

# LP Led Secondaries - the private market ETF equivalent?

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- Illiquid alternatives have gone mainstream even among investors who lack the resources of the large endowments that pioneered them.
- This raises the question of how capital and resource-constrained institutions and individuals can construct diversified private market portfolios most effectively.
- Traditionally, funds of funds have been the most prevalent response, but they continue to be a costly solution.
- In our second Private Market Primer, we are, therefore, providing an introduction to LP Led Secondaries and illustrating why we consider this growing corner of the market a very compelling core building block, in particular during the initial ramp-up of an alternative investment program.

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**The lack of mark-to-market valuation in unlisted securities and the asset classes' high expected returns can induce a dangerously blasé attitude towards cost and risk management. Public market investors holding concentrated positions are likely to quickly learn the hard way what it means to experience 40% or 50% volatility. Still, in private markets, they may sit on a concentrated portfolio of single asset club deals or specialized Private Equity funds with 5 or 10 positions for years without seeing its fragility.**

## 1 From practice to theory

The idea that diversification reduces risk is pretty intuitive and probably as old as humanity. It has most famously been expressed in the proverbial advice not to "put all one's eggs in one basket", a phrase first found in writing in the 17<sup>th</sup> century novel *Don Quixote* [2]. An early proven example of the concept being understood and applied in finance includes the below quote by Shakespeare's Antonio in the "Merchant of Venice".

My venture is not in the bottom trusted,  
Nor to one place, nor is my whole estate  
Upon the fortune of this present year;  
Therefore, my merchandise makes me not sad

Investment trusts in the UK offered so-called 'averaging of risk' as a service even before the First World War, and historical holding data reveals that these firms used impressively sophisticated asset management techniques [4]. Nevertheless, it took another century until Harry

Markowitz and Andrew Donald Roy adequately laid out the theoretical concept and quantitative formula nowadays known as Modern Portfolio Theory (MPT) [9]. The subsequent decades have witnessed many advances in portfolio construction and diversification across and within asset classes driven by increasing financial market integration, deregulation, the maturing of emerging markets, and technological and financial innovation. The latter includes introducing sophisticated portfolio optimization procedures, risk management software, trading systems, and swap-based index replication methods that have fueled the spectacular rise of low-cost ETFs. Consequently, in public stock and bond markets, even retail investors are nowadays able to construct efficient portfolios comprising thousands of securities at almost no cost.

## 2 Diversification in the endowment model

While Modern Portfolio Theory and innovation in the mutual funds and ETF industry have given rise to the traditional 60/40 portfolio, more recently, a portfolio management style dubbed the endowment model has become increasingly popular. The name stems from its close association with the endowments of leading U.S. universities, most importantly Yale. The endowment-style portfolio is characterized by a significant allocation to so-called alternative asset classes like Hedge Funds, Private Equity, Venture Capital, and Real Estate. Over the past years, its popularization has consequently supported strong growth in private markets. The case

for the endowment model thereby rests on two assumptions.

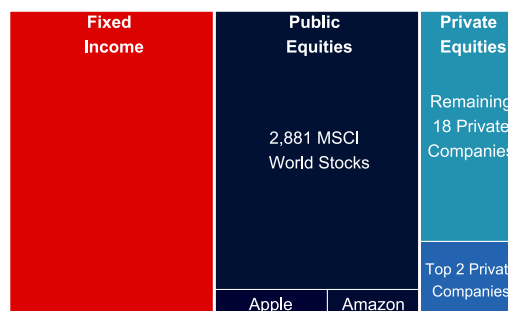
- Illiquid alternatives, such as Private Equity and Venture Capital, can help investors generate higher absolute returns than public equities. Ceteris paribus, this feature shifts the position of the max-return portfolio upward - and we also argue to the right.
- Allocating capital beyond the public market resembles greater diversification and thus allows market participants to realize higher risk-adjusted returns. Ceteris paribus, this feature shifts the entire efficient frontier to the left.

In the context of private markets, the diversification argument, however, is a two-edged sword. In principle, venturing out of the public realm should allow investors to reap further diversification benefits. Allocations to Private Equity and Venture Capital, while still representing equity investments, are, for instance, likely to be less exposed to sudden liquidity-driven shocks like flash crashes, frequently observed in public markets. However, there are several caveats when diversifying into illiquid assets, especially for smaller investors like wealthy individuals.

