

KEYNOTE INTERVIEW

Reopening closed doors



*The democratisation of private equity is not about granting access to private markets, but restoring prior access to economic growth, says **Rajib Chanda**, global head of asset management at Simpson Thacher & Bartlett*

Q How has the retail alternatives market changed in recent years and what are the structural forces driving increased demand?

The answer is twofold. On the one hand, these are interesting investments that institutional investors have been accessing and generating great returns from for some time, so it makes sense that individuals would want to get in on that action. On the other, from an individual investor's perspective, democratisation is not about granting access to private markets – it's about restoring prior access to the growth of the US and global economies.

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earlier to access capital, allowing individuals to get in at relatively low valuations and enjoy the growth of that business.

Today, companies are staying private for longer: Amazon went public at a \$438 million valuation in 1997, and Facebook went public at a \$104 billion valuation in 2012. A huge amount of the growth seen by companies nowadays is for the benefit of private investors: with the advent of private investment, there simply isn't as much need for public investment early in their growth. Meanwhile, public pension plans have largely stepped away from these investments, other than for a small

number of state and federal employees, which was another way ordinary Americans used to get access to long-term investments, whether public or private.

Q Why are investment managers opening their portfolios to individuals?

Private markets firms have seen private employer pension plans drying up as a source of capital. Further, as private markets started to get regulated via Dodd-Frank and subsequent legislation, they put resources and infrastructure in place that made broader access more feasible.

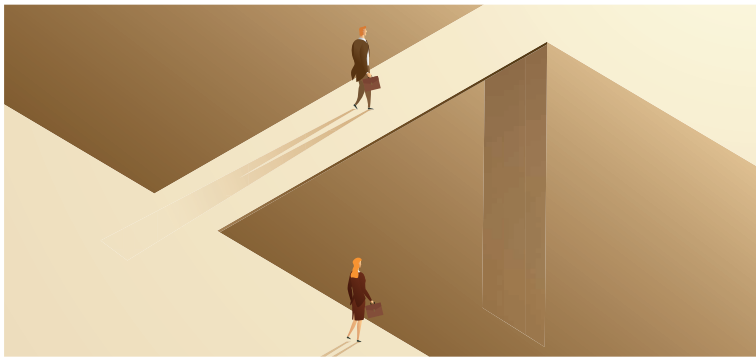
As these private funds think about their own value proposition – whether as public companies or in terms of selling stakes – the recurring revenue

Q How does the regulatory environment need to evolve to improve retail access while preserving investor protection?

A primary element of the regulatory structure in the US is the Investment Company Act of 1940, which serves as a good mousetrap for providing access to individual investors in a fund wrapper. That statute focuses on the right issues – conflicts of interest, leverage, capital structure, governance and so on – but it was written over 80 years ago for a different world.

The 40 Act does not work for private markets investing, and certainly does not work for private markets investing where managers take some level of control and exert influence over the companies they invest in. Today, there is not a single 40 Act-registered private equity buyout fund in the market. There are dozens of products in wrappers that are not registered funds, and those have become available to wealthy investors, but not to the average individual investor. As such, we have created an uneven playing field.

There are plenty of ways to give individuals access to private markets, but those are not currently through the Investment Company Act 1940.



available from individual investors who prefer long-term buy-and-hold investments becomes pretty compelling. That has the potential to help these firms grow and expand into new areas by bringing down their cost of capital. That makes it a good business model for private market managers, both financially and strategically.

Q How should managers entering the retail space think about fund structuring for the private wealth channel?

The main thing to keep in mind is that you are selling to individual investors, meaning the model used for institutional investors will not work without changes. Managers should remember

three key differences regarding timing, liquidity and taxes.

Institutional funds have historically had a drawdown structure whereby you make a commitment and, when the manager has a deal, they ask for your money, sometimes with little notice. That is fine for a big institution allocating across multiple asset classes, but not for individuals who need certainty of allocation and timing.

Regarding liquidity, individual investors need to have some at all times. That does not mean capital has to be accessible on demand, but life events and circumstances change. While these investors do not need to be able to take money out of every asset they own, only being able to get capital

back when managers decide to provide it does not work for an individual investor who may need to manage job losses and estate planning/succession.

