Secondary Strategy in Private Equity

As discussed in the second episode of this series (link), launching an illiquid investment program is a challenging and more complex process than investing in traditional assets. This third report aims to explore further this discussion, demonstrating how allocating to secondary funds can also optimize other risks associated with illiquid investments, such as concentration in specific strategies or vintages, the risk of "blind pool," and the difficulty of accessing renowned managers.

Exposure to Specific Strategies or Vintages:

When it comes to **illiquid investments,** there is a wide range of strategies to explore, the main ones being **Private Equity (PE), Venture Capital (VC), Private Debt (PD), Infrastructure (Infra), Real Estate (RE), and Natural Resources (NR).**

Diversifying across all investment strategies is crucial for **managing risks and optimizing returns.** Each of these strategies operates in different sectors, regions, and stages of the asset lifecycle, meaning they are subject to various types of risks and opportunities. Diversification helps **mitigate exposure to market or sector-specific shocks while capturing growth potential across different economic conditions.** This results in a more balanced portfolio, capable of withstanding volatility and maximizing returns over time.

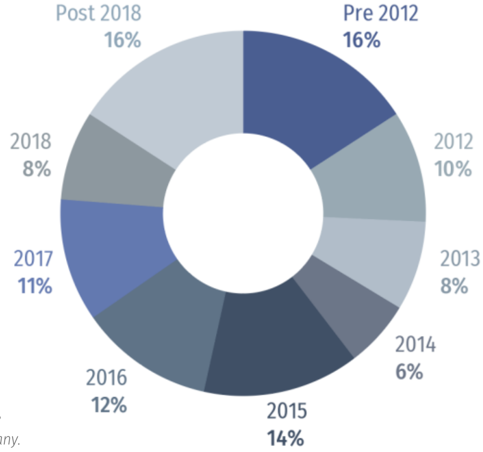
Private equity vintages, on the other hand, are similar to wine vintages: in the same way that the year in which the grapes are harvested is crucial, as weather conditions such as the amount of sun, rain and temperature affect the quality of the grapes, **the year in which a private equity fund is launched** (the "vintage year") **is influenced by the economic environment and market conditions.** A similar process of planting, harvesting, and bottling (or sourcing, diligence, and investing) can result in either good or bad vintages, depending on the macroeconomic conditions.

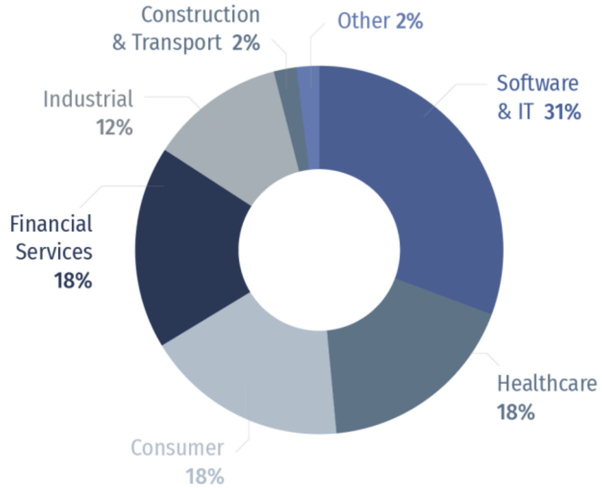
Therefore, **each vintage year can have different risk and return characteristics**—and **diversifying** across different vintages is an essential **strategy to mitigate the risk associated with investing in a single economic cycle.**

However, for **an investor starting an illiquid investment program,** balancing the initial allocation across different strategies and vintages can be extremely challenging. Illiquid funds **often require a substantial capital commitment as a minimum investment,** and **the availability of funds in the fundraising phase is limited, complicating immediate diversification.** Moreover, by **beginning** an illiquid investment program, the investor is automatically **committing to a specific vintage,** which can increase exposure to risks related to the economic conditions at the time the capital is invested.

The good news is that **secondary funds can aid in this diversification by allowing investors to access stakes in existing funds** that have already progressed through part of their lifecycle. This provides **exposure to multiple vintages at once,** helping to balance the program and mitigate risks associated with investing in a single vintage year. Additionally, by acquiring shares in several funds, investors gain immediate diversification across managers, strategies, sectors, and geographies, without having to wait for multiple fundraising cycles, which would be necessary with primary investments.

