EXPERT COMMENTARY

From non-accredited investors to trading platforms, wider access to private market investments will transform how the industry operates, writes Jay Cipriano, senior vice-president at SEI Investment Manager Services

Private markets: Less and less… private?

Even as they made headlines for blockbuster deals and managers' enviable paydays, private markets have long been shrouded in mystique. Roped off from public markets easily accessible by the masses, private market investors cultivated reputations as discerning and discreet operators. Fast forward to 2021, and we are witnessing a confluence of factors threatening to upend the traditional way of doing business. In order to get a handle on where the world of private markets is heading, SEI collaborated with Preqin to survey more than 400 GPs and LPs about their views on emerging trends. Supplementing survey data with interviews, we focused on access, technology, products, transparency and liquidity.

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We found a market in transition, with the final contours yet to be determined. Private markets may look familiar in another 10 years, but any resemblance to its past is likely to be superficial. Beneath the surface, the industry is busily adapting its business models and operational infrastructure to capitalise on multifaceted opportunities.

A retail revolution

In search of higher returns and superior portfolio diversification, retail investors are actively seeking exposure to assets that have been off limits to them in the past. Historically quick to articulate concerns over suitability, regulators have more recently eased restrictions on access. There is widespread support within the industry for broader access to private securities, with almost eight out of 10 fund managers surveyed saying that non-accredited individuals should be able to invest. Institutional investors largely agree.

There is still some scepticism around the future of private securities packaged as investment products such as mutual funds and ETFs, but approximately a third of all GPs and LPs surveyed expect them to become more important features in the private market landscape. In a trickle that may preface an eventual flood, a few managers have chosen to seize the initiative and design private market products for the retail market. Much of their effort has focused on US '40 Act funds that can offer private market exposure with liquidity terms and low minimums more suited to individual investors. Some are structured as tender-offer funds, which give the manager some degree of control over redemptions. Others are structured as interval funds, where the redemption process is prescribed and pricing may even occur daily. Minimum investments in some existing funds are already as low as $2,500.

Mutual funds and ETFs will almost certainly play a key role in allowing mass affluent investors to access private markets either directly or via their advisors, but investments may take other forms as well. Offering steady flows and sticky assets, 401(k) plans are a plum prize for any manager targeting the retail market. As a heavily intermediated market, retirement plans will expect products to be adapted to their needs rather than the other way around. As a result, private market strategies may need to be packaged in collective investment trusts and embedded in target date funds to succeed in gaining market share.

The new active

As the working definition of 'active management' evolves to incorporate a wider range of securities and vehicles, this trend will almost certainly gain steam in the future. The promise of improved portfolio diversification has been a major driver of interest in private markets for retail advisors, particularly in the aftermath of the global financial crisis when so many markets crashed simultaneously. There is still a strong case to be made for diversification, as evidenced by the fact that only one in 10 survey participants say there is significant correlation between private and public markets.

While the vast majority of industry insiders recognise at least some degree of benefit, managers are more than twice as likely to claim that private markets provide an "excellent" source of diversification. Investors are more circumspect, with 38 percent saying the advantage may be less significant than commonly believed, thanks to infrequent pricing and low liquidity. Only 18 percent of managers voice similar concerns. Further democratisation of private market investments will inevitably be accompanied by greater transparency, attribution and performance analysis. The true value of diversifying portfolios with private markets will come into sharper focus as research accrues going forward.

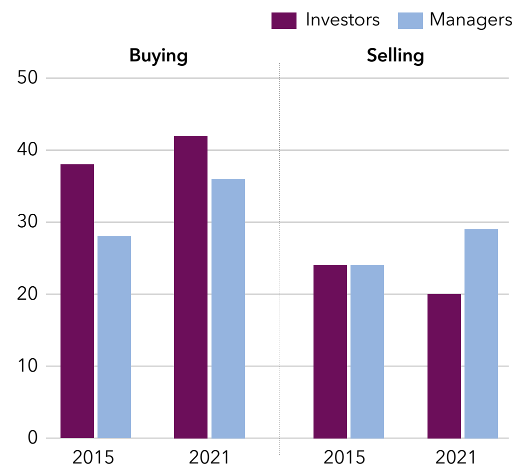
Managing risk and tempering volatility through diversification is not the only appeal. Private securities are often sought for higher returns in return for long lock-up periods. Most professionals continue to believe this trade-off to be valid, and survey respondents claiming there is no longer an illiquidity premium number in the low single digits. Most see a modest premium, with investors more likely than managers to argue that the premium is shrinking as liquidity options expand.

