MONEY MANAGER Q&A

Creating the "Go-To" Private Markets Firm for Financial Advisors and Their Clients

Interview with Joseph DaGrosa, Jr. | Chairman and CEO, Axxes Capital

Joe DaGrosa has been on the front lines of the investment world almost literally his entire life.

"I started working on Wall Street when I was 15 years old," he recalls. "I began as a messenger for Paine Webber, which is now part of UBS. I later became a runner on the commodities exchange floor at the World Trade Center, while also working for Paine Webber's CFO. After college, I joined Paine Webber full time as an auditor before becoming a financial advisor working with high-net-worth clients."

DaGrosa was ultimately tapped to join Paine Webber's Special Accounts Group, serving both retail and institutional accounts. "I had an opportunity to work with Investcorp, which was one of the pioneers in private equity," he shares. "A founding partner of Investcorp co-led the acquisition of Tiffany & Co., Saks, and Gucci, and then left to start his own firm. In 1996, he asked me to join him as his first partner. That launched my career in private equity."

Over the years, DaGrosa was a partner at several other private equity firms before setting up his own shop in Miami. One of his highest-profile deals was buying 248 Burger King franchises out of bankruptcy in 2003. In just over three years, he and his partners grew the restaurant chain's income by more than 1,100%, ultimately selling the business at a significant premium to what is now a division of Blackstone.

DaGrosa subsequently used his magic touch to identify, buy, and rebuild companies across a range of industries including insurance, airlines, cell phone towers, real estate, and even a French soccer team.

These days, as chairman and CEO of Axxes Capital, this veteran investor is focused on giving retail clients access to the same kinds of private market opportunities he spent his career identifying and profiting from.

To assist him, DaGrosa has built an executive team comprised of industry veterans recruited from top-tier firms such as Capital Group, Apollo, Brookfield Asset Management, Neuberger Berman, and Pzena Investment Management.

"I've always been focused on where the hockey puck is headed in the business world, the investment markets, and our industry in general," DaGrosa reflects. "There's no question that private markets offer the strongest potential of any asset class, yet until recently financial advisory clients haven't had many good options for tapping into them. I started Axxes to change that."

Axxes is creating an entire suite of solutions to enable financial advisors to give both accredited mass market and qualified high-net-worth clients direct, targeted, and cost-efficient access to the private markets.

"To be a cutting-edge financial advisor, you really need to include private markets in a client's overall allocation," DaGrosa explains. "We're here to help advisors do just that in what we consider to be the best and the most efficient ways possible."

Axxes is poised to launch a series of funds targeting the entire private markets spectrum. Every solution is slated to be registered with the SEC and sub-advised by some of the world's leading managers.

DaGrosa is also building a proprietary platform called Axxes Direct to enable advisory clients to get in on curated and vetted direct co-investment deals.

"We're building a business to level the playing field for registered investment advisors and independent broker-dealers as it relates to both the credit and equity sides of the private markets universe," DaGrosa observes. "Other firms are bringing private investment products to market, but we're using our team's collective expertise to do it in a much different way that truly puts advisors and their clients first."

Below, DaGrosa talks more about Axxes, how the firm compares to the competition, and his views on the role of private markets investments in client portfolios.

Financial advisors have historically been focused on building client portfolios only using traditional stocks and bonds. Adding private markets is a relatively recent trend. Why do you think it has taken so long for this asset class to gain traction?

It really is interesting because large institutions, pensions, sovereign wealth funds, endowments, and very wealthy investors have always allocated a significant portion to the private markets. It certainly makes sense because private investments have historically delivered the highest returns of any broad asset class while lowering overall portfolio risk. In fact, the best-performing endowments often credit their outperformance relative to the broad stock market to the enhanced returns achieved from their private market investments.

As to why it's taken so long for retail investors to have access to the best private managers, there are two main reasons. First, most private equity firms have historically had large inflows of capital from institutional investors and therefore saw no need to build out a retail business. After all, it's a lot more work raising capital in small increments, not to mention all the paperwork and administrative support required to serve retail investors. In addition, regulatory restrictions for private investment funds have limited private market access to only so-called qualified investors.

Firms like ours are now changing this dynamic. We've carefully studied ways to make solutions available to a wider audience of mass market accredited investors through various registered vehicles. In addition, we've set up an innovative structure for institutional private investment managers to reach a broader set of retail advisory clients in partnership with us.

In a way, I view this period as analogous to what happened when fixed-rate commissions were eliminated back in the 1970s. That opened the door to the start of the entire discount brokerage industry. Pricing was initially lowered for institutional investors but eventually individuals enjoyed the same economies of scale. This leveling trend is starting to play out in the private markets space and we couldn't be more excited about helping to lead the way.

“I estimate that the universe of potential private investment options is nearly three times larger than the number of publicly traded stocks. By not investing in private markets, you’re missing out on a huge pool of potential opportunities.”