For example, the graphs below show the exposure of **Coller Capital's funds,** one of the world's leading and oldest secondary fund managers, **to different vintages and industries.** If an investor chose to **invest** in Coller's Fund VIII, **established in 2020,** they would gain **exposure not only to vintages** from 2012 but also to those from each year between 2013 and 2020. Moreover, the **portfolio** would be highly **diversified** across various industries.





Source: Coller as of March 2024. Percentages are calculated based on FMV by the portfolio company.

Secondary Strategy in Private Equity

The diversification provided by secondary funds results in a **reduced investment risk.** Since secondary funds include a variety of positions that respond differently to various economic scenarios (due to their low correlation), they tend to **deliver more stable and consistent returns compared to primary investments,** while maintaining the same level of risk. This makes secondary funds an attractive option for investors seeking to balance return and volatility in their illiquid investment portfolios.

Blind pool risk

Secondary funds help mitigate the "blind pool risk" associated with alternative investment programs. This risk arises when investors commit capital to a traditional private equity fund without knowing which assets or companies the fund will invest in.

Investing **in secondary markets reduces blind pool risk** by providing **greater visibility into the underlying assets,** allowing managers to evaluate the existing portfolio in advance. Moreover, both managers and investors can access the historical performance of these assets, **enabling a more accurate assessment of risk and potential returns.** This added transparency **decreases the uncertainty** associated with funds where assets have not yet been selected, reducing reliance on the manager's future decisions and enabling more informed and strategic diversification.

In this sense, investing in secondary funds **is analogous to joining a poker tournament in its later rounds, where the cards are already on the table,** and you have a clear view of how the other players are performing. While other players who entered from the start may have made risky bets that resulted in extraordinary returns (like in PE or VC funds), **you have the advantage of making informed decisions based on what has already happened.** This reduces the chances of an unexpected bluff or risky move that could negatively impact your balance, providing a safer and more predictable path to consistent gains.

Access to Managers

Even after an investor sets the guidelines for their alternative investment program, implementing these investments can be extremely challenging due to limited **access to top managers. Private equity funds with an established reputation attract a highly selective investor base. When launching a new fund, they typically prioritize those who have an existing relationship from previous vintages, share a long-term vision, and are aligned with the fund's strategy.** Additionally, these managers often require a **high minimum investment,** aiming to reduce the number of relationships they need to manage, which primarily limits access to institutional investors or high-net-worth individuals. It's almost like a reverse due diligence process, where **the manager selects the investor.** This, combined with the fact **that opportunities to invest are restricted to specific** fundraising cycles, makes access to these investments even **more exclusive and reserved** for a limited group of participants.

In this context, **secondary funds** can again serve as a **strategic shortcut to accessing renowned managers,** allowing **the acquisition of stakes in funds that are already closed** to new investors. Using the example of **Coller Capital's** portfolio, if an investor decided to **invest in the manager's Fund VIII,** they would automatically gain **access to 278 private market managers** with different investment strategies.

Case Study: Coller Diversification

Fund	CIP I	CIP II	CIP III	CIP IV	CIP V	CIP VI	CIP VII	CIP VIII
Number of underlying portfolio companies	250+	150+	600+	1,800+	1.200+	1,950+	2,600+	2,750+
Number of underlying GPs	28	15	26	96	75	199	235	278

