return levels are not sustainable; and this may be so. However, one suspects that the relative outperformance of the asset class versus public markets is likely to continue, because the underlying reasons for the outperformance aren’t going away. Those include the much bigger opportunity set, the legal use of information advantages, the ability to directly improve the operations of companies into which investments are made, and the inherent use of leverage.

Even so, the fear persists that an excess of dry powder—dollars committed to, but unspent by, leveraged buyout (LBO) funds—will lead to return degradation over the next few years. But that dry powder is heavily concentrated at the very largest firms, leading many to conclude that the better opportunities are at the mid-size and smaller PE funds.

Regardless of one’s own point of view, the dry powder concerns illustrate that a flexible allocation to any private-market space may be a prudent approach, because, as is true in the public markets, conditions change over time.

The other two major segments of PE are venture and growth.

Venture capital is the darling of many investors because of the potential for dazzling returns. Uber, for example, generated a return of 5,000 times the investment of its earliest fund investors (and no one recalls what other investments were in that particular fund).

Obviously, these investments come with radically greater risk—even the top funds invest in many companies that fail outright. Worse, only a relative handful of venture capital firms, as few as 15 percent, routinely generate nearly all of the industry’s profits—another example of why investing through an allocator with access to the top funds is critical.

The growth equity field is relatively new, a hybrid of sorts between buyout and venture investing. These funds usually make minority investments into successful, established firms that need more capital to pursue expansion. The investments can mix equity and credit and often take warrants in the package. Many of these managers tend to specialize in certain industry sectors because (as with LBO and venture as well) expertise and relationship networks are the keys to locating opportunities and assisting the operating team.

PRIVATE CREDIT

The field of private credit has exploded in recent years, especially since the Global Financial Crisis, as banks have slowly ceded turf to new categories of lenders. Indeed, the overall opportunity has grown to something on the order of $4 trillion dollars in that time. Although it’s difficult to divide this field into neat categories, many of the top managers specialize in senior or mezzanine direct lending to operating companies, some in asset-based loans, others in distressed lending, an area of particular focus these days in the wake of COVID–19 (see figure 2). Other funds specialize in certain asset classes, such as real estate, infrastructure, and even venture stage companies. A common strategy is to make the leveraged loans that are the debt portion of the capital stack in an LBO transaction (see table 2).

A newer area of focus is that of alternative yield investments, which can
PRIVATE REAL ASSETS
One of the more common reactions from advisors to the category of private real assets is, “We don’t need them, we already have REITs and MLPs,” or real estate investment trusts and master limited partnerships, respectively. But in fact those statutory constructs can capture only a relatively small percentage of the pertinent opportunity sets. The majority of infrastructure, energy, commodity, developmental real estate, agriculture and timber, and other natural resource investments don’t fit into the narrow types of investments permissible for REITs, MLPs, royalty trusts, and commodity funds. For example, REITs generally are confined to passive income opportunities and cannot operate assets or develop properties to sell them. MLPs and business development companies have their own significant constraints on permissible investments.

Even when these well-known investment structures can be used for a given strategy, they often are not ideally efficient. Regulatory infrastructure requirements may involve additional expenses, or they may demand the use of specific investment securities that directly reduce returns. For example, the premium decay of most commodity funds can seriously erode any returns that might otherwise arise from price appreciation in the asset.

Another common reaction from advisors is, “But real assets are mostly inflation hedges, which we don’t need now.” This reaction invites two responses. First, although inflation is certainly quiescent at the moment, the government’s profligate borrowing and spending, combined with the Fed’s extraordinary, hyper-accommodative tools and policies, are inviting its return. Second, aside from acting as an inflation hedge, the raw returns on these asset classes can be attractive (see figure 3).

ENABLING BUSINESS AND REGULATORY DEVELOPMENTS
Structural and legal issues, such as the inability to sell feeder funds down to the accredited investor level, have long plagued advisors’ efforts to spread the benefits of private markets to most clients. But before we address how that world has changed recently, let’s address a different and in some ways more important practical issue: the fees that institutional-caliber allocators typically have demanded and what they have meant for the development of retail products.