Do you believe mass market advisory clients are well served by having an allocation to private markets?

Absolutely. To begin with, I estimate that the universe of potential private investment options is nearly three times larger than the number of publicly traded stocks. By not investing in private markets, you’re missing out on a huge pool of potential opportunities. Plus, many companies today are choosing to stay private longer. It used to be that a company with, say, a $2 billion market cap, was considered significant and could earn a premium valuation in the public markets. That’s no longer the case. This same business can now get a similar valuation as a private company without the headache of being public. This is one reason you’re seeing so few IPOs at the moment. In my view, the public markets will continue to shrink, making private investments all the more attractive. And, as previously discussed, private market returns have historically outperformed the public markets over extended time periods.

“Private markets” is a big catch-all category, much like “alternatives.” How do you define the term?

Broadly speaking, I would say “private markets” refers to investing in either the debt or equity of companies or assets that are privately held, in contrast to the publicly traded securities most people are familiar with. It’s not the same as “alternatives,” though many advisors lump them together. The reason I make the distinction is that alternatives include hedge funds, which usually invest primarily in publicly traded securities. Hedge funds also tend to be very expensive, with multiple layers of fees and a huge lack of transparency.

After years as a successful private equity investor, you started Axxes. Why make the switch over to asset management?

I have a huge passion for private market investing and long felt that retail investors deserved the opportunity to invest more of their assets in this space. A number of firms have started to introduce products in recent years, but frankly, I wasn’t impressed with what I saw. I’m a former financial advisor myself and I’m always thinking about what’s in the best interests of the client. The products being brought to market were typically very expensive and not of the same caliber as what was being offered to institutions.

One big issue is that most of the vehicles claiming to tap the private investment space primarily invest in debt securities, and not the more attractive equity opportunities that I have always been focused on.

I sought to change that with Axxes by mapping out a plan to create a suite of registered vehicles, initially in the form of a business development company (BDC), a registered structure able to invest in both debt and equity. This opens a huge opportunity for new investment options and gives retail clients more optimal access to the most promising parts of the private market universe.

“We will ultimately enable advisors to give their clients access to the same kinds of opportunities institutions have always enjoyed. And, I might add, for far lower fees and with greater flexibility than previously available.”

For me, it’s just an extension of the work I’ve done on the private side for decades. Instead of working on individual company deals, I’m working with our investment team to identify what we consider to be best-of-breed managers to sub-advise our funds. We will closely monitor all the underlying holdings using the same eye for due diligence that has driven my private equity success. I’m now in the role of being an advocate for financial advisors and their clients, which I love. Plus, our firm will be a major investor in all our funds, demonstrating our commitment to eating our own cooking. We firmly believe in the power of every solution we’re creating.

While Axxes has been called an innovator in the space, a number of large, brand-name private equity firms have also started to build out products for the retail market. Why should advisors consider working with Axxes as opposed to some of these more well-known competitors?

Let me start by saying that I have huge respect for all the big firms competing in this space. However, I would note that most of these asset managers, in my view, have one thing in common: they are selling their own existing products, or less optimal versions of them, and not creating solutions that are in the best interests of financial advisory clients. In other words, they are simply trying to bring more assets under management into the organization overall, in many cases because flows from institutional channels are slowing down. They see financial advisory clients as a source of funds to fill that gap.

Beyond that—and this is a huge point—these larger firms tend to specialize in a single area of the market. For instance, their expertise may be in private equity or real estate. However, I've observed they're creating retail products across multiple asset classes, all using their own in-house teams. I can tell you from doing this for a long time that no firm has expertise in all asset classes. That's akin to saying a large cap U.S. growth manager is also an expert at picking bonds, small caps, and international stocks.

What's more, at Axxes we primarily target midsize firms with consistent track records that have not grown so large as to suffer from asset bloat. Too much money under one roof can cause multiple issues and detract from performance. You also have to wonder what priority retail investors will have in getting the best deals at these larger firms, since the big profits still come from the institutions.

That's why we have a very different model at Axxes. We partner with what we view to be the very best firms for each of our investment strategies, and they serve as our sub-advisors. We have a highly experienced in-house investment and due diligence team focused on finding and working with these managers on behalf of financial advisors and their clients.

We join forces with what we like to call "Goldilocks" managers. In general, these firms tend to manage between $5 billion and $100 billion in assets, have proven top-quartile track records, are widely respected by the institutional community, pass our rigorous screening process, and previously have not been available to retail investors. In fact, we will usually have exclusive agreements with these firms that they are only available at the retail level through Axxes.

Importantly, Axxes clients generally pay the same fees as the larger investors, with no added markups, because we're all about providing the best value to financial advisors and their clients.

