INVESTMENT MANAGER SERVICES

Evolving distribution models in alternative investments.

New markets. Different investors. Game-changing platforms.

For Institutional Investor Use Only. Not for Retail Distribution.

The retailisation of alts means the industry may soon look quite different.

You can't always get what you want.

After years of enviable growth, private equity and private credit investments faced a new reality in 2022. Rising interest rates, the unfamiliar spectre of inflation, and geopolitical uncertainty took the air out of the industry's post-pandemic exuberance.

Even before this slowdown, many general partners (GPs) were eyeing the retail market as a particularly attractive source of funding. Individual investors, after all, account for approximately half of all assets, but only the wealthiest have meaningful exposure to alternative asset classes. Frustrated with the lack of diversification and returns in public markets, retail investors and their advisers longed for access to private markets. Demand only intensified amid sagging public markets, especially with publicly traded firms accounting for a shrinking slice of the overall market. According to Capital IQ, 87% of U.S. companies with USD$100+ million of revenue are privately owned.[1]

Conversely, many institutional investors are bumping up against target allocations to alternative investments. In addition to investing aggressively in private markets, institutional allocations grew passively as public market investments declined in value. According to Preqin, almost half of endowments and public pension plans were over-allocated to private equity by 2022.[2]

The mutual attraction is undeniable. Strong flows to alternative mutual funds and ETFs underscore the strength of the trend. While flows to equity funds languished, organic growth among alternative funds surged by almost 100% over the past three years (Figure 1).

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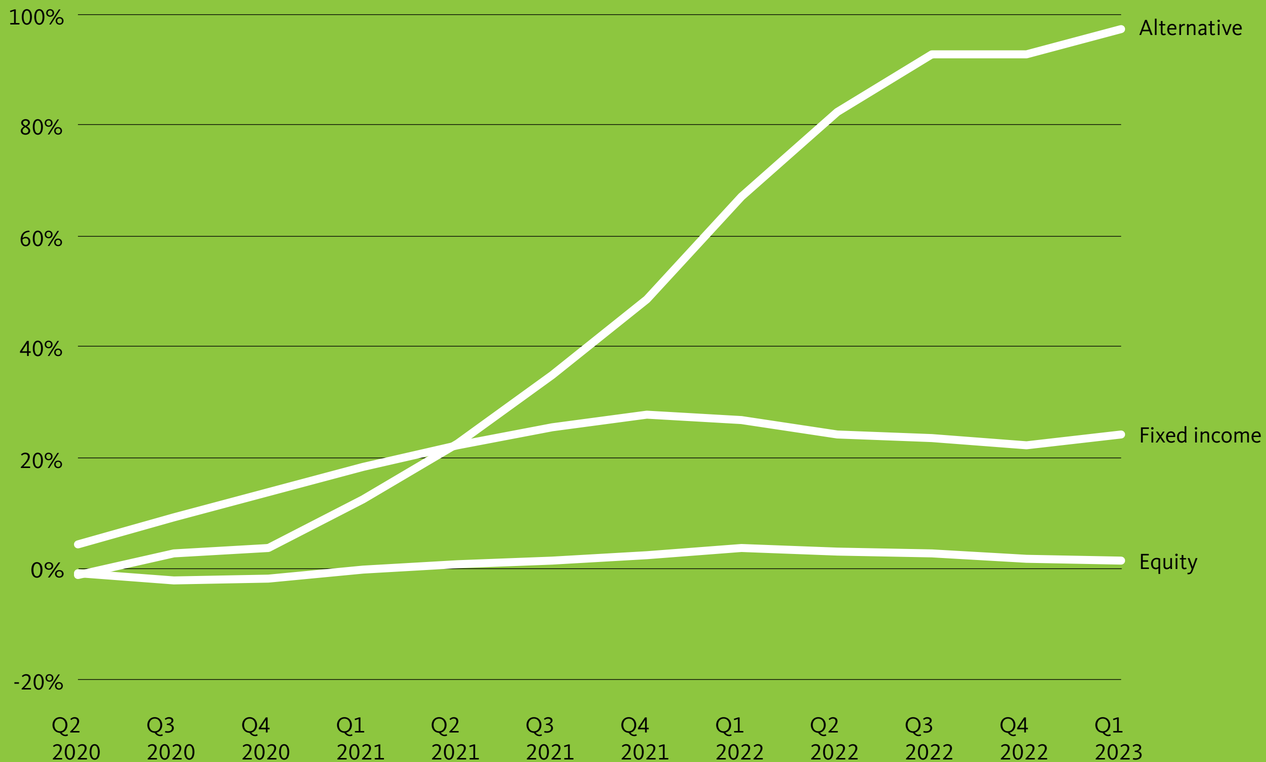
[1] "Private Market Investing: Staying Private Longer Leads to Opportunity," *Hamilton Lane*, 14 April 2022.