A critical element to appreciate about private-market investments is that some styles and stages are more desirable and capacity-constrained than others. Secondaries, co-investments, and venture opportunities (all highly sought after by institutional investors), for example, can absorb only limited dollar flow. Thus, opportunities to invest with the elite managers in these fields are precious. The portfolio managers with access to them already are receiving incentive fees on the investments they make for institutional investors, so naturally they have been reticent to accept simple flat fees instead. But if a financial product does charge incentive fees, it can’t be purchased by those below the qualified client (QC) level.

This has created a bit of a stalemate. The product manufacturer might be able to offer access in these areas but need to charge incentive fees and therefore limit investors to QCs and above, or it could charge only flat fees and compromise on the scope of the portfolio elements. In general, “mere” accredited investors have been caught in that gap.

Recently, however—fueled partly by the regulatory changes that have significantly expanded the size of the retail opportunity set—a few elite PE allocators have decided to make the trade-off. The logic is that the dollars accumulated into the more routine components of the product portfolio will help offset the effective losses suffered by allocating other portions of it into the more constrained areas on a flat-fee basis.

This fee approach by top allocators, combined into interval or tender offer funds qualified as tax regulated investment companies (RICs), would appear to solve most issues that had stood in the way of accredited investor access to institutional-caliber private markets. Such a fund would produce 1099s, have low minimums and no capital calls, and fit inside individual retirement accounts (IRAs) and defined contribution plans.
However, one issue still presented a challenge—the liquidity mechanism. Interval and tender offer funds holding illiquid assets typically offer to redeem up to a cumulative total of 5 percent of the fund’s assets under management (AUM) per quarter. But this has proven problematic for two reasons. The first was highlighted by the infamous Endowment Fund example, which proved—and as some interval funds (and private REITs) also have seen more recently—that a 5-percent fund AUM cap on quarterly liquidity is sometimes simply not adequate. In such cases, investors take a haircut on their liquidity request, and that can (as it did with the Endowment Fund) lead to something of a run on the bank, where many more investors attempt to redeem in the following window, leading to a full-blown liquidity crisis.

Such extraordinary events aside, and perhaps even more perniciously, PE-centric interval and tender offer funds naturally experience significant cash drag that diminishes performance. This is because of the cash or cash equivalents they must hold to meet potential redemption requests. This problem often has been exaggerated, following the Endowment Fund episode, by intermediaries that have required funds to hold more cash than the bare minimum as a margin of safety. In practice, the resulting cash drag often reduces performance by an average of 120–350 basis points per year. And some major intermediaries have reacted to this issue by simply declining to distribute the PE-focused interval funds altogether.

Here, the major development is the advent of an additional liquidity mechanism recently approved by the SEC in a no-action letter issued to Nasdaq Private Markets. The goal of this innovation is to move the primary liquidity mechanism away from the fund itself to address the cash drag problem.

With this new Nasdaq facility, investors have a monthly option to sell their interests, in addition to whatever periodic tenders the fund provides. In times of net fund inflows, new subscribers or buyers should absorb the exiting shareholders at net asset value (NAV). In other investing environments, institutional liquidity providers are expected to be the main buyers—in much the same way as “authorized participants” keep exchange-traded fund prices near NAV. In all cases, would-be sellers either get a price within the limit they specify (which often would be set at NAV, of course), roll over to the next auction, or participate in the next scheduled tender (again, at NAV). In general, this approach should significantly diminish the need for a PE-centric 40 Act fund to constantly hold cash to meet redemptions, and hence allow greater investment in its target strategies.

Nonetheless, advisors and investors must remember that these funds, focused as they are on private-market assets, are still designed as long-term investments. The monthly liquidity option is meant to provide liquidity assurance—the ability to exit if needed on reasonably short notice and at a price at or near NAV—and not as a system for trading PE-style investments.

PRIVATE-MARKET INVESTMENTS FOR DEFINED CONTRIBUTION PLANS

DOL Letter 06–03–20 has focused attention on the vehicles that will deliver private-market exposures to defined contribution plan participants. The first thing to note here is that the letter does not address stand-alone PE investment options; it instead imagines those investments inside some sort of pooled investment option. Still, as the letter makes explicit, plan fiduciaries will have to carefully evaluate the liquidity characteristics of a PE investment to ensure that beneficiaries still will be able to elect out of the pooled investment in which it sits.

