Anchin Alert

Anchin, Block & Anchin LLP
Accountants and Advisors

December 3, 2019

SEC Considers Opening Private Equity to Main Street Investors. Good Idea?

Private equity has been one of the top performing asset classes over the past decade. However, due to current regulations, the typical American investor hasn't been able to participate in these gains. That could change soon.

Earlier this year, the SEC asked for public comment about whether it should open private equity investments to retail investors. Here are some of the pros and cons of the agency doing so.

Current Landscape

Under current law, only institutions and high net worth individuals can invest directly in private equity funds. Private equity investments fall under the accredited investor standards, which means they are only available for individuals with over $1 million in assets excluding their primary residence or annual income of at least $200,000 each year over the past two years, $300,000 per year if married filing jointly, according to Investor.gov.

While non-accredited individuals can purchase mutual funds and exchange traded funds (ETFs) that invest in private equity, the SEC currently limits these funds to investing no more than 15 percent of their portfolio in illiquid assets, according to the SEC. As a result, the typical American investor cannot get much exposure to this asset class.

The Private Equity Drive for Opening Up

The private equity industry appears eager for a change to meet its need for new investors. Beyond high-net worth individuals, private equity funds also raise a large share of their capital from pension funds; but these are becoming much less common. Today, only 4% of private sector workers are covered by a pension versus 60% in the early 1980s, according to CNN.

Now most Americans save through a 401(k) or IRA which means that unless an investor is accredited, it's difficult for them to put their retirement savings into private equity. That's why the private equity industry hopes that the SEC will broaden their potential market.

Benefits to Investors

Over the past decade private equity has significantly outperformed the regular stock market. During this stretch, private equity earned an average return of 14.2% per year, nearly double the 7.3% return of the S&P 500.

Beyond the strong returns, private equity could add an additional asset class for investors looking to diversify their portfolios. While past returns are not a guarantee of future performance, for now it appears that Main Street investors are being blocked out of a potentially useful investment.

Potential Downsides

Private equity funds do have their share of potential downsides. First, there is a much higher variance in returns, with the worst-performing private equity funds posting annual losses of nearly 30% over the past five-year period, according to McKinsey. Even though there are performance swings with regular mutual funds, they aren't as severe.

Finding an appropriate private equity fund also takes more research. PE funds are more involved than mutual funds with the companies they buy into. They often take board seats and have the ability to change the management team of a company. For this reason, investors need to be familiar with the track record of a fund to make good decisions. This necessary due diligence could be beyond the capabilities of the typical Main Street investor.

Finally, private equity funds are not liquid and designed for a long-term investment horizon. Once investors commit, they typically can't request withdrawals of their money and the fund will only periodically make distributions only after investments are sold. Investors may also be committed to invest even more in the fund going forward. This illiquidity could catch regular investors off-guard, especially those with little in other savings who may need access to their money in a downturn.

Looking Ahead

The SEC has finished taking comments from the public and is now deliberating on its next move. They will have to decide whether the upside of opening private equity to Main Street investors is enough to justify the potential risks. Analysts expect that the agency will ease restrictions for this market in some way, but the exact changes and when they could go into effect remain unknown.

ANCHIN®
Your Expert Partner
Accountants and Advisors

Anchin, Block & Anchin LLP
Accountants and Advisors
1375 Broadway, New York, NY 10018
212.840.3456 • www.anchin.com