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OPINION

The perils of democratising private markets

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Markets Insight

Retail investors face outsized risks without safeguards from regulators

At a time of lofty stock market valuations and low interest rates, investors are seeking — and increasingly finding — ways to gain greater exposure to so-called "alternative" investments, private equity in particular.

This democratisation of private markets has merits. After all, why should professional investors have monopoly rights to what has been a strongly performing and diversifying asset class?

The question is not "if" this process should happen, but "how": to what extent and with what safeguards in place? And whether regulators have adequately considered the risks involved, especially given the unique characteristics of the current investment cycle which has been marked by extraordinary central bank support for markets?

There are a number of initiatives under way, led both by investors and regulators,with the objective of making private markets more accessible.

Some retail investors are seeking exposure simply by buying shares in publicly traded private equity firms. Others are using private equity investment trusts to participate in the market. Then there are technology platforms, some of which allow individuals to invest as little as €50,000 directly into private equity feeder funds.

The motivations of retail investors are understandable. Traditional equity opportunities are being squeezed. Public companies have been delisting, while high-growth companies are staying private for longer.

This is reflected in terms of the growth of the industry and the returns it has generated. Despite an initial "Covid correction" last year, the private equity industry broke a 40-year record in the first six months of 2021, striking 6,298 deals worth $500bn, according to figures from Refinitiv.

Regulators have also been working behind the scenes. Their reasons are different and follow the recent trend of deregulation. This has allowed retail investors direct access to the world of finance, from trading securities on the Robinhood app to cryptocurrencies on fintech Revolut.

In Europe, policymakers created European Long-Term Investment Funds — and are currently reviewing this regime — with the objective of allowing savers in defined contribution pension funds and non-professional investors more direct access to deals that require long-term capital. Meanwhile, regulators in the UK are working on a similar regime to allow pension fund savers and non-professional investors access to alternative asset classes.

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Across the Atlantic, regulatory changes have made it possible for so-called mom-and-pop investors to gain access to private equity via their defined contribution pension plans, the 401(k).

The result is a fresh and growing flow of capital into private markets. Much of this is coming from investors who, until very recently, had found private equity largely out of reach. On a theoretical level, none of this sounds especially problematic. However, it is not happening in a vacuum but in the current environment of excessive liquidity fuelled by central banks.

This late in the business cycle, public demand for private equity feels distinctly TINA (There Is No Alternative), the Wall Street acronym that describes the inexplicable popularity of assets that are already expensive.

Valuations in buyout deals are already at historically high levels. Opening this asset class further to retail investors will merely add more funds to already sizeable capital pools searching for investable assets. In the future, receding liquidity in markets and higher interest rates are also likely to have a drastic impact on products like private equity funds backed by high debt levels.

In addition, apart from the longer-term commitment required for such products, there are technical aspects of private equity that many new investors may be unfamiliar with. Given private equity firms tend to "front-load" costs at the start of an investment in a company, retail investors will need to consider how funds might perform over a cycle.

For those with few savings and a need for liquidity, investing in this asset class is simply ill-advised. Unsophisticated investors also require a clear understanding of the fees in private equity, which are not always transparent.

It is inevitable that the democratisation pressure will only continue. If dealt with correctly, this can be positive. It allows investors to diversify their portfolios and — potentially — generate better returns. However, the next cyclical downturn could have an outsized impact on investors who are not as well equipped to deal with it. With little prior knowledge, private equity investment by retail investors with little or no advice is unlikely to lead to success.

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