Democratization of private markets

Putting this asset class within everyone's reach

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Marie-Hélène Naud MBA, CFA

Senior Director, Development and Portfolio Management,
Private Equity and Infrastructure

Is private investment an asset class reserved for institutional investors? Not anymore. The winds of change are sweeping through the investment industry, aiming to democratize access to this asset class and reach a broader clientele.

This development won't happen overnight: managing such vehicles is complex, and "new" investors will have to familiarize themselves with the new opportunities. Such efforts are worthwhile because of the benefits of including alternative investments in portfolio construction. In an era when private equity, infrastructure and private debt are making headlines, you may wonder why your financial advisor still hasn't recommended them to you. The answer is simple: only a few years ago, this option wasn't available in Canada. But the situation is improving from one quarter to the next.

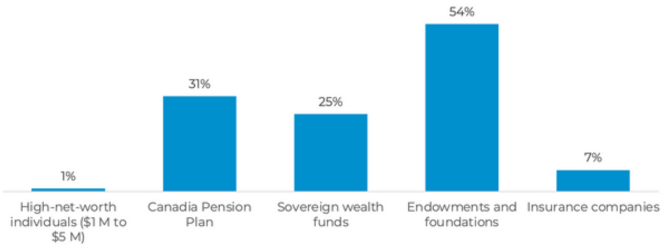
The advantages of private investment

Let's start by defining private equity. It's an investment in a company whose shares aren't publicly traded. To use the example cited in our September 2023 Private Markets Overview, this definition covers everything from a small local company that sells heating, ventilation and air-conditioning systems to residential and industrial customers to a giant like Ikea, an international furniture distributor with annual sales of more than €47 billion.

Private companies play a major role in the economy, although they don't receive much coverage. Even though the global stock market capitalization is US$101 trillion, the value of private equity under management is only US$13 trillion. However, the number of privately owned firms is significantly higher, making up 87% of companies in the United States and 95% in Europe. Apollo's chief economist, Torsten Slok, pointed out earlier this year that 80% of total employment in the United States is outside the S&P 500. In short, the U.S. economy consists mainly of private firms. This vast and expanding pool of opportunities can help diversify a portfolio as the number of public companies continues to decline in the United States and the United Kingdom.

Not only are Canadian institutional investors active in private markets, but they have also increased their allocation to it over the years.

Average Allocation to Alternatives



Source: PIAC (2023 - Median Mix (excl. Hedge funds), Bain analysis, Preqin

The advantages are substantial:

- Long-term historical performance superior to that of the public market
- Low correlation with the public market, reducing portfolio volatility
- Access to a wider pool of investment opportunities.

Correlation of Asset Classes (2012-2023)

	Stocks	Bonds	Private Equity	Private Infrastructure	Private Real Estate	Private Credit
Stocks	1					
Bonds	-0.1	1				
Private Equity	0.8	-0.1	1			
Private Infrastructure	0.5	-0.1	0.7	1		
Private Real Estate	0.4	-0.3	0.6	0.6	1	
Private Credit	0.7	-0.3	0.7	0.4	0.5	1

Source: Data as at December 31, 2023, Cambridge Associates, Bloomberg, KKR GBR Analysis

That said, the industry needs to become more knowledgeable so that it can better explain how this market works and demystify some preconceived ideas.

Why does private equity outperform? This oft-analyzed question has a number of answers. Long-term ownership and vision are key factors. Managers at privately held firms, unlike their counterparts at publicly traded companies, can develop strategies over a number of years without having to meet quarterly performance expectations. They can absorb initial losses and expenses while building a solid foundation for growth. Since it takes years to create value, this asset class is less liquid and requires investors to patiently reap the rewards of their investments. Lack of liquidity is a crucial feature of any private investment.