Importantly, we partner with firms that put the best interests of their clients first, just as we do. I want advisors to know they can always trust us to deliver the best possible outcomes to their clients. That's why Axxes exists, and it will always be our number one mission.

How do you find these Goldilocks firms?
That's part of the huge value of working with Axxes. I'd argue we have one of the highest-quality due diligence and review processes in the marketplace looking for these managers every day.

I'm also very involved in the research effort, since I've personally been doing this kind of work for more than 30 years. Our chief investment officer, Ray Joseph, is the former head of multiple pension plans, including the $100 billion State of New Jersey Division of Investment and the $25 billion Los Angeles Fire and Police Pensions fund. He was also an executive at Wilshire Associates for many years. In addition to Ray and his team, we have an outstanding board of directors overseeing all these managers, consisting of highly experienced industry professionals. We've further contracted with a renowned independent private market due diligence firm as an added layer of initial and ongoing research. We're fully committed to developing solutions managed by the best teams in the industry in order to make financial advisors heroes in the eyes of their clients.

What exactly do you mean by "heroes"?
As I mentioned earlier, I started my professional life as an advisor with Paine Webber. I know what it's like to work with retail clients and the challenges of building a successful practice. Indeed, almost every member of the Axxes C-suite has spent considerable time on the advisory side of the business, including our head of distribution and even our chief marketing officer. We're all committed to not only delivering outstanding solutions but also educating advisors and their clients on the merits of private markets investing. In fact, we're in the process of building out a robust educational program along with tools for advisors to use in helping their clients understand exactly what they're investing in and why it is likely to improve their overall outcomes. Simply put, we want advisors to have the tools and solutions they need to do a great job for their clients.

Some advisors new to private markets may feel like it's not worth the extra effort to go beyond the traditional stock and bond allocation. What case would you make for changing that viewpoint, especially given the uncertain economic environment?
In my view, it's a huge missed opportunity not to consider private investments. Advisors have a fiduciary responsibility to put their clients in suitable investments. Including private markets exposure is an excellent way for clients to be better diversified and potentially achieve greater diversification.

I'd also point out that offering a private markets allocation is a huge competitive advantage. The financial advisory business has really become commoditized, and a lot of firms are saying the same thing. One way for advisors to stand out is by offering access to investment opportunities clients can't otherwise get on their own. A simple 60/40 stock and bond allocation, for instance, is very easy for clients to replicate. Adding in a more sophisticated investment mix including private markets to increase portfolio returns and lower risk is a value-added differentiator. We are here to help advisors of all sizes offer these important solutions. To my knowledge, we're the only firm in this space that is 100% focused on working through advisors and, in turn, improving outcomes for their clients.

I definitely understand why many advisors haven't explored this asset class up until now because accessible options simply weren't available. But that's all changing thanks to firms like Axxes.

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What percentage of a portfolio do you believe advisors should allocate to private markets?
This is a very client-specific decision, but I will provide some context into how I think about it. Private investments, by their nature, are illiquid. For that reason, private investments should generally not constitute a significant portion of one's portfolio. They are best considered as a "booster" to both increase potential returns and lower overall risk.

If I were setting the allocation for the average retail client, I'd recommend somewhere between 5% and 20%. Anything below 5% probably won't move the needle, in terms of delivering meaningfully better overall returns and better diversification. It really comes down to risk tolerance, the client's age, and financial circumstances. All other things being equal, a 40-year-old executive with a steady income stream may be better suited to a higher private markets allocation than a 65-year-old living off the income from his or her investment portfolio.

You've chosen to create solutions focused on specific areas of the private markets universe, as opposed to a catch-all fund-of-funds offering. Why is that?
To start, by setting up strategy-specific fund, you avoid the double layer of fees that almost always come with

fund-of-funds. I don't think that a fund-of-funds vehicle is necessarily in a client's best interest. Plus, we think about it the same way most advisors do when constructing equity allocations. You start by saying, for instance, I want my client to have a 70% exposure to U.S. equities and 30% to international. On the U.S. side, you might subdivide between large caps, small caps, mid caps, and even growth and value. For international, you may opt to put half in Europe, or some in the emerging markets, and so forth. We empower advisors to make those same suballocation decisions for the private markets portion of the portfolio, down to individual companies through Axxes Direct. Plus, as I mentioned, no one firm is good at everything. By targeting specific private market sectors — such as real estate, private equity, credit, and so forth — we can select among the most knowledgeable and proven managers for each one, increasing the odds of investor success.

You referred to fees and illiquidity earlier. Those are often cited as potential drawbacks of private markets investments compared to traditional stocks and bonds. Are these legitimate concerns?

They are, but you can't look at private markets the same way as publicly traded investments. Let's compare private markets to investing in, say, a large cap stock mutual fund. When it comes to investing in the stock fund, you have the option of going with a more expensive large cap active manager or using a cheap index such as the S&P 500. Large cap stocks are highly liquid and the market is very efficient, so it's tougher to make the case for paying high active management fees. However, the private markets are very different and also less efficient. Therefore, fees may be higher, but this can be more than offset by the returns delivered by some of the most successful managers. And the incentives are all aligned to deliver outstanding performance.

