THE RETAILIZATION OF PRIVATE MARKETS IN ALTERNATIVES

A Historic Shift in DC Plan and Retail Asset Allocation is Accelerating

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WHY ALTERNATIVES?

Diversification is at the heart of modern portfolio theory: portfolios that include uncorrelated returns can be more resilient and outperform undiversified portfolios over time.[1] Alternative investments, which potentially offer a variety of different return profiles, many of which are markedly different to listed securities, can help investors to achieve this goal and therefore may boost their investment or retirement returns.[2]

The benefits are not just theoretical. While private market investments, such as private equity and debt and real estate, have come under pressure as the interest rate environment has changed and public markets have declined, these alternative assets have had notable long-term performance. Based on market data, private equity investments outperformed public equities by more than nine percentage points on average for the five years ended March 2023.[3] Private debt outperformed high yield debt by more than five percentage points for the same period. Moreover, challenging conditions could prove advantageous for future returns.

The outperformance of alternative assets has the potential to deliver significant benefits for retirees. A study by WTW with Georgetown University showed that the addition of alternatives can increase annual retirement income by as much as 17%.[4] At a time of soaring energy costs and high inflation, that 17% difference between a portfolio solely focused on publicly-listed securities and one that incorporates alternative assets could help shield pensioners from further forthcoming shocks and cost of living increases. Moreover, by reducing overall portfolio volatility and enhancing yield stability, private assets could have much to offer at a time of public market turbulence and lower return expectations for traditional asset classes.

Financial advisors are unequivocal that change is required given today's investment climate. According to a recent survey conducted by CAIS, which offers an alternative investment platform for independent financial advisors, more than a third believe that the traditional 60/40 mix of stocks and bonds is no longer effective for investing, while a further 42% assert that it is not as effective as it used to be.[5] The same survey stated that more than eight in 10 financial professionals believe that all retail investors should have access to alternative investments.[6]

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THE DEMOCRATIZATION IMPERATIVE

Historically, access to alternative assets has been the preserve of institutional investors such as defined benefit (DB) pension plans, sovereign wealth funds, governments and not-for-profit endowments and foundations. In addition, ultra-high-net-worth individuals have also been able to access these assets, with 81% currently invested in the asset class, according to global consulting firm EY.[7]

Retail investors – as well as defined contribution (DC) plans – have enjoyed few if any opportunities to access such assets. It is estimated that private equity penetration by North American individual private investors accounts for 10.7% of all funds raised from local private equity funds, with the balance coming from institutional investors. This is a significantly more than APAC with 8.8% and Europe with 7.4%.[8]

Instead, most retail investors have focused on more traditional investments, such as mutual funds and collective investment trusts (CITs) composed of the stocks and bonds of public companies. The inability of many retail investors to access private markets is particularly striking given the continued rapid growth of this segment. Research by Cerulli Associates shows that retail and institutional professionally-managed assets in the United States both now stand at around $34 trillion each.[9] However, retail client channel assets recorded 17.5% growth during 2021, and are expected to soon surpass institutional assets.[10]

Alternatives have been hard to access for retail investors and for many DC plans seemingly because appropriate investment paths for alternatives have been limited in number or simply been unavailable. In certain jurisdictions, regulators are focused on retail access with concerns about alternative assets' complexity and potential risks (principally relating to lack of liquidity).[11] Relatively high fees (compared to funds comprised of listed securities) and high minimum investment amounts can act as barriers. Another hurdle has been the capabilities of DC plans to amend existing practices because of longstanding expectations regarding asset liquidity and concerns over risk and pricing.

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WHAT WILL DRIVE RETAILIZATION?

In recent years, the appeal of alternatives' past stronger returns have become sufficiently compelling to spur efforts by private markets to democratize alternative assets by broadening access to them – so-called retailization. There are a number of drivers of this change.

1 Demographics Drive Change

Demographics are playing an important part. Pensioners and other retail investors are seemingly seeking to secure strong long-term returns so that they can support themselves as life expectancy increases. Some countries may also be motivated to reduce the potential burden on the state. Democratizing access to savings vehicles also seemingly aligns with many governments' social objectives as part of their environmental, social and governance (ESG) strategy.

In response, many countries are creating new access routes that could benefit savers by increasing future retirement income. They have begun to loosen existing investment frameworks and guidelines or sought to create new alternative asset product structures to make alternative assets more accessible to retail and individual investors.

