STATE STREET

# New Opportunities

## Growth of Retail Investment in Private Markets

**May 2023**

## Introduction: An opportunity but not to be taken for granted

In a tough economic and competitive environment, as described in the previous chapters, new distribution channels and sources of capital inflows are clearly desirable to managers, while the shift in most global pension systems from defined benefit to defined contribution structures means demand among asset owners for more quasi-retail private assets vehicles is also growing.

The popularity of Real Estate Investment Trusts and other real asset funds marketed to retail investors shows the demand among individual investors. In our survey, institutions acknowledged the growth of retail demand for private market assets, with more than half of total respondents (55 percent) seeing "strong" interest in the asset classes from individual investors. Not surprisingly, fund selling institutions are most likely to witness this demand and among them, traditional asset managers, i.e., those likely to have retail clients, were more alert to it than private markets specific ones (64 percent and 59 percent respectively). Diversification (63 percent) and yield (59 percent) were what institutional respondents saw as the main drivers of demand from retail investors, while more than half (56 percent) also cited the growth of high profile privately owned companies and publicity surrounding successful initial public offerings (IPOs) as generating awareness of private equity as an attractive asset class.

In terms of the private markets asset classes perceived to be most appropriate for retail investors, real estate, where there has already been some penetration into the retail markets through Real Estate Investment Trusts (REITs) and open ended retail property funds, was the first choice of respondents (60 percent), followed by private equity (46 percent).

However, there are a number of obstacles to this growth, and its rate of increase cannot be taken for granted or expected to mitigate the structural problems in private markets investment operations outlined above that need to be addressed by better data and systems. This was clear from our research, where was a strong consensus that the current market and product conditions are not right to make mainstream retail access to private markets happen in the near term.

Only 29 percent of respondents felt that private markets would function similarly to public ones in terms of accessibility and liquidity within the next 10 years. Nearly three quarters of respondents (72 percent) said private markets need to become more transparent for this to take place, while two thirds (66 percent) said new products are needed.

**72%**

**of respondents said private markets need to become more transparent for this to take place, while 66 percent said new products are needed.**

**To what extent do you agree with the following statements on the democratization of private markets (% agreeing)?**

| | Global Asset Manager | Traditional Asset Manager | Private Markets Asset Manager | Asset Owner | Insurance |
|---|---|---|---|---|---|
| There needs to be more transparency in private markets to make them suitable for retail investors | 72% | 77% | 58% | 73% | 80% |
| There is currently a lack of suitable investment products and platforms for retail investors who want to invest in private markets | 66% | 69% | 60% | 74% | 62% |
| There is strong demand from retail/DC investors for increased access to private markets assets | 55% | 64% | 59% | 53% | 43% |
| Complexity/lack of transparency makes private markets unsuitable for retail investors and DC pension fund members | 55% | 53% | 54% | 52% | 60% |

## Government support is growing for retail private markets

The private markets institutional participants are not alone in recognizing the current barriers to entry for retail investors. Governments and regulators in several jurisdictions have launched initiatives aimed at dealing with these transparency and liquidity issues.
In the European Union, the European Long Term Investment Fund (ELTIF) and the similar UK Long Term Asset Fund (LTAF) are government lead attempts to enable vehicles that can hold illiquid assets and be invested in by retail investors and defined contribution pension fund members, with a view to generating investment in domestic infrastructure and real estate projects. In the United States, the Securities and Exchange Commission (SEC) issued a consultation in 2019, on making private markets more accessible.

## ELTIFs & LTAFs Explainer

ELTIFs were originally launched in 2015 as a means of directing cross-border European capital into certain long term useful investment projects such as infrastructure. In its initial announcement of the rules governing the funds, the European Commission (EC) defined appropriate assets for ELTIFs as:

"Unlisted companies needing long-term capital, such as infrastructure, notably in network industries such as transport and energy, but also social infrastructure (hospitals, schools and social housing). ELTIFs can also invest in certain listed small and medium sized enterprises (SMEs), real assets that need long-term capital to develop them, intellectual property and other intangible assets, as well as European Venture Capital Funds (EuVECA), and European Social Entrepreneurship Funds (EuSEF)[1]."

ELTIFs were initially required to have at least 70 percent of their assets invested as above.

Last year[2], the EC published a review updating rules for ELTIFs in a bid to increase uptake of the products. The 70 percent minimum asset level was reduced to 55 percent and the definition of acceptable assets was simplified to widen the pool of available real estate, infrastructure and private equity holdings available to ELTIFs.

