The Democratization of Private Equity

A Webinar Sponsored by
Private Capital Project at Harvard Business School
and **the Private Capital Research Institute**

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Mass affluent and high-net-worth individuals have investable capital over three times larger than that of pension funds. Yet, only about 5% of the investible capital of these wealthy individuals is allocated to alternative assets. This suggests an opportunity for the growth of the private equity industry broadly defined. However, private equity fundraising from individuals is both time-consuming and costly, driving most PE firms to only raise capital from large institutional investors. In addition, managing private wealth requires liquidity provisions, different valuation and compliance standards, and education. Nevertheless, several creative solutions have emerged by firms, both well-established and new, to address this challenge.

On June 22, 2023, two industry veterans who are at the cutting edge of this global trend, Steffen Pauls (Founder, Chairman and CEO, Moonfare) and Joan Solotar (Global Head of Private Wealth Solutions, Blackstone), met with Victoria Ivashina at the Harvard Business School to discuss this interesting opportunity.

Private equity (PE) space is evolving from a niche investment opportunity accessible only to sophisticated institutional investors to an asset class available to a broad range of investors. This “democratization” of private equity has gained significant attention and momentum in recent years. Much of this activity is being driven by investment demand. High-net-worth retail investors (those with at least $1 million of investable assets) are beginning to challenge the wisdom of the relying exclusively on equity and fixed-income securities in their investment portfolios. The broad market expectation is that these individuals will increase their allocation to alternative investments from 5% to 10% by 2030, representing an additional significant capital for the private equity industry.

Meanwhile, different firms have been experimenting with different offerings geared to retail markets to take advantage of this opportunity. Capital invested by equity strategies in the broader PE space surpassed $500 billion in 2022, marking a substantial increase from $200 billion just five years earlier.[1] Much of this growth has been driven by inflow of capital from individual (as opposed to institutional) investors.

Increasing Demand for Private Investments

In the past, there was little demand for or interest in private equity on the retail side. Only fund of funds provided access to alternative investments for individuals, primarily high-net-worth, and very few retail advisors understood the products. Several factors are leading to an increase in retail demand for alternatives:

- **Search for Yield —** Retail investors are continuing to search for higher yield, despite rising interest rates. PE has historically experienced higher returns compared to public markets.[2] Institutional investors, such as pension funds, endowments, and sovereign wealth funds, have long recognized the benefits of allocating a significant portion of their portfolios to PE. Indeed, the outperformance of the largest endowments has been driven by their PE allocations: colleges with endowments over $ 1 billion had about 33% invested in private equity assets.[3]

- **Shift Away from Traditional Portfolio Allocation —** Traditional portfolio allocation strategies, like the “60/40” rule (60% stocks, 40% bonds), are being challenged as investors get comfortable seeking alternative ways to diversify their portfolios and enhance returns. The traditional reliance on public securities leaves out a big piece of the investing universe, as

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[1] For example, Preqin Global Reports 2023: Private Equity, February 2023. https://www.preqin.com/insights/global-reports/2023-private-equity.
[2] Arthur Korteweg, “Risk Adjustment in Private Equity Returns,” *Annual Review of Financial Economics*, 11, 2019: 131-152.
[3] Dusty Hagedorn, “Private Equity, Venture Capital Outpace Public Equities in 2022 Higher Education Endowments,” Chief Investment Office, Feb. 17, 2023. https://www.ai-cio.com/news/private-equity-venture-capital-outpace-public-equities-in-2022-higher-education-endowments/

90% of companies with $100 million in revenue and under, as well as the bulk of commercial real estate, are privately held. These private assets, if relatively uncorrelated to investors' existing portfolios, offer the opportunity to increase expected returns and, at the same time, reduce overall portfolio risk.

One advantage of private equity investing funds over directly in public equities is the ability of individuals to get access to fund managers' industry insights and more thorough due diligence, thus giving them a competitive edge. For retail investors, investment advisors ideally preselect top-performing private equity funds on behalf of their clients. This information advantage contributes to the potential for generating higher returns.

- **Perceived Lower Volatility —** PE is illiquid, and as such it is not subject to temporary market swings in valuations. Private firms are marked to market infrequently. Public equities are more volatile as they are subject to the whims of individual traders. This often can lead to undesirable portfolio rebalancing due to intermediaries' institutional constraints or behavioral patterns.

- **Technological Advancements —** Technology plays a significant role in making PE asset class more accessible to retail investors. Technological advancements including electronic signatures, digital platforms, and streamlined processes all help reduce administrative burdens and costs or private equity investing.