2 Industry Economics

Many alternative asset managers are evolving their offerings so that non-accredited individuals can invest in private markets so that they can better diversify their portfolios. While costs remain high, and a potential barrier to greater retail participation, changes such as tokenization may drive further product innovation and potentially lower costs for retail investors.

Of course, there is self-interest in private market managers willingness to open the market to retail investors. A recent survey by BNY Mellon of traditional and alternative asset managers revealed that, over the next one to two years, 74.5% expect to increase their firm's offerings of private equity, and 43% expect to increase their firm's offerings of private credit.[12]

Alternative asset managers are keenly aware that the DB plans that have been a mainstay of investment in recent decades are in long-term decline.[13] Consequently, many leading alternative investment managers are looking to attract new sources of investment, including from retail investors and DC plans, which are now the predominant pension plan type in most countries. Many have already announced major efforts to target these retail or retail like markets with these new products.

- Ares launched Ares Wealth Management Solutions (AWMS) in 2021 with a mission to expand individual investors' access to Ares' private markets platform. This group is focused on bringing innovative solutions to the wealth channel. AWMS believes in the power of education for unlocking growth and in 2022, launched its Financial Advisor Solutions Team exclusively dedicated to helping advisors incorporate private market strategies into portfolios.[14]

- Blackstone, the world's largest private equity firm, announced in 2021 plans to "virtually double" its workforce focused on the so-called mass wealthy market[15] and has since increased headcount in both Europe[16] and Asia.[17]

- KKR & Co. recently suggested a "Private Wealth Style" portfolio could include up to a 30% allocation to Alternatives.[18]

- Partners Group was one of the earliest movers in the space and began offering private markets solutions to individual investors in 2001.[19] In 2011 they officially launched their private wealth business, which has grown into a $233 billion business with offices in all major dealmaking hubs.[20]

- Other leading firms, including CVC EQT and Pantheon, are also increasing their focus and launching products targeting this market. The Apollo Aligned Alternatives vehicle aims to eliminate the friction points that have stopped high-net-worth investors from accessing alternatives, according to its CEO, Marc Rowan, who believes its private wealth product could become its largest fund.[21]

Despite the commitments by leading alternative investment managers, the uncertain economic backdrop, higher interest rates and weaker public markets have created headwinds for private markets as assets of all types are being repriced due to valuation and liquidity. However, following its record highs, fundraising for alternative assets products slowed significantly in the second half of 2022 and have continued their downward trend through 2023.[22] Despite the decline, private market managers' focus on retail investors is expected to continue to grow over the long term.[23]

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3 Evolving Retail and DC Plan Attitudes

Retailization is something of a chicken and egg situation – investors cannot demonstrate their interest in alternatives without suitable vehicles. But the outlook appears positive. Fundraising for non-traded alternative investments (including BDCs, Interval Funds, non-traded REITs, etc.) totaled $57.8 billion year to date as of October 2023, according to Robert A. Stanger and Co.[24]

Nevertheless, more education – about the merits of including alternative assets in a diversified saving or retirement plan – is required. Research consistently shows that people will save more for their future needs if they are given proper incentives, services and guidance.[25]

At the same time, DC plans could broaden their outlook to reflect the challenges of the future and shifts in the balance of assets between the public and private markets. Many DC plans have historically been hesitant to innovate and include alternative assets. As employers seek to attract and retain talent in a tight labor market, many are reassessing their benefits packages,[26] which can include their DC plans. There could therefore be greater willingness to innovate DC plans and focus on participant outcomes, by allowing DC participants to access a return profile similar to DB plans through the inclusion of alternatives.

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A CLEAR DIRECTION OF TRAVEL

Efforts to broaden retail access to alternative assets have two principal components: the creation (or expansion) of funds focused on private markets that are available to retail investors and DC plans; and (where necessary) amendments to plan rules, regulations or practices that hamper DC plan investment in alternatives. While the pace and nature of change varies around the world, major geographies are moving in the same broad direction.

The U.S.

