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Zooming in on Retail Investors

By Eugeniu Guzun – HedgeNordic

The Asset Management Advisory Committee of the US SEC unanimously approved a report in late September recommending the increase of retail investor access to private investments such as private equity, private debt and real estate vehicles. Managers of private real estate funds, so far effectively limited to institutions and wealthy individuals, have increasingly been turning their attention to the under-served retail investor market.

"Historically, real estate, private equity and infrastructure managers have primarily raised money from institutions and wealth managers," says Dirk Holz, director of product management, head of private capital services at RBC Investor & Treasury Services. "We have seen significant growth in real estate managers' assets under management over the past decade or so, mainly stemming from institutional investors. However, we have seen a lot of big managers starting to approach retail investors over the past two years," he continues. "Private real estate managers have largely ignored the retail space, a large part of the world's overall assets and wealth."

So-called retail investors, who do not meet the wealth or professional requirements to qualify as professional investors, generally cannot access private real estate funds as these funds require investors to meet certain qualification requirements. According to Holz, the definition of a retail investor is broad and can capture both individuals investing as little as $50 a month on one end and high-net-worth investors who can allocate several hundreds of thousands or more to a single investment. "New funds have been designed to entice retail investors. This is a significant trend, which is likely to provide a new investor base for private investment funds going forward."

Dirk Holz, Head of Private Capital Services, Product Management – RBC Investor & Treasury Services

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Aside from smaller direct investments in properties, retail investors usually access retail estate investments primarily through real estate investment trusts (REITs). "Few retail investors have the possibility of investing private funds," says Holz. It is estimated that around 13 percent of US households meet the "accredited investor" threshold and only two percent meet the "qualified purchaser" threshold that enables access to private investments. However, returns from private real estate investments generally generate similar to better returns relative to comparable public market REIT indices.

"The exposure and the returns retail investors can get through investments in real estate investment trusts are not the same as those non-retail investors can get in closed-ended structures," emphasizes Holz. "With retail investors seeking exposure to institutional-quality real estate, managers are increasingly looking to roll out suitable products into the retail market."

CHALLENGES IN THE PURSUIT OF RETAIL MONEY

The managers of private real estate funds are encountering challenges as they seek to tap into the under-exploited retail investor market. "Traditional real estate funds predominantly have a closed-ended structure, which requires investor commitment the whole life cycle of the fund," says Holz. "This is not what the average retail investor is looking for. Retail investors always want a little bit of flexibility, which creates a challenge for real estate managers," Holz describes. "Real estate is a rather illiquid asset class after all."

"The real estate managers opening up towards retail investors need to design a model that offers redemption possibilities," he argues. "Daily redemptions may not necessarily be an option for this illiquid asset class. However, one could design a product that allocates a portion of the portfolio to more liquid assets, such as real estate investment trust units or other real estate-linked liquid products, elaborates Holz. "This design automatically takes away a bit of the performance, particularly when those liquid assets include cash and cash equivalents," warns Holz. Increased liquidity can come at a cost, usually in the form of lower returns.

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Holz and his team at RBC Investor & Treasury Services are observing some managers opting for so-called semi open-ended funds, which require a notice period and some lock-up periods, thereby giving managers more flexibility in case of redemptions. "While these structures work in most market environments, they are vulnerable in a downturn," argues Holz. There was a run on some funds during the financial crisis of 2008, as investors wanted to liquidate their holdings and get all their money out. "These are the limitations of this asset class. One cannot just sell off a building overnight, and sales are even more difficult to execute when everybody else is fire selling."

There are mechanisms such as lock-up periods and investor queues to get around these obstacles, according to Holz. "Managing the mismatch between the illiquidity of a long-term real estate investment and the liquidity preference of investors is the greatest challenge for managers." In addition to liquidity management, "reporting and the feedback from investors will also be different," according to Holz. "The world of private real estate has been quite a closed niche, an under-the-radar universe not facing any public discussions and noise about performance or transparency."

"Retail investors will require more visibility of funds, which managers need to be prepared for," points out Holz. "If retail investors go into these fund structures, real estate managers will have more presence on social media and that presence may not always benefit managers. This will require a completely different kind of perspective, which some managers have not yet fully assessed or even understood."

LARGE MANAGERS IN POLE POSITION

Dirk Holz believes that large real estate managers are better positioned to benefit from the industry's shift towards retail money. "The leading large managers will have a big advantage in the retail space," says Holz. "The largest managers have the needed infrastructure to raise and invest a lot of capital," he continues. "This gives them a completely different kind of investment power. Institutional investors love mega-funds and the diversification they bring. This will appeal to retail investors too," concludes Holz.

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