The LTAF is a new authorized open ended fund structure structured to accommodate long term and illiquid assets. The fund will be regulated by the UK's Financial Conduct Authority (FCA). The LTAF can take various legal forms – Open Ended Investment Company (OEIC), Authorised Unit Trust (AUT) or Authorised Contractual Scheme (ACS). Firms who are authorized as a full scope UK Alternative Investment Fund Managers (AIFM) with permissions to manage an authorized AIF are allowed to manage an LTAF[3].

The creation of the LTAF forms part of a strategy of the UK Government and Bank of England to capture greater investment from DC pensions schemes into long term assets. The intention of the government is unlock hundreds of billions pounds held in UK institutional investors accounts and to drive the UK's recovery. There is a plan to change the UK pensions charge cap (currently 0.75 percent) on the default arrangement of certain employer pension schemes, which should encourage trustees of DC pension schemes to consider investing in long-term assets.

The design of the LTAF has been made to allow investment flows towards assets such as infrastructure, private equity and real estate from investors that have historically been hesitant to invest in long-term assets, despite such assets being in line with their investment horizons.

As these products and initiatives are relatively new, they do not seem to be high in the consciousness of either institutional or retail investors. When asked to what extent things like ELTIFs and LTAFs are drivers of retail demand for private markets, only 17 percent of respondents thought it was a factor, by far the smallest selection from the available options (by contrast the next lowest potential driver on the list was access to green infrastructure with 41 percent). Furthermore, when asked, "What do you see as the most suitable ways to invest in private markets for new entrants such as retail investors?" 30 percent said dedicated retail private market products such as ELTIFs/ LTAFs or others relevant to their markets. But this was below said mutual funds (48 percent), funds of funds (43 percent), investment trusts (33 percent) and ETFs (31 percent). The new structures did, however, gain preference over DC funds, which were seen as suitable by only 22 percent of respondents.

So far, uptake of these funds has been limited. For example, the assets under management of ELTIFs has been estimated by various sources, as between €2.4 billion and €7.5 billion, according to the European Fund and Asset Management Association (EFAMA)[4]. This data refers to 2021, and regulator the European Securities and Markets Association (ESMA) has recorded the registration of 84 ELTIFs since then[5], so it is plausible recognition of the vehicle will grow in the minds of investors, both institutional and retail, when thinking about private markets. However, given the current size of the market, the challenges of perception in our survey outlined above remain a factor.

## Private equity bubble risk threatens retail growth

Another challenge to the growth of retail investment in private equity in particular is bubble risk. When asked about what they see as growing risks to private market investment, a significant minority of institutions (32 percent overall but, interestingly, also 32 percent of private equity managers specifically) feared this growth in retail interest in high profile private equity was indicative of a bubble in the asset class, in which increasingly unprofitable companies were being taken to IPO, transferring risk from the initial private investors into the public markets. There is evidence that unprofitable IPOs are growing more common. In 2020, only 22 percent of companies were profitable after their IPO[6].

Meanwhile, 81 percent of 2000 IPOs were of unprofitable companies (immediately prior to the .com bubble), dropping to an average of 50 percent over the next 17 years but rising to 81 percent again in 2018 (and incrementally increasing through the 70 percent from the mid-2010s)[7].

Signs of irrational exuberance have been noted in investor decision making in private equity and post IPO, especially in high profile tech stocks: "Many unprofitable companies with no earnings on which to base a multiple still have high valuations because investors are simply willing to pay at that price[8]." This has potential knock on effects for public markets, as evidence also suggests medium term (three year) returns on unprofitable IPO companies are lower than profitable ones[9].

**Paul Fleming**

Global Head of Alternatives Segment, State Street

## Asset Management Perspectives On Private Markets

### Allocation

Typically, three factors are driving interest in private markets: returns, income and diversification. There is greater acceptance of the liquidity challenges in private markets, and some products are becoming more transparent. Markets are now showing a greater willingness to pay additional fees to get better returns. This is opening doors for retail investors; private markets are not just for the uber-rich.

Generally, we have seen outflows from the mutual fund industry with new allocations to private markets. Private equity is the hottest asset in private markets right now, and much of the demand is driven by the potential returns on offer. Private equity has outperformed public markets by a sizable margin in recent years. Although there have been years also where performance has been considerably lower and there has been volatility, by and large, private equity has outperformed.

There is also growing demand for infrastructure in investments, but real estate and private credit might be less popular because of higher interest rates.