- While ETF investors are used to owning funds with hundreds or thousands of positions, the typical buyout or infrastructure fund holds around 10-20 companies and thus qualifies as highly concentrated.
- Primary funds build and unwind portfolios over investment and divestment periods lasting several years, which implies that for extended periods, limited partners (LPs) will be exposed to and depend on the performance of a few companies only.
- Investors who desire to diversify across private market funds can not deploy their capital at the click of a button but are subject to the fundraising windows of their selected managers.
- The market's lesser transparency, the complexity of reporting and cash management, the need for time-consuming due diligence, and minimum ticket sizes of often USD 1-5m further complicate diversification across primary funds.

In consequence, end investors pursuing the endowment model are at risk of overestimating the level of diversification they genuinely achieve. Given a minimum ticket size of USD 1m, A wealthy individual with a USD 10m portfolio who decides to allocate 20% to private markets may end up subscribing to two buyout funds targeting 10 underlying holdings each. Some firms may have considerably higher weights within these two portfolios than others, e.g. >25%. In the end, as Figure [concentration\_buyouts] illustrates, on a look-through basis, our hypothetical individual may eventually have a portfolio in which one or two typically tiny private companies command a higher

Example Endowment Portfolio with 2 Buyout Funds



Source: Bloomberg, Amadeus Capital SA

**Figure 1:** Venturing out of the public realm should, in theory, offers diversification benefits. However, in the presence of cumbersome due diligence, subscription processes, and high minimum ticket sizes, end investors, especially in private wealth, may end up overweighting a few small corporations resulting in inefficient portfolios.

weight than the world's largest and most successful corporations.

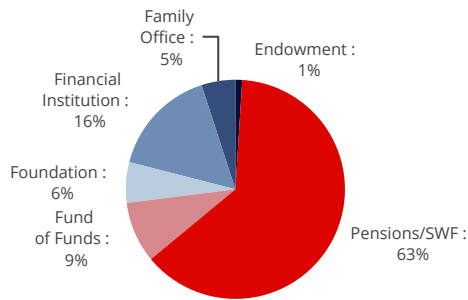
### 3 Tackling the diversification problem

The most obvious approach to a smaller investor's scale problem is the fund-of-Funds. According to Preqin data, the industry accounted for USD 1.1tn AuM, roughly 16% of Private Equity's total assets under management (AuM) [7]. However, the drawbacks of this model are also evident. Funds-of-Funds are known to come with a rather unattractive cost structure, layering management, and performance fees. In this article, we are, therefore, focusing on another smaller but fast-growing market: LP Led Secondaries. As of 2020, Private Equity Secondaries funds managed around USD 300bn, out of which a bit more than USD 150bn were dry powder [3]. Transaction volumes reached USD 130bn in 2021 with an almost equal split between GP Leds and LP Leds [8].

For clarification, this article refers to Secondaries as LP Leds since we covered GP Led Secondaries in our first [Private Market Primer](#). The differentiation is not always straightforward as many Secondaries funds pursue a mix of LP and GP Leds. However, market participants typically specialize in and consequently overweight one of the categories. Furthermore, while we often refer to Private Equity, the dominant asset class in the private space, there are LP Led Secondaries funds pursuing investments in Venture Capital, Infrastructure, and Real Estate, and the statements and analysis quoted here are equally relevant for these products.

LP Led Secondaries describe deals in the secondary market in which a buyer acquires a stake in a fund or a portfolio of funds from a limited partner (LP), thus

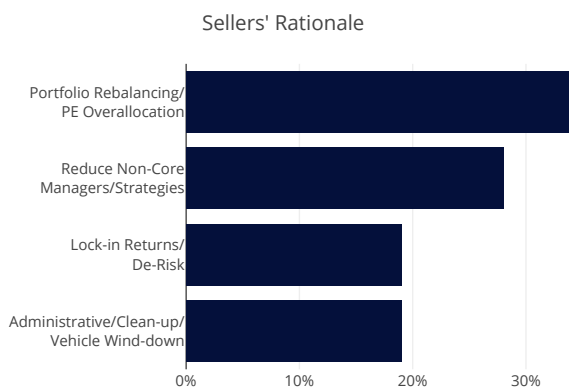
LP portfolio transaction volume by seller type (2022)



Source: Jefferies [5], Amadeus Capital SA  
**Figure 2:** Large institutional investors dominate the secondary market.