Finally, the importance of tax simplicity for individual investors is often underplayed. While institutions have shown a willingness to accept an almost infinite amount of complexity in their tax structuring to maximise returns, the same is not true for individuals. Managers have to design their strategies accordingly, as individuals do not want extended filings or multi-state tax implications from a single investment.

Q What mistakes do first-time retail entrants commonly make?

Entering the private equity retail space is a decision that should not be taken lightly. Too many managers underestimate the difficulty and the investment needed. Retail requires meaningful adaptation, and you cannot avoid making changes to the way you work. The biggest mistake is wanting to do this off the side of the desk, which can lead to real legal and compliance issues. Retail investment has fundamentally different kinds of reporting and compliance requirements. This means that having outside counsel is helpful, but not enough – internal capability is essential.

Managers also tend to underestimate deployment issues, including timing and pacing, and how it varies for individuals versus institutions.

Underestimating the importance of transparency is another mistake first-time retail managers make. The infrastructure and frameworks in these products must be able to give the kinds of transparency that individuals want and, from a regulatory perspective, need.

Q What core operational infrastructure is needed from day one?

The infrastructure comes down to having financial reporting designed for

retail. These are products that are sold, not bought: no matter how strong your brand is, no new individual investor knows the difference between fund X and fund Y. As a result, you cannot pursue an ‘if we build it, they will come’ philosophy.

You have to have an intentional strategy for sales, which means meeting people where they are. If the financial advisers you want to sell to are in Dallas, Miami and Los Angeles, that is where you need to go. You need to get in front of people, which requires a strong distribution model that is fundamentally different to what most managers in the private funds world ordinarily have.

The good news is that most private markets sponsors have good instincts and experience when it comes to building relationships, so while this distribution requires a different level of commitment, it draws on the same expertise that has served successful institutional managers well. Being able to talk about your investment philosophy and how that fits into an investment allocation is the key message, and that needs to be scaled. Then it comes down to treating the distribution channels as important, valued clients.

Q Why are we starting to see newer evergreen and interval funds blending liquid and illiquid assets within single vehicles?

We are witnessing an evolution of what it means to be an alternative. A lot of private markets funds are not actually alternatives to the typical 60:40 portfolio allocation across stocks and bonds – they are simply private versions of the same type of risk. In other words, private equity is not actually an alternative to public equity – it should instead round out the equity allocation.

True alternatives are not correlated. If you are investing in equity, you should have some, but not all, of your allocation in private equity or private credit. These new products try to offer

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people a one-stop-shop that achieves that, with the added benefit of meeting people where they are.

You can also achieve a bit more liquidity with private equity products by putting them in vehicles alongside public equity, so these products provide an additional layer of flexibility.

Q What convergence trends are you seeing between institutional and retail product design?

The products being built for individual investors increasingly appeal to institutions as well. We are finding a

surprising amount of demand coming from institutions attracted by the ability to achieve permanent allocations outside of a drawdown structure.

The line between institutional and individual investors is blurring, so there are clear convergence trends in product design. Over the next five years, we anticipate a maturation of hybrid and evergreen funds – vehicles that combine public and private exposures in adviser-friendly platforms. Multi-asset interval funds are proliferating, and evergreen funds are adopting institutional mechanics like side pockets, vertical-slice redemptions, fee deferral and heavy reliance on secondaries for early-stage diversification.

Q How should managers balance liquidity promises with inherently long-duration assets?

This comes down to education: people need to understand that these products are not built to be fully liquid. Investors cannot both benefit from an illiquidity premium and also have liquidity on demand. These are semi-liquid, non-traded products, which means there is a fundamental inability to get money back on demand. The product design should meet investors’ needs during life events, not provide daily liquidity.

Over the long term, investors should welcome a structure that reduces the need to sell illiquid assets at fire-sale prices in order to meet liquidity demands. The products, in my view, are well designed to balance the return rewards from illiquid investing with the recognition that human beings need to account for life events. There are times when that design has been called into question because a small percentage of people are displeased, but that doesn’t undermine the basic value of the structure.

As long as managers are clear about the mechanics and never do anything that is not in the best interests of the fund, then these products should continue to work exactly as they are. ■