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In the U.S., alternative assets are accessible through a number of vehicles, including net asset value real estate investment trusts (NAV REITS), corporate entities, non-traded business development companies (BDCs), interval funds (which must be purchased directly from the investment company that manages the fund) and Delaware statutory trusts (which typically require a minimum investment of $100,000).[27]

Of these, NAV REITS could provide potential opportunities for retail investors given their characteristics. In 2021 and 2022, NAV REITs raised $34.4B and $33.2B, respectively. Through Q3 of 2023 the total was down to $8.9B. During 2023 NAV REITs experienced market challenges driven by high interest rates and uncertain property valuations that triggered a run of redemption requests and slowed the flow of capital into the product.[28]

Starting in 2015, Blackstone's BREIT revolutionized the NAV REIT space with enhanced transparency, lower fees and incentives aligned with investors, while bringing high-quality institutional real estate to individuals.[29] Despite some recent challenges for the product, the market continues to see new entrants, with some offering more niche products such as triple net leases (NNN), renewable infrastructure, ESG, and Real Estate Debt.

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In December 2019, the Setting Every Community Up for Retirement Enhancement (SECURE) Act was signed into law and the SECURE Act 2.0 was passed in 2022, expanding on the original. According to Georgetown University's Center for Retirement Initiatives, while the Acts encourage lifetime savings solutions and allows the creation of groups of small businesses that can offer 401(k)s together,[30] it does not explicitly enable people to invest part of their 401(k) portfolio in alternative assets. Nevertheless, given its intent, they are seen as potentially supportive of this goal in the medium term.

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In June 2020, the Department of Labor (DoL) issued an Information Letter in response to a request from Partners Group and Pantheon about the role of alternative assets in DC plans. The Information Letter clarifies that under federal law, DC pension plan fiduciaries can incorporate certain private equity strategies into diversified investment options, such as target-date funds.[31] The DoL guidance helps address an important hurdle for DC plan managers, who have to-date been reluctant to meaningfully incorporate private markets exposure into DC plans, including 401(k)s, for fear of non-compliance with their fiduciary duty under federal law. By contrast, DB plans included in a 2019 survey of the 200 largest U.S. retirement plans had invested an average of 8.7% of their assets in private equity.[32]

While highlighting the potential complexities of such a strategy, the letter was interpreted by many in the industry as being broadly supportive of efforts to broaden the assets that comprise DC plans. In a report, the Defined Contribution Institutional Investment Association (DCIIA) said the move "creates an opportunity for DC fiduciaries to provide their plan participants with access and diversification."[33] It should be noted that in December 2021, the DoL issued a Supplemental Statement that states that the Information Letter "did not endorse or recommend" private equity investments and cautions that plan fiduciaries should not expose plan participants and beneficiaries to unwarranted risks by assuming that private equity is generally appropriate for a typical 401(k) plan."[34]

European Union (EU)

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A number of managers are assumed by industry observers to be in the process of creating société d'investissement à capital variable (SICAV) Part II funds in the EU. SICAV Part II funds are allowed to invest in all types of assets and qualify as an alternative investment fund (AIF); they can be sold to all types of investors.[35] SICAV Part II is a long-standing regime with a broad range of potential uses for saving and retirement planning. However, more recently there has been a realization that the structure is a suitable vehicle for retailization of alternative assets.

Examples of SICAV products launched in 2023 include KKR & Co.'s Private Markets Equity Fund SICAV SA, or K-PRIME, which targets European and Asian investors and is designed as a single point of entry to KKR's private equity platform;[36] Apollo's Private Markets SICAV, a Luxembourg-based product platform designed to offer full suite of alternative investment solutions across asset classes including credit, equity and real assets to investors in EMEA, Asia and Latin America;[37] and EQT Nexus, ETQ's first strategy for individual investors which enables them access to the same range of investments that EQT's institutional clients benefit from.[38] CVC has also recently established a European private credit focused SICAV, approved by the CSSF in January 2024.[39] In geographies where there is a move to a DC market, such as the Netherlands, industry participants believe that alternative assets could play an increasing role.

02

Other managers are reexamining the opportunities presented by the ELTIF structure, a collective investment framework that allows investors to put money into companies and projects that need long-term capital. One potential benefit of the ELTIF structure in contrast to SICAV Part II is that it is explicitly designed for broader retail distribution in line with the Markets in Financial Instruments Directive (MiFID) II client categorization rules; SICAV Part II funds may be more applicable for a broad high-net-worth client base.