2024

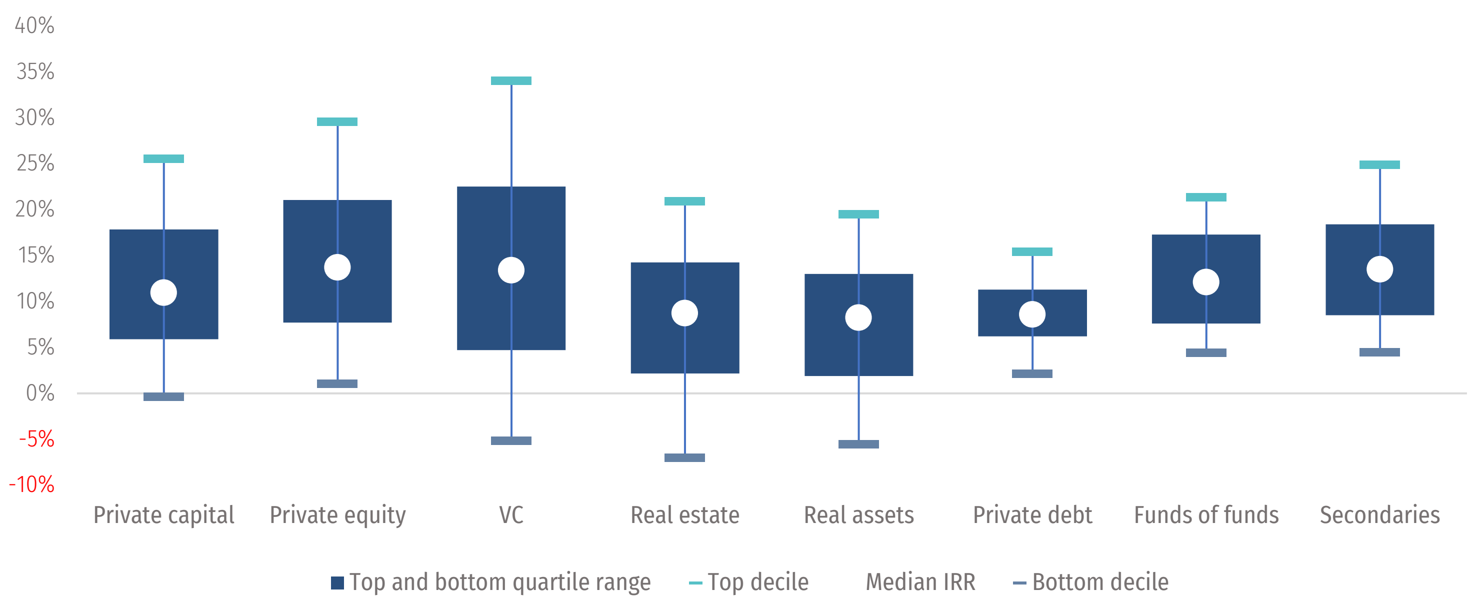
Secondary Strategy in Private Equity

Gaining **access to elite private equity managers is like landing a table at a three-star Michelin restaurant with a months-long waiting list.** Just as these exclusive restaurants reserve limited spots for their regular, preferred guests, **top private equity managers favor investors who already have a strong relationship and demonstrate a significant commitment to** the firm. However, just as last-minute cancellations can open up a coveted table, **secondary** private equity **funds offer investors the opportunity to acquire stakes in existing,** hard-to-access funds with limited capacity.

Using Secondary Funds to Optimize Portfolio Performance

In this third report of the series, we explore the complexities of launching an illiquid investment program, **with a particular emphasis on how allocating to secondary funds can help mitigate risks commonly associated with alternative investments.** These risks include concentration in specific strategies or vintages, blind pool risk, and the challenges of gaining access to top-tier managers.

The historical data presented in the graph below illustrates that **secondary funds have almost never led to losses for investors and exhibit significantly lower return dispersion compared to other alternative strategies.** In other words, while certain PE and VC funds may achieve exceptionally high returns, **secondary funds consistently offer more stable and superior overall returns.**



Interpretation of the boxplot graph: The central box of the graph encompasses 50% of the data, while the lines extending from the box indicate the range of the data up to the minimum and maximum values, excluding outliers. The median is represented by the sphere inside the box.

That's why secondary funds stand out as a **valuable tool for balancing return and volatility,** making them an **attractive choice for investors seeking stability and better risk-adjusted returns** in their alternative investment portfolios.

Know more about secondaries

Contact us hmccapital@hmccap.com www.hmccap.com

BRAZIL Sao Paulo | CHILE Santiago | COLOMBIA Bogota & Medellin | MEXICO Mexico City | PERU Lima | UNITED KINGDOM London | UNITED STATES New York