### Operations

Liquidity has become a key consideration for investors. When the COVID-19 pandemic began in Europe, many real estate funds started to gate redemption requests because they could not easily sell holdings quickly enough. That is something tokenization may be able to help with.

There has been a move towards less liquid strategies in recent years, and the industry is moving towards structures and products that can accommodate those, such as interval funds, but there are operational challenges that the industry needs to address.

Demand has outpaced the ecosystem's ability to handle efficient data flows, but some tasks still involve operational inefficiencies and manual processing. Those have already been highlighted and will get fixed, but they are not there just yet.

There is a life cycle for many products and asset classes where, as demand increases, the noise and friction need to be worked out because of the demand for more efficiencies and the obvious risk of something going wrong and the expense associated with that.

**Democratization**

Retail investors are seeking returns and diversification. There is a lot of cash on the sidelines. If public markets dip a bit, it will put even more pressure on asset managers to find decent returns.

Technology has also helped significantly. Private markets investors used to be very large, but you are seeing improvements in technology that allow for smaller accounts and allow dollars to flow in and out of the private markets with greater frequency. Investors' cash is no longer locked up for extended amounts of time like it used to be.

Regulations will increase because of the Sophisticated Investor rule for private markets. An average retail investor is not a sophisticated investor in the eyes of the SEC. So, as you start going downstream, the products will have to become more regulated. And suddenly, they will start looking a lot more like a '40 Act fund requiring a certain level of rigor and scrutiny from regulators.

## Is blockchain the answer to retail private markets?

One mechanism that has the potential to dramatically alter the liquidity and accessibility of private markets is the fractionalization of real assets in particular into tokenized securities to be held and traded digitally, using the smart contract and blockchain/distributed ledger technology that currently enables the market for crypto currencies and other digital assets.

Most institutions anticipated this becoming a mainstream part of the investment landscape eventually, but were divided on the likely timescale. A fifth (20 percent) expected this in under two years, while a further 38 percent of respondents said it would take an unspecified longer time than that, with the remaining 38 percent saying it was unlikely in the next decade. Most institution types thought real estate was the private markets asset class most suited to digital fractionalization (and this has been a common use case in digital finance for some years now[10]), with only private markets specialist managers disagreeing. More than half of them (53 percent, compared to 39 percent of the total) chose private equity and private debt (43 percent, compared to 35 percent).

**One potential method for making private markets more suitable for retail investors is to create liquid digital tokens out of private assets ('Tokenization'), or fractional shares of large illiquid private market assets, using the blockchain/distributed ledger technology that underpins crypto currencies ('Fractionalization'). To what extent do you see this becoming mainstream over the course of the next two-three years?**

| | Global Asset Managers | Traditional Asset Managers | Private Markets Asset Managers | Asset Owners | Insurance |
|---|---|---|---|---|---|
| Likely (Likely + Very likely) | 38% | 38% | 25% | 46% | 44% |
| Unlikely in the next 2-3 years but likely in the longer term | 38% | 37% | 46% | 38% | 33% |
| Unlikely (Very unlikely + unlikely) | 20% | 23% | 26% | 12% | 21% |

But there is other evidence that institutions see private markets as the primary beneficiaries of digital tokenization. In a separate State Street survey of digital asset and finance preparedness[11], a similar respondent base to that of the private markets survey were asked the same question but with response options widened to other non-private market asset classes. Even with these additional options they chose private equity (51 percent) and physical assets (48 percent) and private credit (44 percent) as their top three, with public market fixed income (33 percent) the nearest asset class to the private markets ones.

In our study, the opportunity for retail investors to get access to these asset classes was one of the top potential benefits of digital finance, cited by more than half of respondents (54 percent), with only increased speed, liquidity and lower cost of trading getting chosen by more (59 percent). Interestingly, asset owners made retail access their top potential benefit of the technology (62 percent).

Digital investment technology was also seen as posing certain risks to institutions and their clients or members. Principally, cyber security and new regulation specific to the technology that would increase their costs with compliance obligations (both 55 percent). However, asset owners and insurers were also significantly more likely than managers to express concern about distortions to the long-term nature of private market assets, if they could be traded as simply and cheaply as public ones. More than half of each felt the trend could lead to pressure on privately owned firms to adjust their business strategies, or for infrastructure projects to be designed with quicker returns in mind, potentially reducing the appeal of socially or environmentally useful ventures.

# Endnotes


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State Street Corporation
One Lincoln Street, Boston, MA 02111
**www.statestreet.com**

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