ELTIFs were created in 2015 but have taken time to attract interest. By October 2021, only 57 ELTIFs were authorized (across Italy, France, Spain and Luxembourg) and a European Commission Impact Assessment described the market as sub-scale.[40] However, there is renewed interest in the structure and funds are now being created with sizes of €300-€500 million. ELTIFs could be further boosted by reforms now underway.

In November 2021, the European Commission proposed a number of amendments to existing regulations to broaden the range of eligible assets and increase flexibility in relation to portfolio composition, distribution and authorization. According to Irish business law firm, Mason Hayes & Curran, the European Long-Term Investment Fund regulation (ELTIF 2.0) also removes barriers to retail investor access, and establishes an optional liquidity window mechanism for redemptions, allowing investors to exit early.[41]

In December 2022, the European Council and the European Parliament reached agreement on ELTIF 2.0, amending the existing ELTIF regulation. It was published in the Official Journal of the European Union on March 20, 2023. On December 19, 2023, the European Securities and Markets Authority (ESMA), published its final Regulatory Technical Standards (RTS) under the revised regulation, in advance of ELTIF 2.0 coming into force on January 10, 2024.[42]

The United Kingdom (UK)

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Alternative asset managers active in the UK are focused on the Long-Term Asset Fund (LTAF), a new category of authorized open-ended fund specifically designed to enable retail investors to access nontraditional investments in a search for diversification or higher returns. LTAFs, which were announced in November 2020, can be used for a wide range of investment purposes, not just retirement planning.[43]

Many asset managers are exploring LTAF launches, with several already authorized by the FCA including BlackRock's Diversified Alternative Strategies LTAF, Aviva Investors' Real Estate Active LTAF, Schroder Capital Climate+ LTAF, and Schroders Greencoat LTAF.

In June 2023, the Financial Conduct Authority (FCA) officially published a policy statement announcing that a unit in an LTAF will no longer be categorized as a Non-Mass Market Investment (NMMI) but will, instead become a Restricted Mass Market Investment (RMMI). This broadens LTAF access to retail investors and more defined contribution pension schemes.[44]

CONSIDERATIONS FOR ALTERNATIVE ASSET MANAGERS

The new fund structures required to reach retail investors and DC plans create new challenges and additional costs for alternative asset managers. These include:

New and potentially complex regulatory reporting requirements given distribution to retail investors.

Amendments to existing operational arrangements to accommodate new types of investors, including benchmarking and participant communications, as well as enhanced reporting requirements.

The need to accommodate trading activity on a regular basis (in contrast to a typical private market fund where investors only receive a return when the underlying investment is sold).

There is a need for more frequent valuation in order to provide pricing for periodic subscriptions and/or redemptions; many private funds are moving to quarterly or even monthly valuations. This more rigorous approach to the valuation process and greater frequency of valuation will significantly increase workload for asset managers.

However, they do not need to manage these additional requirements alone: many may choose to outsource some tasks to custodians or other third parties.

TACKLING THE LIQUIDITY CHALLENGE

Historically, retail-focused funds and those aimed at DC plans have prioritized daily liquidity. Traditional alternative asset funds have a lifespan aligned with a specific investment, and few if any opportunities to exit prior to maturity: it is these characteristics that have helped to put them off-limits for retail investors and DC plans.

As part of the democratization of alternative assets, retail investors in DC plans must accept that daily liquidity in illiquid asset classes is neither achievable nor desirable – illiquidity is one of the reasons why alternative assets have historically outperformed publicly-listed assets.[45] However, the alternative asset community also has to accept some compromises in order to better accommodate the needs of retail investors and DC plans, which necessarily differ from institutional investors.

Different investment vehicles in various jurisdictions offer different solutions that seek to avoid the risk of an alternative asset manager being unable to meet redemption requests, which would damage their reputation, while also providing some of the flexibility that retail investors are accustomed to:

- Non-traded BDCs offer monthly or quarterly liquidity (as in the case of Blackstone Private Credit Fund), although this is not guaranteed.[46]
- Many non-traded REITs have liquidity provisions, which allow clients to request liquidity after they have owned shares for a certain period of time. However, REITs can terminate this provision during real estate downturns, so that they are not forced to sell properties at the wrong time to fund redemptions.[47]
- Funds may impose limits on redemptions. The imperative to avoid harming remaining investors must be balanced against the need to maintain the credibility of a fund and access to liquidity. Many funds have a limit on redemptions based on the quarterly net asset value (NAV) of the fund, with some funds limiting redemptions to 5% of NAV. In January 2023, several managers had to limit withdrawals from their non-traded REITs when requests from investors exceeded their caps.[48]

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- A similar redemption structure is deployed for ELTIFs, with redemptions limited to a percentage of the ELTIF's assets in line with the strategy set by the manager.[49] Proposed reforms to ELTIF would enshrine the options of an optional liquidity window mechanism for redemptions.[50]

- The long-term nature of alternative investment strategies is often reflected in initial lock-up periods. For instance, SICAV Part II funds impose twelve-month lock-ups (with a penalty for redemption during this period).