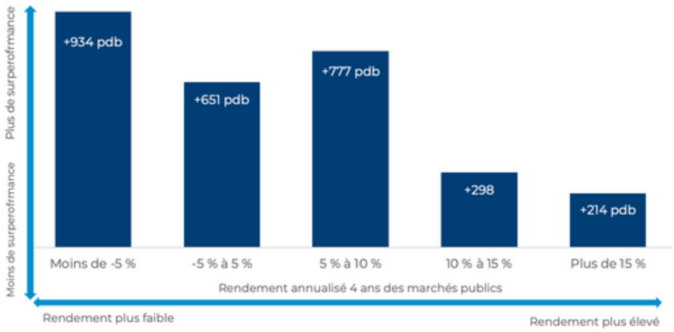
Investors must also be aware of the structure of private equity firms and the governance put in place when such a company is acquired. When acquiring a private company, a fund will typically take the reins of the board of directors and work directly with the management team. A capital structure will be established to facilitate implementation of a value-creation plan. To ensure alignment of interests among all stakeholders and to foster an entrepreneurial spirit, shareholder participation rights may be allocated to management and employees, with this practice becoming increasingly common for the latter.

Moreover, private equity firms have separate teams to handle matters such as optimization of a company's operations and its capital structure. After the acquisition, active day-to-day management is put in place. This involvement extends to a number of companies, so the lessons learned at one company can be applied to others over the years.

A common criticism levelled at private equity is its more flexible and less restrictive regulatory framework. In this regard, Partners Group has already raised the idea, in a white paper, that the governance imposed on public companies has the consequence of emphasizing internal controls and risk management at the expense of entrepreneurial objectives. Moreover, private markets are regulated, and private equity firms have a fiduciary duty to their investors. So the private market isn't the Wild West.

In conclusion, despite the frequently cited argument of high management fees for private investment, multiple market scenarios demonstrate the value added in terms of net returns, as the following chart shows.

All Private Equity Average 4Y Excess Return by S&P Return Regime by Public Market Regime



Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2024)

Barrier to accessibility for retail investors

Given the advantages, a logical question arises: Why was this asset class held mainly by institutional investors until recently?

If such investments are offered to non-institutional clients, advisors and clients alike need to understand their nature, benefits and risks, including their illiquidity.

Institutional investors are well versed in the specific features of these assets, such as contract structures, investment-vehicle types, management and administration fee mechanisms, investment terms and associated risks. However, a significant educational effort will be needed to ensure these products are recommended wisely. Privately owned companies will need significant resources to handle marketing, public relations, and client service, including managing large volumes of requests. This is in contrast to the current structure used to manage an institutional clientele.

The industry has traditionally offered mainly closed-ended funds (although the situation is changing). With this fund structure, the minimum investment is usually $10 million, which creates another barrier to individual entry. Investing in a fund involves deployment of some or all of the capital over three to four years, followed by a holding period of four to five years. Distributions have to be reinvested to maintain a stable allocation. Let's imagine a portfolio made up of multiple funds, with different maturities, that need to be integrated into its construction. Although institutions have developed tools and qualified teams to manage this type of allocation, such complexity is hard to manage for an individual.

The reduced liquidity of alternative investments is another issue. However, it is also a source of value creation (the liquidity premium), which develops over several years during which the investment is generally unavailable. Again, individual investors have to understand this disadvantage so that they can allocate funds accordingly.

Finally, unlike publicly traded shares, private investments entail far more administrative work owing to legal, regulatory and tax obligations. This complexity creates a significant entry barrier for advisors, who have to manage the paperwork and must acquire tools to facilitate the process. This issue was equally challenging for most private managers, who were simply not equipped to handle a high volume of transactions. Fortunately, fin-tech solutions provided by platforms such as iCapital and Moonfare have facilitated accessibility by lowering this barrier to entry.

Transforming the market to democratize it

The democratization of private equity involves reducing the frictions discussed above to facilitate access for a larger number of investors. Undeniably, this effort also aims to increase such managers' assets under management. Even though individual investors represent 50% of global assets under management, they hold only 16% of alternative investment assets.[1] This immense potential has prompted industry players to redouble their efforts to offer new investment options to individual investors – a situation that benefits all parties involved. This trend depends on two main themes, however: the easing of regulatory requirements and innovative product design.

