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Business

PERSONAL FINANCE

For the affluent, private equity can be worth the risk

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MATTHEW STAVER/THE NEW YORK TIMES

Robert Rich, 76, has put nearly a fifth of his wealth into private equity.

As a young lawyer in New York, Robert Rich sometimes bought stocks based on tips he received while playing squash at the Yale Club. Most of them did not do well, so eventually he chose to put his money into mutual funds and focus on his work.

But then the itch for more control and the potential for bigger gains got the best of him and now, at 76, Rich has put nearly a fifth of his wealth into private equity — an illiquid, risky asset class with returns that range from double digits to a complete loss of principal.

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In this, Rich has been at the vanguard of a wave of affluent do-it-yourselfers investing in private equity by buying into funds that focus on a sector of the economy or on direct investments in particular companies. They most often do this through self-directed individual retirement accounts — a type of account that can invest in nonpublic securities. These accounts have been around since the 1970s and are typically used to invest in real estate.

But in the past five years, the custodians for self-directed IRAs report an increasing interest in private equity. Equity Trust, in Westlake, Ohio, said private equity now accounted for 10 to 15 percent of the $12 billion it holds as a custodian. Pensco Trust Co., based in San Francisco, said 60 percent of new accounts in the past three years had been opened by people who wanted to invest in private equity.

Kelly Rodriques, chief executive and president of Pensco, attributed the increase to the financial crisis. People left or lost jobs and converted their 401(k)s to retirement accounts, and many of them lost confidence in the stock market and became more interested in investing directly in companies.

“It’s more comforting to be in a business or tangible asset that you know,” Rodriques said.

While this may be comforting to certain people, it is not risk-free or easy to do successfully. People investing through self-directed retirement accounts do not have the staff to vet deals the way very wealthy investors do. Nor do they have hundreds of millions of dollars to lessen the sting of a loss.

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Rodriques said his firm, which holds just less than $11 billion as a custodian, focuses on people who are accredited investors — meaning, their annual income has exceeded $200,000 for two consecutive years or they have assets greater than $1 million, not including a primary residence. He said the average account was $250,000.

Self-directed accounts are still a niche. Equity Trust said they accounted for only 2 percent of all money held in IRAs. But the growing interest in private equity shows a shift in some investors' mindset toward what Pensco calls "choose and control."

Today Rich, for example, has investments in separate funds invested in technology, health care, and biotechnology as well as different financial strategies. His most recent investment was in a fund focused on hydraulic fracturing, or fracking — a controversial method for obtaining natural gas. The opportunity came to him like the others.

"The fracking fund was a man I had known for years," he said. "They gave me the opportunity to join it if I wanted to."

This may sound as reckless as getting stock tips on the squash court. But Rich said he had been part of the vetting process for the fund in his role as a trustee for a trust.

"It's a different story from the average guy who wouldn't have access," he said. "If I was someone who hadn't had that access, I'd have been a little more cautious."

Rich's candor points to an important issue for anyone investing in this world: Do your homework, understand the investment and ask why you are being offered it.

"You have to be fully versed in what you're doing," said Robert M. Hofeditz, who works in private equity and also has 40 percent of his wealth invested in private equity, with three-quarters of that in his retirement account. "You have to have a level of expertise to do something like this. It's not for everyone. It's for people who have the time to study the asset class."

Custodians like Equity Trust and Pensco make investing IRA money in private equity fairly easy. They assess the validity of an investment by Internal Revenue Service standards. They also hold the investments, as a traditional custodian would, and process forms, like the ones calling for money.

"Our role is to figure out if something is administratively feasible," said Eileen Loustau, senior vice president and head of marketing at Pensco. "Is this a going concern? Is your paperwork in order?"

The company has developed an online tool that it calls an Opportunity Analyzer. It allows people to check if the IRS would disallow their investment, which could disqualify the whole IRA and result in taxes and penalties.

Red flags for private equity investments through an IRA revolve around who owns the company — ownership by you, your parents or your children would disqualify the investment — or whether the opportunity to invest is part of a compensation package. Knowing someone does not disqualify you.

But making sure an investment will not run afoul of IRS regulations is not the same as assessing whether it is a good investment. Custodians don't do this. Rodriques said, for example, that his firm approved a retirement account investment in an underwater pet cemetery. (The man making the investment owned several pet cemeteries and saw this investment as the next wave, as it were.)

Jeffrey A. Desich, chief executive of Equity Trust, said his firm told clients it was up to them to make sure they understood the investment.

"Private equity provides a lot of opportunity, but one has to do their homework and understand what they're getting into," he said.

With smaller retirement accounts, people tend to make direct investments in a local business — a different level of risk and compliance.

Despite the risks and responsibility of assessing the investment, a self-directed account that is not someone's sole source of income could be a good match of retirement money and private equity investments.

Rich has converted 80 percent of his retirement account to a Roth IRA, which will pay out distributions tax-free, with plans to leave it to his children. But he still brings to bear a certain cautiousness in selecting private equity managers.

"I go with organizations that seem conservative," he said, "and not ones that are trying to hit a home run."