[2] "Fundraising from Private Wealth: A guide to raising capital," *Preqin*, 28 March 2023.

Figure 1. Cumulative organic growth over 3 years



Cumulative net flows since 3/31/2020, expressed as a percentage of AUM on 3/31/2020. "Alternative" includes alternative and nontraditional equity categories. "Fixed income" includes taxable income and municipal bond categories. "Equity" includes U.S. equity, international equity, and sector equity categories. Long-term mutual funds and ETFs as of 31 March 2023. Source: Strategic Insight Simfund, Morningstar, Anzu Research, SEI analysis.

Still, myriad barriers stand in the way. Regulatory hurdles are the most obvious, but the operational challenges that come with smaller investments cannot be overlooked. Are retail investors fated to get only what they need, instead of what they want? An array of investment firms and fintech startups are betting otherwise, busily chipping away at barriers to meet pent-up demand and gain an advantage as early movers.

The retailisation of private markets shows every sign of being a long-term secular trend, and a cyclical downturn is not likely to dissuade anybody. Institutional investors still dominate alternative investments, but their share of the market is shrinking. Retail investors are now the fastest-growing segment of the alternative investments market, and they are expected to continue to grow in the coming years. For any firm wishing to play a role in this evolving market, it is imperative that they understand what they can expect.

Anticipate, then adapt.

It is no secret that the market for alternative investments is evolving, but the scope, scale, and precise nature of these developments are not obvious.

Without this clarity, the key to successful adaptation is anticipation. In our view, it is critical to track developments on four fronts.

1. Regulatory environment

Various regulatory hurdles historically limited retail participation in private markets for good reason. Complexity, illiquidity, and a lack of transparency were all seen as potentially harmful to the financial health of retail investors, who were not as well-equipped to absorb shocks to their portfolios. Well-intentioned efforts to limit risk-taking effectively shut retail investors out of private markets, but perspectives evolved over time, prodded by supply and demand, shaped by related regulation, and influenced by technological innovations.

Regulatory hurdles have been systematically lowered over the past few years. For any manager competing in multiple jurisdictions, the global scope of these changes is noteworthy.

The SEC effectively expanded the market for alternative investments in the U.S. by broadening the definition of accredited investors in 2020, moving beyond financial metrics such as assets and income to include the consideration of expertise and knowledge. Meanwhile, the U.S. Department of Labor (DOL) clarified the fiduciary duties of plan sponsors and investment managers with respect to the inclusion of alternative investments as options in retirement plans.

In the UK, the Department for Work and Pensions (DWP) introduced regulatory changes that allowed defined contribution (DC) pension plans to invest in a broader range of illiquid and alternative assets. More recently, the UK's FCA authorised long-term asset funds (LTAFs) to provide a regulated pathway for retirement investors to get access to illiquid asset classes, including private equity, private credit, infrastructure, and real estate.

In 2019, the European Union (EU) introduced an innovative concept called the pan-European personal pension products (PEPP), which aimed to create a voluntary, standardised, and portable personal pension product that can be offered across all member states. Crucially, PEPP regulation included provisions for investing in alternative assets, including private equity and private credit. PEPPs have yet to gain much traction, but the groundwork was laid. Furthermore, the EU recently introduced an updated (2.0) version of its European Long-Term Investment Funds (ELTIFs) that took effect in April 2023.

2. Investors

Family offices technically represent individual investors, but they share many characteristics with institutional LPs, including significant allocations to alternative investments. Ultra-high-net-worth investors with USD$30+ million of assets may not have family offices, but this segment also boasts a significant exposure to alternatives of approximately 20%. Neither group is "retail" in any meaningful sense.

More important to firms targeting the retail segment are smaller investors. These range from very-high-net-worth (VHNW) with USD$5+ million to invest down to investors whose portfolios have yet to exceed the USD$1 million threshold. This group hits above its weight class: the mass affluent segment alone accounts for almost half of the estimated USD$140 trillion of non-institutional wealth globally.[3]

Most important of all may be the advisers who guide their retail clients. Ranging from private bankers catering to their clients' every whim to suburban RIAs dutifully managing the more modest retirement assets of their many clients, advisers are the ones making most of the critical decisions. They are knowledgeable but busy, interested but sceptical. They will need to be handled with care, lest a suboptimal experience becomes a contagion. More positively, it is this group that will help individual investors understand the risks and rewards of alternative investments, guiding and supporting them in constructing portfolios that reflect their goals, risk tolerance, and other factors.

3. Products

The most direct route to the retail market involves lower investment minimums. This means using well-established investment vehicles specifically designed for smaller investors. In the U.S., this means 40 Act funds. Following in the footsteps of some hedge funds, a growing number of private markets managers have launched 40 Act funds to address the retail market.