This issue isn’t new. Some plan sponsors and fiduciaries already had been considering adding PE elements to their target-date plans prior to the DOL letter, despite the concern about higher fees. They will be relieved that the letter has addressed that point. But, like the DOL, they’ve also been focused on the PE liquidity question.

Many plan sponsors probably could manage routine liquidity needs of target-date funds, collective investment trusts (CITs), or separately managed accounts (SMAs) with small holdings of PE-style assets by using cash from inflows and existing investments. But that might not be enough in the case of an extraordinary event, such as a plan design change or a spin-off of a division with a large number of employees.

One approach to the issue has been to create a CIT established to hold private-market assets, but which itself also holds a cash sleeve to meet liquidity needs. But this re-introduces a version of the cash drag issues noted above.

The new Nasdaq facility noted above may help address this issue, and so PE-centric 40 Act funds with this feature may be good candidates for providing private-market exposures inside defined contribution plans. Obviously, however, fiduciaries will have to carefully evaluate their costs, because registered funds typically have higher structural expenses than, for example, CITs or SMAs.

This is an area to watch closely, because it offers the most direct path to “private markets for everyone” and is likely to provoke fierce competition among potential product providers.

PRACTICAL CONSIDERATIONS AND IMPLEMENTATION

Financial advisors who wish to consider private-market allocations for their affluent clients should soon be able to choose among numerous products. But before choosing, they’ll want to consider many aspects of these products beyond the obvious ones of fees and features.

Of these, perhaps the most important is whether the allocator for the product can
deliver access to top managers across all the asset classes it covers (see figure 4).

The differences between average managers and top-quartile managers in the private-market world is far more pronounced than it is for listed securities. As a result, it is hard to overstate the importance of finding, and investing with, the better-performing managers. It is for this reason that the majority of institutional allocators outsource their private-market portfolio construction to well-known allocators and consultants—and why having these experts now acting as allocators for individual investors is such a major development.

Obviously, the breadth and composition of the product’s intended portfolio is also critically important. There are several factors to consider here. One is whether the portfolio is expected to experience a J curve, and how deep and long it might be. (The J curve describes the way primary investments in PE partnerships tend to be cash-flow negative in the early years, but then push upward during the harvest periods; the resulting curve may look like a flat J.) Many PE-focused products will aim to negate the J curve by focusing a healthy portion of early investments in secondaries.

Another important issue is whether to invest in a product that has a nearly exclusive focus on one of the three major private-market asset classes or a product that combines all three. Some advisors will favor PE-centric products because they typically will improve expected returns the most. Others will want a mix of the asset classes to maximize return and risk improvement and to provide more downside protection.

The investments that a client already may have in private-market categories also will impact this decision. A client’s first allocation into private markets might tend to be in a product providing a mix of the asset classes. Subsequent allocations might focus on particular niches that provide more focus on specific asset classes and strategies. Regardless, care should be taken to avoid overlap with what the client may already own.

Probably the two most frequent questions from advisors considering an allocation to private markets are: “How much should be added? And from where?” Almost any expert will respond to the first questions with, “Enough to matter,” but that could vary widely, perhaps 10–30 percent. As for how to fund the allocation, many would recommend a “like for like” approach: Allocate to private equity from public equities, to private credit from standard fixed income, and to private real assets from REITs, MLPs, and the like.

CONCLUSION

Institutional quality private-market products are in the works for clients down to the accredited investor level, complete with all the features, and at the fee levels, that those clients need. At the same time, the products may enable defined contribution plan sponsors to better replicate the defined benefit plan investing styles that long funded the retirement benefits for their employees.

Bob Rice is managing partner at Tangent Capital and Rice Partners, an adjunct professor of law at Florida State University, a director of the Investment Manager of the Value Line mutual funds, and a senior advisor to Nasdaq Private Market, Macquarie Investment Management, and Wilshire Associates. He serves on the investment committee of the FSU Foundation and on the Investments & Wealth Monitor editorial advisory board. Contact him at rer@ricepartners.com.

ENDNOTES

7. Ibid.
8. Ibid.
9. Tangent Capital analysis based on average cash positions of the five largest private equity interval and tender offer funds for the year 2019, multiplied by average target strategy returns.

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