Crossing the Rubicon?

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Viewpoint

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Fabrizio joined Muzinich in June 2018. Prior to that he was in the public sector where he has held a number of roles including most recently Head of the Office of Italy's Minister of Finance, responsible for developing policies targeting macroeconomics, tax, finance and banking. Before that he served as G20 Sherpa and Senior Economic Counsellor to the Italian prime minister. Previously, during his time at the OECD in Paris, he also held the role of Chief of the Sherpa Office and Special Counsellor to the Secretary General in Paris, responsible for coordinating the OECD's contributions to the G20 and G8 during and after the financial crisis. He holds a degree in International Affairs from the Scuola S. Anna in Pisa and a Masters in International and European Law from the European University Institute.

How can retail investors and the real economy benefit from a changing regulatory environment?

For ordinary retail investors, the opportunity to invest in private markets (e.g. private equity and private debt funds) has broadly been off-limits.

According to the Securities and Exchange Commission (SEC), "A private equity fund is typically open only to accredited investors and qualified clients. Accredited investors and qualified clients include institutional investors, such as insurance companies, university endowments and pension funds, and high income and net worth individuals".[1]

Typically, ordinary savers are excluded.[2] Indeed, we believe similarly restrictive rules apply to the majority of alternative investments.

A Changing Landscape

However, the combination of evolving economic and monetary conditions, market developments, new ambitious government policies and more open supervisory drives means the landscape is changing.

In June 2014 the European Central Bank (ECB) introduced negative interest rates – a first from a major central bank.[3] Other central banks, such as the Bank of Japan, followed suit, while in countries such as the US rates stayed positive, but at historically low levels.[4]

What was considered a temporary measure has become a long-term trend. Today we believe the consensus is for interest rates globally to stay negative or at depressed levels for some time.

The effects and pressure on fixed income products are obvious. Yields have decreased and, in several instances, become negative. It appears to us that basic fixed income products – previously long-term staples for ordinary savers – are losing their appeal.

We believe monetary and economic conditions are pushing retail investors to search for new strategies which can offer better returns. In our view, this hunt-for-yield mentality has increased the appeal of private markets, where returns can be higher.

Opportunities for Savers and the Broader Economy

An allocation into private markets offers the potential for healthy diversification, with demand reflected by strong growth in the asset class; in the last ten years, alternative assets under management have more than tripled - from US$3.1tn in 2008 to US$10.7tn in early 2019.[5]

Meanwhile governments have been keen advocates of channelling savings into domestic businesses, particularly small and medium-sized enterprises (SMEs), and have devised polices accordingly.

Treasury departments, especially in Europe, are eager to see domestic savings funnelled towards financing the real economy in order to broaden and diversify funding sources.[6]

We believe policy makers view a less bank-centric economic system as an encouraging development at the point that it can provide tax breaks for individuals investing in the real economy.

As highlighted by the UK government, the UK's Individual Savings Account (ISA) scheme provides favourable tax treatment for retail investors and has been progressively opened up to include alternative asset classes.[7] In Italy, since 2017 the Piani Individuali di Risparmio (PIR) has provided private investors full exemption from taxes on capital gains if they buy equity or debt issued by Italian SMEs, including unlisted ones.[8] France's PEA-PME (Plan d'épargne en actions destiné au financement des PME) scheme, in operation since 2014, also facilitates retail investment in small businesses by providing better tax treatment.[9]

These programmes are contributing to transforming "private individuals and households from passive savers into more active investors, thereby increasing the opportunities for improved long-term financial planning".[10]

In our view, in a different way, but with a similar rationale, in the US special federal tax treatment is provided for Business Development Corporations (BDCs), which are typically traded public companies that invest in SMEs.

However, we believe these national incentives should be coordinated with a friendlier and more open regulatory environment.

Supportive Regulation

In 2015, the European Union (EU) launched a new investment framework, the ELTIF (European Long-Term Investment Fund), which regulates private investment in non-UCITS funds, i.e. alternative products.[11]

ELTIFs can invest, with a long-term view, in equity and debt of EU-based SMEs, including unlisted companies, infrastructure and real assets.

These funds are conceived for retail investors, but with certain limits in an effort to provide protection to ordinary savers. For example, a private investor (with a portfolio below €500,000) cannot invest more than ten per cent of their portfolio into ELTIFs.

However, this new vehicle did not receive immediate acceptance and uptake has been slow, likely due to the product's innovative nature. Only recently have asset managers fully understood its potential, which has resulted in the successful launch of several ELTIF products.

We believe supervisory authorities are also showing some openness to allow private savers further access to alternative investments.

Alternative investments have inherent characteristics, e.g. illiquidity, type of risk and concentration limits etc., which must be considered when they are marketed to retail. Therefore, the supervisory authorities strive to establish adequate information and disclosure requirements and risk mitigation principles.

In the UK, in response to certain cases of malpractice, the Financial Conduct Authority recently introduced a new category of 'funds investing in inherently illiquid assets', subjecting them to additional requirements.[12]

In the US, in June 2019 the SEC launched a consultation on how to expand retail access to private markets.[13] The consultation is ongoing and participation broad.

Balancing Risk with Reward

We believe a balanced approach is being developed in Europe and in the US to permit retail investors to access private markets. In our view, the right balance must be struck between facilitating funding the real economy and providing adequate protection for savers as the regulators and supervisors strive to establish the correct disclosure and risk management requirements.

Asset managers and distributors have a responsibility to comply with these requirements and ensure that these products are sold and marketed responsibly. Within this framework, we believe the scope for further product innovation seems wide and deep.

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Important Information