Strict regulation continues to impede access to this asset class, such as, in Canada, the need to be an accredited investor,[2] which limits access for most investors. However, Europe and the United States have seen positive regulatory developments in recent years.

In the United States, the Securities and Exchange Commission modernized the "accredited investor" definition in 2020 to go beyond the concept of net-worth and income tests. The purpose of the change was to incorporate a new accreditation category based on professional certifications, designations and credentials issued by an accredited educational institution. Moreover, the Equal Opportunity for All Investors Act took a major step forward in May 2023 when it received overwhelming support (383-18) in the House of Representatives. It aims to expand the definition of accredited investor to include individuals who can pass an SEC examination that tests the investor's general knowledge. It is estimated that 10% of households are currently accredited.

Europe is increasingly seeing the democratization of private investment with the emergence of the European Long-term Investment Fund (ELTIF) structure,[3] especially since the revised version (ELTIF 2.0) took effect at the start of the year. The new version has given open-ended funds access to the program and has introduced the concept of funds of funds, allowing the addition of direct investments as well as private funds. Even though these investment vehicles are heavily regulated, they simplify administration and offer access with a minimum investment of €10,000, which enhances their scalability.

[1] Bain & Company, Why Private Equity is Targeting Individual Investors, February 27, 2023.
[2] There are a number of criteria based on the investor's total net worth and/or minimum average annual income.
[3] A type of collective investment framework that allows investors to put money into companies and projects in need of long-term capital. ELTIFs are designed to increase the amount of non-bank financing available to companies investing in the real economy of the European Union. At least 70% must be invested in unlisted opportunities.

Overcoming obstacles

To better understand the outlook for individual investors' access to private investments, we have analyzed three main obstacles to its democratization.

1.Complex fund structures and mechanisms

The complexity of managing allocation through closed-end funds has been mitigated with the significant growth of open-ended funds. An open-ended fund eliminates the concept of committed capital, and cash flow management is often simplified, as most funds manage distributions by reinvesting them in other private assets. The client is responsible for deciding on the initial allocation, while the manager of the investment vehicle handles its maintenance (including growth) by planning reinvestments. In short, the burden of managing the portfolio allocation is put back in the hands of the manager, who has the necessary expertise.

2.Illiquidity

Lack of liquidity generally remains a challenge for retail investors, but the market has adapted with structures that allow redemptions at predetermined intervals. Although the term "semi-liquid fund" is sometimes used, we think the nature of the asset class remains much the same. It's true that such funds offer individual clients access to liquidity through redemption mechanisms, but it's worth noting that they are generally not guaranteed within a predetermined period.[4] Thus, it's important to recognize that this asset class remains relatively illiquid. In other words, the investment horizon is a key factor that determines the percentage of exposure to alternative investments.

3. Financial Requirements

Specialized tools and intermediaries such as iCapital facilitate the high-volume management generated by individual clients and have made it possible to reduce the minimum investment to $10,000 to $25,000, well below the usual $10-million threshold for closed-end funds.

Conclusion

Even though efforts to democratize access to private markets still have some way to go, progress is being made. Long reserved for institutions, the asset class is opening up to a larger number of investors. Perhaps it's time to think about how to adjust your portfolio construction to reap the benefits of alternative investments, which include reducing the volatility of your overall portfolio and diversifying your sources of return.

If you're wondering about the advisability of adding alternative investments to your retirement plan, don't hesitate to talk to your financial advisor.

[4] A cap mechanism, or gate, is put in place to limit redemption requests. For example, a 5% limit means no redemption request can exceed 5% of the fund's market value.

About iA Global Asset Management (iAGAM)

A magnet for top investment talent, iAGAM is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths, and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAGAM's unifying commitment to strong risk management, analytical rigour and a disciplined, process-driven approach to asset allocation and security selection.

Rooted in history. Innovating for the future.

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