

Individual Investors Are Increasing Private Equity Allocations. Is it the Right Move For You?

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With the downturn in public stocks beginning in 2022, many institutional limited partners are struggling with the so-called denominator effect, and so reducing their exposure to private equity. On the other hand, individual investors increasingly conclude that they need to make private equity a core component of their portfolios. Key motivators for this include higher returns than those available in public markets and the enduring need for portfolio diversification.

Historically, private equity products have been targeted at institutional investors, with individuals facing several barriers, such as high minimum investments, lack of liquidity, high fees and insufficient domain knowledge. However, things are beginning to change: New investment products are being launched to better cater to individual investor needs, and new technologies are being developed to reduce the costs of servicing individuals.

Although there is a need for more innovation, it's encouraging to see the private equity industry starting to make a concerted effort to democratize access to this high-performing asset class, and individual investors are responding by increasing their allocations to it.

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Higher returns

Individual investors are increasingly aware of the higher returns available in private markets. For example, over the two decades ending in 2021, private equity generated an IRR of 15%, compared to 8% in public markets, according to Cambridge Associates. To put this in perspective, a dollar invested in 2001 would have turned into \$15 by 2021 if invested in a private equity index portfolio, compared to just \$5 if invested in the public markets.

Further, companies are increasingly staying private longer, meaning more growth is being captured in the private markets. For example, the average age at IPO is almost 12 years for technology companies now, as opposed to five years back in 1999.

Critical for diversification

Individual investors are also trying to find new opportunities for broadening the sweep of their portfolios because traditional diversification offered by public market indices has significantly reduced. (For example, the technology sector now makes up 40% of the S&P 500 index, and just five technology firms make up 23% of the index.) More broadly, the universe of publicly listed companies has been shrinking – down by almost 50% from approximately 7,500 in the mid-’90s to 3,500 today. This significantly reduces an individual investor’s ability to diversify using only public equity investments.

By contrast, the private market provides significant opportunities. Eighty-five percent of companies in the U.S. with more than \$100 million in revenues are private. That translates to 18,000 private businesses compared with 2,800 publicly listed ones. By increasing their investments in private equity, individual investors can access these

thousands of privately owned enterprises and become partial owners of a broader swath of the economy.

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Traditional restraints to access

Historically, private equity products have been targeted at institutional investors, such as endowments and pension funds. Inefficient fund structures that require high minimum investment amounts (more than \$500,000) and have 10-year lock-up periods with no liquidity have been a significant barrier for individual investors. In addition, high fees and limited domain knowledge for picking among the available investment options have kept individual investor allocations from being meaningfully higher.

Innovations enabling increased access

Over the past few years, there have been two key developments democratizing access to private equity. First, technology platforms such as iCapital and CAIS are building software to automate portions of the workflow required for investing in private funds. Traditionally, this has been a manual and paper-based process, but these new tech products make it easier for wealth managers to add private equity funds to their clients' portfolios, removing a key barrier.

Second, blue-chip private equity firms like KKR, Blackstone and Apollo have recently launched products that better align with the needs of the individual investor. For example, KKR's private market fund, targeted at the individual investor segment, offers access to KKR's private equity portfolio. Importantly, the fund offers monthly subscriptions with minimums as low as \$25,000 and limited liquidity, up to 5% of

the fund's assets every quarter.

While this is an encouraging beginning, there is still a long way to go, with individual investors allocating less than 5% of their portfolios to private markets today compared to 30 to 35% for institutional investors. Future innovations need to further simplify products, increase liquidity, reduce fees and provide access to high-quality funds beyond the handful of mega-cap managers to materially increase individual investor allocations. In addition, work needs to be done to further familiarize individual investors with private equity and make them comfortable allocating meaningfully higher portions of their portfolios to this asset class.

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It is heartening to see individual investors becoming open to adding private equity to their portfolios and the private equity industry beginning to make individual investors core to their fundraising efforts. Although this trend will provide an opportunity for private equity funds to continue growing, most importantly, it will drive higher retirement savings for individual investors and provide additional capital for private businesses.

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