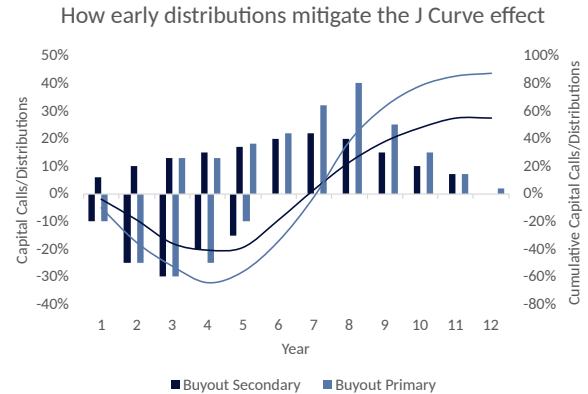
providing liquidity to an investor who wants to prematurely exit one or several closed-end fund investments. While still small as a percentage of global private equity AuM, trading LP stakes in the secondary market has become increasingly common. Most importantly, what used to be a stigmatized emergency solution for distressed investors searching for urgent liquidity, has inched closer to becoming a standard tool in active private market portfolio management.

This evolution in the market’s perception of the space is underpinned by the seller’s stated rationales and the heavy involvement of large institutional investors, particularly pension funds and sovereign wealth funds in the market. As Figure 2 illustrates, in 2022, almost two-thirds of transaction volume in LP stakes was generated by disposals by these two investor types, followed by Financial Institutions and Funds-of-Funds. Not surprisingly, looking at the deal count, smaller players command a bigger share of the pie, but pension funds, sovereign wealth funds, and funds-of-funds still account for more than half of all transactions. More importantly, as Figure 4 shows, transactions are frequently motivated by typical active management tactics



Source: Jefferies [6], Amadeus Capital SA  
**Figure 3:** As secondary trading is becoming more common, sellers’ most common motivations have evolved.

such as rebalancings or changes in the desired allocation to specific funds or managers. Both observations point to a convergence of public and private markets in some ways, with maturing private markets becoming more easily accessible and thus traded more actively by a growing number of investors.

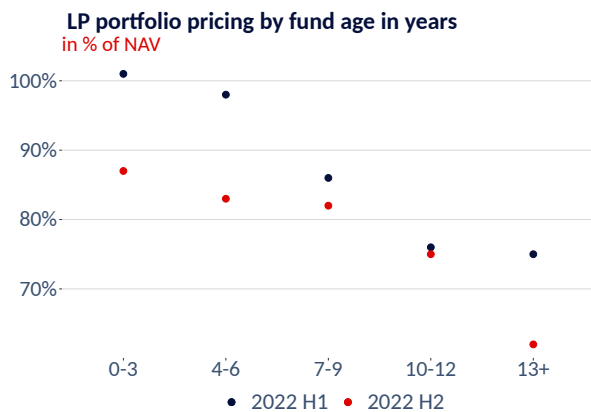


Source: Amadeus Capital SA  
**Figure 4:** Secondaries investors pre-buy into portfolios that have reached the end of the investment period (years 4-6). This results in a significantly faster return of capital to LPs. The graphic serves illustrative purposes only but uses average values published by Cambridge Associates in 2017 as an indicative basis. [1]