- **Younger Investors —** Millennials are driving a shift in investment preferences. They are more open to exploring alternative investments, as they recognize the potential for higher returns and reduced risk through diversification. Millennials, who have grown up in a digital age, are also more comfortable with technology and digital platforms. This aligns well with the technological advancements that have made investing in private equity more accessible and convenient. In addition, more and more business schools have classes dedicated to private equity.

Challenges to the Democratization of Private Equity

Several important considerations for the viability and expansion of retail investing in private equity have been raised during the conversation:

- **Regulation —** If PE democratization is to continue, regulatory changes are needed to enable broader participation of retail investors in private markets. Given the risky and complex nature of PE, disclosure and compliance requirements will need to be enhanced to protect investors. While new regulation can significantly help facilitate these changes, it could also increase costs, and, consequently, the management fees. (Traditionally, fees charged by retail private equity investors have been considerably higher than the already elevated costs[4]

[4] For example, see David T. Robinson and Berk A. Sensoy, "Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance," *Review of Financial Studies*, 26, 2013:

incurred by institutions.) It is unclear whether these higher costs will outweigh the higher returns achieved by private equity for retail investors. Additionally, technology enhancements could help keep the costs of regulation lower.

- **Liquidity —** Private investments are not traded daily, so the lack of liquidity will always be a concern. First and foremost, the education of retail investors about the lack of liquidity in private equity is essential. Regulatory changes can help clarify this understanding. Furthermore, as private markets gain more retail investors, the importance of having a vibrant secondary market for private equity increases. While liquidity is a concern, investment advisors must also better match the actual need for liquidity to their clients' investment time horizons.

- **Blockchain and Other New Technologies —** Blockchain technology is a potentially disruptive change, which may accelerate the democratization of private equity. However, regulatory clarity is still needed to fully leverage blockchain technology's benefits. In addition, for blockchain technology to work in investing in private equity, there would need to be more clarity on technical details, such as how to deal with up-front capital calls and the definition of who qualifies as an investor. Generative artificial intelligence (AI) is a nascent technology with the potential to lower costs, improve communication, and enhance decision-making processes within the private equity industry. These technological advancements could help reduce entry barriers, enhance efficiency, and improve investor experiences in private equity investing.

- **Education of Retail Investors —** Education and raising awareness about PE are of utmost importance in the democratization of private equity. Private equity investing is not simply buying stocks. Private equity and other private investments have unique structures and characteristics that are complex and difficult to understand. The entire ecosystem, including general partners, wealth managers, and media, has a crucial role in educating the public about private equity by providing transparency and clear communication about the nature of private equity investments. Education and awareness initiatives, training programs, webinars, and educational resources for financial advisors and investors aim to strengthen their understanding of the private equity asset class, its benefits, and the associated risks.

- **Quality of Fund Manager —** PE, as compared to public market vehicles, is notorious for significant dispersion in performance. Thus, choosing the right investment managers is an important factor in the democratization of private equity. The most experienced asset managers in the PE space can sift through the myriad of investments and present only the top prospects to retail clients. In addition, these groups can screen out investments that have problematic aspects, such as negative environmental and social impacts. By offering reputable and transparent investment products, the industry can build the trust needed to expand into the retail markets.

2760–2797, and Ludovic Phalippou, Christian Rauch, and Marc Umber, "Private equity portfolio company fees," *Journal of Financial Economics*, 129, 2018: 559-585.

- **Private Equity in Retirement Accounts —** There is potential for retirement plans, such as 401(k) offerings in the United States, to allow private equity investments. If individual investors increase their exposure to PE alternatives through their 401(k) plan, their direct demand for this asset class might dampen. However, there are some important considerations. Liquidity is a key factor: for the most part, vehicles that are currently being developed for retail investors, have a liquidity provision mechanism.

Conclusions

Whether the democratization of private equity continues to grow depends on many factors. There is no single magic bullet that will spur the transformation. Retail investors are typically less sophisticated than institutions, so there is a huge responsibility on the private equity industry to educate wealth managers and the retail investors themselves. Ease of purchase will be necessary, but the key factor will be retail investors' trust in their managers, who will need to understand how products work, pricing, liquidity, and how the asset class fits into the overall portfolio of their retail clients.

For private equity fund managers, democratizing private equity is an excellent opportunity to access a new pool of largely untapped capital. Technology will have a considerable role in the success of democratization. For investment advisors, the democratization of private equity expands the available products for clients. Regulators should insist on investor protection and education, without making the barriers to these investments too high. Overall, the significance of democratization in the private equity industry cannot be overstated, as it sets the stage for a more inclusive and vibrant investment landscape.