Top-quartile private markets managers have a demonstrated record of delivering exceptional returns after all fees are accounted for, and that's exactly what we're looking for at Axxes. I really believe you get what you pay for in this space. Having said that, there's no reason to pay a double layer of expenses, which is why we're creating registered vehicles with direct exposure.

With respect to liquidity, most private markets funds have a defined life of, say, 10 years. Ultimately that's because the underlying investments are illiquid until they get sold or go public. But you can mitigate this by providing investors with periodic liquidity windows, as our vehicles are slated to do. Our funds are being structured to provide at least 5% liquidity to investors every quarter. To be clear, that means if the fund has $1 billion, $50 million is made available every quarter. So, if only 5% of investors want to redeem, a client theoretically could get their entire investment back.

We further expect that the Axxes family of funds will also enable investors to exchange across various Axxes solutions on a regular basis for rebalancing and other purposes.

How would you position the importance of having an allocation to private markets to clients given your experience as an advisor?

I would position private investments as the portion of your portfolio designed to drive higher long-term returns than you can get in the traditional public markets. While the difference of getting an extra percentage point or two each year by adding this exposure may not sound like much, compounded over time, it's huge! People are living longer and will likely need their portfolios to work as hard as possible. This is a great way to get enhanced long-term returns while also lowering overall risk and volatility.

It's also important to note that almost every well-known publicly traded company started out in the private markets. Google, Amazon, and Apple all began as private companies that ultimately went public. Those early private investors enjoyed significant gains.

By the way, there's a growing trend for publicly traded companies to go back to being private, which is another reason to consider this asset class. The number of publicly traded investment options is shrinking dramatically. I was just speaking to a public equity firm the other day that is investing in companies with some of the most exciting artificial intelligence technology I've heard of to date. The only way to participate in the growth of these companies at the moment is through the private markets.

Also, think about Warren Buffett's Berkshire Hathaway. Many people focus on the publicly traded stocks held in Berkshire's portfolio. However, much of the company's value over time has been derived from the private companies in the portfolio, such as Geico.

And through various forms of private debt securities, clients can earn yields and capital appreciation far beyond what one can expect to achieve through the traditional bond markets. That makes a significant difference over time.

With all the market turmoil in recent months, not to mention the slowing economy, is this a good time to be investing in private markets?

I've been doing this for decades and I believe this is actually one of the best entry points I've seen in many years. There's been a big shakedown in the market that has created excellent opportunities on both the credit and equity venture sides. You never want to invest at the top, and I believe we're far from that right now. I'd also emphasize that private investments are meant to be held over a 10-year-plus time frame. As a result, what happens in the short term shouldn't be of great concern. That's also true of the stock market, of course. When I started in this business, the Dow was around 3,000. We've had a lot of economic challenges since then, and yet the Dow is well on its way to 40,000. By the time my kids retire, it's likely to be at 150,000. Returns in the private markets have historically been even more impressive than that. Indeed, I feel the bigger risk is to keep your money tied up in a low-yielding money market fund for the next 20 or 30 years. While the higher yields today may look tempting, that's definitely not where wealth will be made over time.

What are some of the funds Axxes plans to bring to market, and what form will they take?
We intend to have all of our fund solutions registered with the SEC, which means they will be highly transparent and fully regulated. The form is likely to vary over time as we continue to innovate, but we will initially be offering investments in the BDC structure I mentioned earlier. Advisors will be able to easily make purchases on behalf of their clients through a variety of platforms and custodians. Our initial fund will likely focus on private equity co-investments, secondaries, and credit investments. Future offerings, depending on a variety of factors, including market conditions at the time, may include direct lending, real estate equity and debt, distressed credit, leveraged buyouts and control investments, and venture capital.

In addition to the funds, you are starting another division of the company called Axxes Direct. Can you tell us more about that business?
Our vision as a firm is to provide financial advisors with access to the private markets in multiple ways for all of their clients. Axxes Capital is largely built to deliver solutions to mass market accredited investors, which I would estimate to be 80% or more of the average advisor's book of business. That generally means clients with assets of between $500,000 and $10 million. For those larger net worth clients falling into the "qualified purchaser" category, it may be more optimal to provide direct access to specific individual investment opportunities. A fund may hold dozens of underlying companies selected by an experienced manager, which is perfect for most investors. However, some clients may say, "I want to own specific individual businesses." These kinds of opportunities have traditionally only been available to the largest institutional investors.

Through Axxes Direct, RIAs and independent broker-dealers will be able to tap into similar direct opportunities, investing alongside some of the largest private equity firms.

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