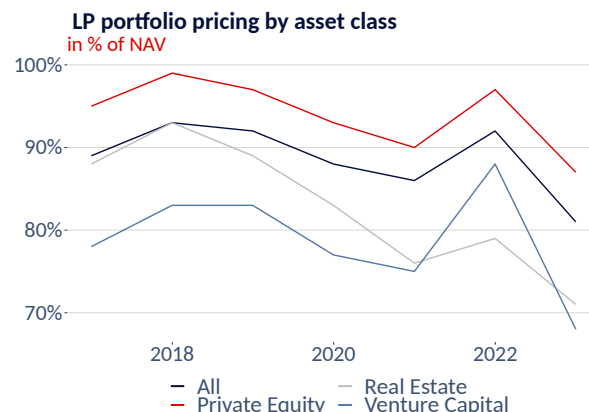
#### 4 A scale game

It is straightforward to see how actors in the space can quickly construct highly diversified portfolios. In large-scale transactions between market-leading Secondaries funds and large pension schemes, portfolios of dozens of positions can change hands. Consequently, even smaller Secondaries funds may own 50-100 underlying assets instead of the 10-20 companies typically held in a buyout fund, while bigger funds focusing on LP Led can have 100s or more than a thousand underlying assets. Moreover, by acquiring funds launched at different times, Secondaries can achieve adequate vintage-year diversification despite typically deploying capital faster than primary funds. This brings us directly to another important aspect: the so-called J Curve mitigation.

Private market funds usually call and deploy investors’ capital over several years while distributions are back-end loaded, especially in the new world of Private Equity driven buy-and-build activity. In a common buyout fund, the GP will focus on repaying debt first and return the bulk of the LPs’ money upon the successful exit. As Secondaries funds acquire vehicles already in harvesting or divestment mode (often in years 4-6), they tend to see cashflows much faster, making them especially interesting for investors more concerned about liquidity and the reliability of stated valuations. Notably, the accelerated deployment and distribution profile can be a



**Source:** Jefferies [6], Amadeus Capital SA  
**Figure 5:** Discounts are elevated for older portfolios as secondary market investors attempt to reach their MOIC targets within a shorter estimated lifetime. Older funds are also likely to be subject to greater public market sensitivity as they seek exits through trade sales or IPOs.



**Source:** Jefferies [6], Amadeus Capital SA  
**Figure 6:** Discounts have widened in 2022 and 2023, with Venture Capital and Real Estate being seriously under pressure. Investors should be cautious and avoid putting too much emphasis on headline discounts to stale NAVs but ensure that the products they invest in get the underwriting right.

two-edged sword as it confronts LPs with the challenge of rapidly re-deployment funds to minimize the cash drag in IRRs. Given that maximum net cash drawdowns often don't exceed 50% to 60%, LPs will tend to over-commit to achieve desired deployment levels. While LP Led typically target a slightly lower MOIC (Multiple on Invested Capital), market participants who care about DPI (Distributions to Paid-in Capital) may be happy to accept this trade-off. High DPIs also reduce investor risk during the due diligence phase, especially when dealing with younger managers. Seemingly successful GPs will typically raise new funds once every few years. This implies that a manager may be pitching for Fund III or IV, pointing to high IRRs (Internal Rate of Return) and MOIC in Fund I and II while most of the money deployed by these products is effectively still in the ground. The practice puts critical investors in the uncomfortable position of having to trust a GP's capability to generate value at a point in time where it has delivered mostly paper gains. As various GPs utilize the substantial degrees of freedom available in determining NAVs differently, with some firms staying closer to public market benchmarks than others, it is thus also difficult to compare unrealized IRRs and MOICs across the universe. The size of transactions, the number of underlying assets, and the relationships required to underwrite deals efficiently can intuitively be expected to result in significant economies of scale. While buy-out funds and GP Led are a preferred playing field for corporate finance experts diving deeply into a limited number of companies, Secondaries focused on buying diversified portfolios are more concerned with the fast pricing of a large number of assets.

This tends to be a much more high-level, data-driven exercise. Leading funds, therefore, benefit from advanced technology (e.e. proprietary AI-driven applications for automated extraction of key figures from

data rooms) and broad but possibly more high-level knowledge of the private industry landscape. It is thus not surprising that the market for LP Led is highly concentrated, with industry sources estimating that the most prominent four players account for roughly 50% of transaction volume - a concentration level not far from that observed in the ETF market where Blackrock, SPDR, and Vanguard controlled almost 80% of the U.S. market in 2022 [11].