Of course, facilitating redemptions could have consequences for performance as part of the portfolio must be held in cash or cash equivalents; these assets will necessarily yield less than the private assets in the main portfolio. Typically, funds being developed currently have the ability to maintain 10%-15% of the fund in liquid assets to manage redemptions, and thus the overall fund framework will have both liquid and illiquid assets that need to be accounted for and managed effectively. More generally, constructing and managing such a fund is complex and may increase costs compared to a regular alternative asset fund.

However, open-ended alternatives funds may have some advantages over traditional private asset funds. In a traditional closed-end alternative asset fund (which might have a term of upwards of over 10 years), it may take up to five years for a fund to be fully deployed: cash in the fund may only be put to work for as little as 70% of the term[51] and during the rest of the term investors may hold unfunded commitments in low yielding cash equivalents; in an open-ended fund, investment may be faster and therefore cash will be put to work for a longer period. Moreover, the likely greater scale of open-ended funds should create greater opportunities for diversification and potential enhancement of returns as a result.

One common concern about opening up alternative asset funds to retail investors is that the lag in publishing NAVs means that it can be difficult to assess the true value of funds. However, in the aftermath of recent volatile markets, the sizeable discount currently applied to many private equity funds listed on the London Stock Exchange indicates that the market may be capable of accurately pricing this risk.

REFRAMING THE FOCUS ON FEES

The higher fees associated with private markets – which often include a sizeable performance component – have long been seen as a barrier to retail investor and DC plan participation. DB plans have enjoyed significant latitude when it comes to assessing the merits of paying higher fees for potentially higher returning asset classes. Indeed, they have often embraced alternative assets and now either coinvest or have created their own teams.

In contrast, DC schemes can have a cap on the total expense ratio (TER), as in the UK.[52] Some market observers believe that DC trustees' traditional prioritization of the TER restricts DC plans' ability to invest more widely, potentially hampering returns.[53]

Alternative fund managers need to be flexible and demonstrate an understanding of the needs of investors. Many are now working with DC plan trustees to help them consider the return opportunities that may result from broadening their focus to consider long-term returns (net of fees) or are focused on education efforts relating to the characteristics and benefits of private markets. While trustees must keep costs within strict guidelines – in the UK, for example, there is a cap of 75 basis points – this target must be achieved on an aggregate basis, rather than at a fund level. Consequently, DC plans have considerable leeway to invest in higher returning assets with potentially higher costs. Even further, larger open-ended alternative asset funds are likely to be less costly than traditional closed-ended limited partnership style private market funds.

Nevertheless, it will be necessary for some DC schemes to evolve their culture in response to the new world of alternative assets, not just in relation to fees but also with regard to liquidity. Some DC plans' Benefits Committees should consider deepening their expertise and capacity to evaluate and monitor alternative investments in the DC plan. One solution could be to engage an independent third-party consultant, oversight or outsourcing solutions, according to the DCIIA. A consultant could advise plan fiduciaries and make recommendations with decision-making control remaining with plan fiduciaries. Alternatively, a consultant could assume fiduciary responsibility and full discretionary control over evaluation, selection, and monitoring of alternatives.[54]

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WORKING WITH THE RIGHT PARTNER

The retailization of alternatives is already underway and accelerating. Greater democratization of private equity, debt and other private markets offers compelling opportunities for retail investors and DC plans. Change will take time and requires managers, investors and service providers to listen to other parties and find ways to accommodate their requirements and overcome barriers.

The alternative asset ecosystem needs to work for all parties if it is to continue to grow and deliver benefits to a wider universe of investors. BNY Mellon, as a full-service organization, is committed to supporting this ecosystem, deploying its capabilities to help its clients globally.

For more information and to discuss how the issues raised in this paper impact you, please contact your BNY Mellon representative.

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