Widely seen as an attractive compromise between the need for long-term commitments and a desire for greater liquidity, interval funds have exploded in popularity, with more than USD$63 billion managed across 79 funds at the end of 2022.[4] Other 40 Act products are registered as tender offer funds, which are similar, but allow for more flexibility around liquidity options. Both types of funds allocate assets to a mix of direct investments and secondaries.

While less widespread, business development companies (BDCs) offer another convenient avenue for retail investments in privately held companies. The liquidity of portfolio assets may not change, but the ease with which their shares can be traded means BDCs have an enduring appeal.

Hybrid structures that combine the benefits of private and public investments are another option. Funds commingling investments in private companies with assets traded on a public exchange could offer greater liquidity and accessibility whilst still maintaining the advantages of private markets investing.

Some private funds sell only via financial advisers, eliminating direct transactions. With approximately USD$70 billion of client assets in direct real estate investments, the Blackstone Real Estate Income Trust (BREIT) is one of the most widely known examples.

More experimental approaches are also being tried. Tokenisation, for example, offers a novel way to securitise almost any asset by creating digital tokens on a distributed ledger. Its ability to divide large assets into small ownership units has captured the imagination of some in the industry. The use of blockchain technology means tokenisation combines flexibility with a strong emphasis on privacy and the potential to inject liquidity into myriad markets. Despite its promise, tokenisation has yet to be widely adopted, leaving it outside of the mainstream for now.

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[3] Or Skolnik, Markus Habbel, Brenda Rainey, et al., "Why Private Equity Is Targeting Individual Investors," *Bain & Company*, 27 February 2023.

[4] "Interval Fund Market Keeps Setting New Records," *Interval Fund Tracker*, 14 February 2023.

4. Platforms

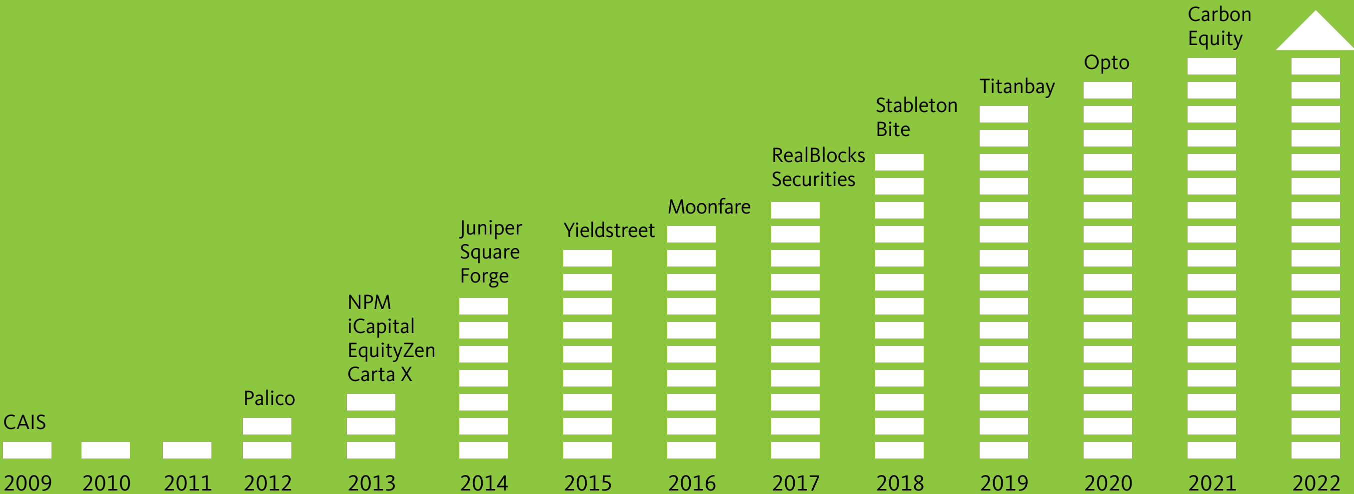
Until recently, alternative investments were usually direct transactions between GPs and their institutional LPs. Investment decisions were often aided by consultants. As the number of participants on both sides exploded, digital platforms were created to facilitate deals. In this flourishing ecosystem, platforms rely on a variety of approaches to fill niches large and small.

Broadly speaking, alternative investment platforms aim to broaden access, simplify the investment process, increase transparency, and lower costs. In some cases, data analytics is being used to inform recommendations. AI-powered portfolio construction tools are around the corner. While some platforms focus on information, others emphasise their role as marketplaces. Some go a step further by providing retail investors with access to alternative asset classes from which they were previously excluded. Direct investing is relatively rare. Instead, the focus is generally on serving the RIAs, banks, and broker-dealers who advise retail investors.