## 5 The pricing of LP stakes

Despite becoming more common and widely accepted, Secondaries transactions in LP stakes are typically traded at discounts to their NAV. This discount reflects the significant transaction costs involved, including due diligence by the buyer on a look-through basis and the legal and negotiation work required to transfer stakes in private market funds, often demanding approval from all GPs involved. Beyond that, research reveals that discounts are time-varying and significantly widened more recently with the slump in public market equivalents. Furthermore, there has been a strong link between discounts in the Secondaries markets and a fund's lifecycle stage during the current cycle. In 2022, discounts were significantly higher for older funds (see Figure 5) and, according to market participants, also tended to expand more for large-cap funds compared to mid-market products.

Lastly, according to Jefferies over the past years, discounts increased substantially more in Real Estate and Venture Capital than in Private Equity and are higher in Europe than in the U.S. Intuitively, times of elevated volatility should increase buyers' negotiation power with distressed buyers seeking liquidity or attempting to rebalance their portfolios. However, beyond this, as



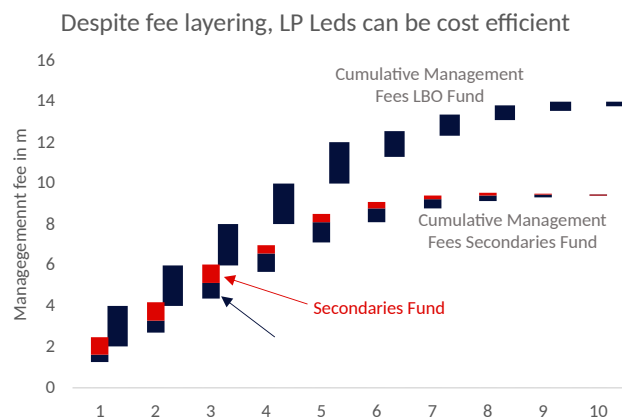
Figure 6 indicates discounts are highest and increased most pronouncedly in asset classes where public market valuations dropped strongest (Real Estate, Growth) and for assets most exposed to public market conditions (large companies close to an IPO, older funds in exiting mode).

Discounts in secondary markets thus indicate some distrust in stated, typically smoothed, and infrequently updated valuations. For investors in LP Led, this is good news. As assets in the secondary markets are repriced more actively, the chance of overpaying for a portfolio is diminished. The category can even be viewed as a countercyclical play. With limited dry powder in the secondary market, it is likely that difficult times during which many investors, and especially the most recent and inexperienced joiners in the private realm, seek an exit, can deliver real bargains.

## 6 Cost efficiency in the presence of fee layering

As outlined, LP Led have many merits but what about the drawbacks? One point that investors need to consider is the additional layer of fees. Market-leading Secondaries funds charge management fees of typically 1% during the investment phase, 0.75% to 1% during the harvesting phase, and carried interest of 10-15% with hurdle rates around 8%. These costs come on top of the fees taken by the primary funds held in the portfolio (often 2% management fee and 20% performance fee). It thus induces a fee layering problem already familiar to the Fund-of-Funds world. Fortunately, there are mitigating factors, and some market participants argue that the total fee burden of Secondaries funds may even be lower than that of primary funds. First of all, Secondary funds usually hold products that are past their investment phase and, therefore, don't charge on committed capital but instead take a typically lower fee on the capital deployed.

Secondly, LPs may indirectly benefit from primary funds' size discounts frequently given to important investors if a Secondaries fund purchases portfolios from sizable pension funds or sovereign wealth funds. This being said, it is difficult to derive a total fee load for a Secondaries fund on a look-through basis, and we have yet to see products disclosing this figure. However, it is possible to run simulations based on usual commitment schedules. Figure 8 illustrates this, comparing the management fees paid to a buyout fund with that charged by a diversified LP Led fund and its underlying portfolio positions. We hereby assumed a buyout fund charging 2% on committed capital during an investment period lasting five years and 1.5% of deployed capital thereafter. Furthermore, we took the assumption that the Secondaries fund charges 1% during a 3-year investment phase and 0.75% afterwards.



Source: Amadeus Capital SA

**Figure 7:** The inherent cost inefficiency of the J Curve is a factor often overlooked in primary funds. Private market funds typically charge 2% on a not-yet-existing portfolio during the investment period. By avoiding this time, Secondaries funds, LP and GP Led alike, can effectively be cost-efficient despite a second layer of management fees. Admittedly, there still needs to be more transparency around products' total fee load, especially once performance fees are considered. The graphic uses the same J Curve for the primary fund and the portfolio holdings in the Secondaries fund but assumes that the latter holds five different vintages.