Out of the shadows

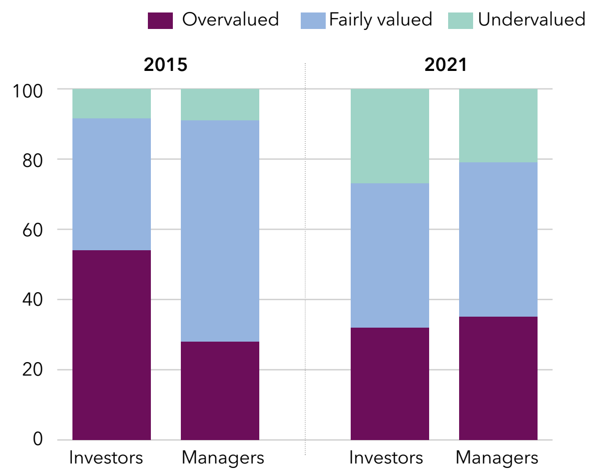
Once considered unsavory due to its association with distressed situations, the secondary market carries very little stigma anymore. Vividly demonstrating how the cloistered world of private markets is opening up, half of all managers and investors surveyed indicate they will participate in the secondary market in 2021. This is dramatically higher than our survey six years ago, when only 28 percent of managers and 38 percent of investors planned to buy or sell in the secondary market.

The slowdown in activity that accompanied the arrival of covid-19

Secondary market activity: 2015 vs 2021 (%)



Secondary market valuations: 2015 vs 2021 (%)



Source: 2020 SEI Private Market Liquidity Survey, 2014 SEI Private Market Liquidity Survey allowed the secondary market to cool down and reset. By the end of 2020, few investors or managers thought valuations were extremely out of line. In striking contrast to six years ago, both groups are much more aligned with one another. Thanks to the transparency ushered in by deal volume and data access, widely divergent opinions on secondary valuations have become virtually indistinguishable today.

A key hurdle in the way of an even wider embrace of secondaries is the paucity of transparency. There is widespread agreement that more clarity would benefit the secondaries market. Investors in particular are eager for more transparency, with fewer than one in 10 saying they didn't think it was necessary.

Recognising its pivotal role, many are rushing in to address this pent-up demand. Infomediaries and industry media promote the flow of information. Markets and exchanges create feedback loops that amplify transparency. Data and service platforms are making it progressively easier for managers to provide greater access and insights to investors.

The future

Wider access, new use cases and louder demands for transparency are forcing private markets to change. Investors are already asking questions that extend far beyond their traditional focus on operations, process and controls. Environmental, social and governance and diversity and inclusion issues are becoming more prominent, leaving managers scrambling to adapt and creating the potential for turnover as investors attempt to restructure portfolios to better align with their values.

Investor queries may be aimed at establishing common philosophical ground, but they also focus on more tangible operational details like formal written guidelines. Soon service providers will also need to provide the same information as part of due diligence, further enhancing transparency and setting the stage for additional liquidity in the market.

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These developments mean new approaches are needed, and advances in technology and data science mean greater use of trading platforms and exchanges: 68 percent of investors and 47 percent of managers now expect them to gain market share, compared with only 10 percent and 16 percent six years ago. Technology-enabled platforms will have structural repercussions across the industry. They can, for example, make it easier for smaller managers to compete for investors' attention, effectively levelling the playing field. Technology can also enable greater transparency and make it easier for investors to conduct diligence.

More radical change could be around the corner, as a rapidly growing blockchain-based ecosystem awaits to facilitate trading and investing in private markets. Any financial asset can theoretically be tokenised, and an extremely efficient infrastructure with embedded smart contracts facilitating the management and trading of private equity, credit or even real estate is undoubtedly appealing. The jury is still out on the near-term prospects, but given the potential for disruption, managers and investors will want to monitor developments in this area.

Proactive partnering

Even as the details are being ironed out, there is little doubt that private markets are evolving before our eyes as broader access, heightened transparency and greater liquidity create a virtuous cycle. Managers will need to adapt if they wish to exploit this emerging paradigm. Investing in private markets will be less about who knows who, and more about return on investment, fees, access, investor experience and other factors that have determined success in other parts of the asset management industry for decades.

While diversifying their client base and revenue streams, managers will also need to get comfortable with fee erosion and avoid product cannibalisation. Greater access and transparency mean inevitable pressure on fees. This is the cost of growth.

To shield (and potentially enhance) the margins to which they have become accustomed, managers will want to proactively address operational issues. Existing operating platforms may not be up to the task, so valuation methodologies, process transparency, regulatory compliance, reporting frequency and others will need to be revisited and potentially revamped. Choosing a carefully curated roster of partners will be vital in ensuring the expertise and tools necessary to compete effectively.

Managers planning to sell their expertise via different distribution channels will want to make a point of finding partners with expertise and experience in building bridges between the world of alternative investments, retail markets and regulated structures. No one can go it alone. The right partnerships should serve as springboards for anybody intent on succeeding in the soon-to-be transfigured world of private markets. ■

To request the complete survey results, email SEIInvestmentManagerServices@seic.com