Virtually anything is tradeable. Investors use platforms to buy or trade everything from early-stage equity and artwork to securitised music royalties and wine. Established alternative asset classes such as real estate, private equity, private credit, and hedge funds, however, continue to account for the bulk of transactions at most platforms.

Trailblazing platforms such as CAIS arose in the wake of the global financial crisis, intent on making these products more accessible. Their appearance was noteworthy, but the distribution landscape was not transformed overnight. Managers and investors initially licked their wounds and took their time to reconsider their investment frameworks. Amid mounting evidence that risk-adjusted returns might benefit from greater exposure to alternative investments, a growing number of advisers and other intermediaries began seeking out ways to expand the range of products in their client portfolios. Over the past decade, a steady stream of startups has sought to meet surging demand, with European entrants joining those in North America (Figure 2).

Figure 2. Alternative investment platforms



Note: This chart includes selected names only and is not intended to be comprehensive. The size of the columns is intended to illustrate the growth of the ecosystem. Source: Anzu Research, SEI analysis.

A team effort.

The combined effect of these changes? The world of alternatives will become even more competitive, with incumbents contending with brash newcomers, especially as they converge on the retail market.

With much to gain and plentiful resources available to them, large incumbents have led the way so far. This is not to say that these same companies will ultimately dominate retail investments in private markets. Like the rest of the asset management industry, success will ultimately come to those that demonstrate superior risk-adjusted returns and deliver the best client experiences. While returns can ultimately be traced back to the skill of the manager, creating competitive client experiences will invariably be a team effort.

GPs may bring incomparable skills in valuing and restructuring corporate entities, but they are ill-equipped to interact directly with individuals. The small ticket sizes of retail investors come with sky-high expectations shaped by countless consumer transactions featuring competitive pricing, seamless integrations, rapid feedback, information transparency, and even community. Whether they are pedigreed private banks or digital upstarts, advisers will play significant roles in shaping these client experiences. They will also exert considerable influence on managers asking themselves some critical questions: Who do you want to reach? What do they want? Which products make sense? How do I reach them?

Answers to these questions form a solid foundation for a retail strategy, but the real challenge comes next. Any fund manager weighing the opportunities and challenges posed by the individual investor market quickly realises that external partnerships are critical to successfully implementing a strategy. Client-facing intermediaries and platforms are vital, but partners operating outside of the limelight also bring much-needed infrastructure and expertise, paving the way for managers to effectively meet the needs of individual investors and their advisers.

External partners contribute many things, but marketing and distribution prowess may be some of the most important. Accustomed to relatively opaque and close-knit markets, most alternative managers have relatively weak brand recognition compared to traditional managers.[5] As the battle for retail assets unfolds, even the best strategy or deal-making in the world will be meaningless without the ability to connect with the advisory community. Furthermore, at firms that value investment acumen above all else, the marketing challenge is easily overlooked or underestimated. Partnerships can solve both problems with the right networks, finely tuned messaging, and scalable sales coverage.

[5] Guy Taylor, Olivia Copping, Tasha Locke, “The Alts 50 2022,” *Peregrine Communications*, September 2022.

As regulations ease and technology advances, retail investors and their advisers will enjoy wider access to a greater array of asset classes and strategies.

Regulatory compliance is also rife with pitfalls for any manager new to retail investors or alternative investments. AML (anti-money laundering) and KYC (know your customer) compliance alone can overwhelm understaffed compliance teams. Any managers tempted to muddle through with existing resources owe it to themselves to investigate the wide range of compliance solutions now available.

The right partner can also revolutionise the onboarding of new investors. The sub doc (subscription document) process is widely acknowledged to be an antiquated way to sign on limited partners. Automation brings the process into the 21st century by dramatically improving efficiency, reducing errors, and improving the client experience. Sub-doc processes that once took a month can now be completed in a single day.

Most other aspects of fund administration are commonly performed by partners bringing automation, knowledge, and infrastructure. Client reporting can be digitised and integrated with dashboards or other planning applications. Thought-leadership efforts can support educational materials used by advisers. Due diligence can be more systematic and thorough. Advice delivery can be personalised. Technology integration with intermediary platforms makes access to new customers a simple proposition.

Hedge funds and private market investments have long moved past the point where they merit being described as "alternative." Already firmly ensconced as key components of institutional portfolios, they will gradually find themselves playing a similar role in the portfolios of individual investors. As regulations ease and technology advances, retail investors and their advisers will enjoy wider access to a greater array of asset classes and strategies. Rather than fighting for access to products that were never designed for them, they will increasingly get what they want in addition to what they need.

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[6] Based on *Pensions & Investments'* "Largest Money Managers" 2021 ranking.

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