PA Insights: the Advantages of Primary Fund Investing

A carefully constructed portfolio of primary fund investments can offer greater return dispersion and the potential for lower overall portfolio risk

Alternative investment programs are often managed through the use of private investment vehicles, or primary funds, engaged in direct buyout, venture capital, or special situations strategies. These strategies and structures can provide a host of potential advantages to investors, including attractive risk-adjusted returns, low correlations with publicly traded assets, and lower volatility than public markets. However, accessing multiple individual primary funds directly requires having significant assets to invest as well as the appropriate internal infrastructure to research, access and follow the right fund managers. Meanwhile, anything less than a carefully constructed portfolio of such funds can lead to concentration risk in terms of expertise, strategy and diversification.

Accordingly, many investors opt to build their core private equity exposure by investing through a dedicated fund-of-funds vehicle, which can pool, or commingle, capital from a variety of limited partners and deploy it into a wide range of selected primary fund managers. In this manner, an investor may be able to access a far larger number and far broader variety of managers (and the companies held in their respective portfolios) than it could ever do on its own.

Key Takeaways

A primary fund-of-funds can deliver core private equity exposure plus diversification across strategies, geographies, sizes, vintage years and industries.

A fund-of-funds approach can be more cycle-agnostic, avoiding undue exposure to economic swings and swoons.

A deep and wide network of primary fund managers can provide access to best-of-breed managers and also result in promising co-investment and secondary opportunities.

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Distinct Advantages

Aside from reducing the risks associated with investing with only a single primary fund manager, a portfolio of funds sponsored by different managers can provide tremendous diversification benefits across several important criteria, including strategy (buyout, venture capital, special situations, etc.), geography, target size, industry and vintage year.

Similarly, a primary fund's structure and underlying mandate often require a cycle-agnostic approach. Although timing the market is a favorite pastime of many investors in traded markets, the lock-up, long-term investment and realization timeframes of most primary funds mean they are almost certain to go through at least a couple of up- and downdrafts during economic cycles during their lifetimes. As managers do not generally have the option of sitting in cash, they can effectively dollar-cost average their underlying investment portfolios across different stages of a cycle, shifting macro and micro views as necessary to take advantage of major market dislocations or expansions. Over time, this steady-as-you-go discipline across all strategy types and cycle stages means investments can be made during both market swoons and surges, in turn helping to construct portfolios that are not unduly exposed to frothy economic cycles or underexposed during slowdowns or recessions. As a result, there is greater potential for smoother return dispersions over the life of a fund, and the prospect of lower overall portfolio risk.

Another potential key advantage of a fund-of-funds is the ability to be relatively opportunistic. Ultimately, private equity funds may outperform as an asset class because they are intensely focused on those sectors of the economy that are growing the fastest. By nature, these sectors require capital to achieve such growth, but can also benefit from private equity managers' hands-on approach to value creation, including skills in deal structuring, management changes, accretive acquisitions , operating improvements, talent recruitment, growth strategies, and creative exit strategies.

The Network Effect

Successful fund-of-funds managers also share a characteristic that may be a significant advantage: they have deep and broad networks of primary fund managers with whom they invest. In some cases, these networks have been built

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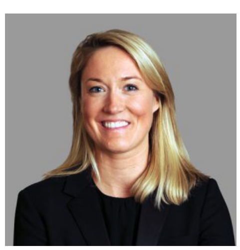

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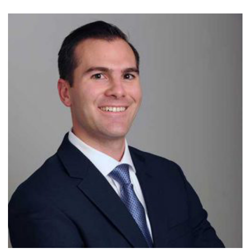

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over decades of experience and extensive due diligence with the managers in question. This creates a depth of knowledge that a stand-alone investor might never attain. For example, knowing a particular fund manager's loss rates and dispersion of returns across different portfolios of underlying company investments helps in understanding the volatility and consistency of returns. This can help answer questions such as: How much of a fund's performance can be traced back to one or two home runs? What are the investment team's performance attributions, depth and motivations?

A broad base of manager knowledge can also shed light on questions such as: What is a fund's risk profile on both an absolute basis and relative to its strategy? How does a fund manager create value in its investments – does it rely on purchase price discipline, multiple expansion, revenue growth or the use of leverage? Qualitatively, what are the manager's competitive advantages in sourcing, operating capabilities and reputation within certain sectors? What is the manager's team depth and organizational stability? All of these questions are easier to answer when armed with comprehensive, multi-year experience in working with managers.

Moreover, such networks can provide access to specific best-of-breed managers, sector expertise, oversubscribed established funds, and outstanding new ones – all of which can add tremendous value, diversification and risk reduction to an investor in a private equity program. Another possible benefit of a strong underlying network of primary fund managers is the potential for promising tangential opportunities. Co-investments and secondaries can complement a fund-of-funds manager's activities and allow for selectively targeting investments with outperforming managers.

The fund-of-funds space has experienced a natural maturation since the financial crisis, as allocations to alternative investments in general (and private equity in particular) have increased. As those allocation percentages have grown, the larger dollar amounts being devoted to the segment by larger institutional investors have increasingly justified building in-house teams to craft the kind of primary portfolios discussed above. However, for many smaller institutions, family offices, foundations and endowments, the numbers still don't add up – in-house management of a primary fund portfolio remains too costly and difficult to manage successfully. In such cases, a fund-of-funds solution may still be the right approach, as it delivers the private equity exposure desired at a nominal cost and is already inclusive of the arduous due diligence and comprehensive risk management work that can take years to develop.

The Bottom Line

Consistency is the key. Any good manager can run into a rough patch, and every economic sector and industry will go through up and down cycles. On balance, a primary fund-of-funds made up of heavily-vetted, high-quality underlying managers, chosen for their qualitative and quantitative attributes, can appropriately serve as an investor's core private equity exposure. Diversified across multiple criteria – sectors, sizes, managers, geographies, etc. – such funds can provide the attractive risk-adjusted return, correlation and diversification benefits of the private equity asset class. ■

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