Lastly, we assumed that the Secondaries fund holds a portfolio of 5 primary funds, which it acquires at the end of their respective investment phases. The Secondaries fund is thus subject to minimal J-Curve effect and pays fees only on deployed capital. In both cases, we express fees in millions, assuming a total committed capital of 100m. Based on these input parameters, we find that despite the layering fee effect, investors in the Secondaries fund would pay more than 23% fewer management fees over the fund's lifetime than the LPs of the similarly sized direct fund.

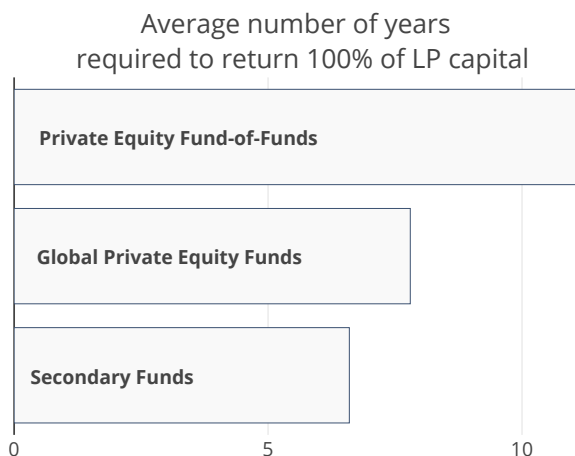
The average annual management fee as a percentage of committed capital would be 1.1% instead of 1.4%. As Secondaries funds typically have a lower maximum net cash outlay (60% vs >90%) and a lower level of capital deployed relative to committed capital, we also looked at average total fee load as a percentage of capital deployed and maximum net cash outlay. Here, the primary fund compares favourably (3% vs 3.2% and 1.4% vs 1.6%, respectively). Nevertheless, this relatively small difference doesn't question the relatively high cost-efficiency obtained by LP Led despite the fee layering problem. Lastly, this analysis does not account for mitigating other costs typically incurred by investors in primary funds during the investment phase, such as setup costs, due diligence charges, and deal break fees.

## 7 Conclusion

Funds focused on LP Led Secondaries are the most diversified products in the private market universe and, thus, a great cornerstone investment for end investors. While some degree of fee layering is inevitable effective expense ratios can in fact, be close to those of primary funds and reasonably be expected to be more attractive than those of Funds-of-Funds Absolute return expectations in the space are lower, with LP Leds targeting MOICs of around 1.5x-1.7x (but may in some cases seek to up the numbers with leverage) compared to the 2x primary funds and GP Leds aspire to [10]. However, given the faster deployment and return of capital, leading to a substantially lower maximum net cash outlay, this can still translate into very attractive IRRs.

In a “walk before you run” approach, rather than starting with direct fund investments, many investors build exposure and knowledge through the use of funds-of-funds (FOFs), and some start programs with secondary funds.

*Cambridge Associates*



**Source:** *Cambridge Associates[1], Amadeus Capital SA*  
**Figure 8:** *According to a 2017 research by Cambridge Associates Secondaries funds on average achieved 100% DPI more than one year earlier than primary funds and almost 5 years before Funds-of-Funds.*

On balance, the space thus offers a very appealing value proposition, particularly during times of financial distress with elevated discounts. While the industry has produced a growing number of products with differentiated offerings, investors need to remember that LP LEDs are the area where scale matters the most, resulting in significant market concentration. Apart from selecting the right partner, effective cash recycling remains a crucial challenge for investors in the space. While Secondaries offer an excellent route into the private market, LPs must stay on the ball to avoid being weighed down by the cash drag.

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We offer a one-stop solution to wealthy individuals and families including private office services, portfolio consolidation, and discretionary portfolio management and advisory.

With a diverse team of investment professionals, Amadeus tailors customized investment solutions including globally diversified, cost-efficient core portfolios, liquid alternative strategies, and private market exposure.

<https://www.amadeus.ch/>

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