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Buy-and-hold is becoming blasé in private equity. The hot new trend: Trading fund stakes like stocks

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A new mentality is upending decades-old norms in the trillion-dollar global private equity industry, with fund investors trading their holdings like public stocks at a record pace.

For decades, swapping a position in a private equity fund was almost unheard of, because the industry was built on a particular mould of the buy-and-hold model. Investors in a fund typically had to commit their money for at least five years. The fund manager, known as the general partner, was expected to return their capital by the seven-year mark, as well as any profits.

"In the early 2000s, if you called up a general partner and said you wanted to transfer your fund interest, you might get hung up on," Tom Kerr, global head of secondaries at U.S.-based Hamilton Lane, said in an interview. The thinking at the time: "You're supposed to be my partner, this is not what I signed up for. When I raise my next fund, don't call me."

That mentality does not fly any more. "Today, not only is the fund manager prepared for [a trade]," Mr. Kerr said, "they're embracing it." Close to US$100-billion worth of global private equity investments are expected to change hands this year, up from US$2-billion annually in the early 2000s, according to Hamilton Lane.

The secondaries market, as it is known in the industry, has exploded so quickly that private equity managers are now raising record amounts of capital for funds whose sole purpose is to buy and sell these private stakes. In February, Hamilton Lane closed its fifth secondaries fund and raised US$3.9-billion, its largest amount to date.

Geographically, New York and London are major hubs for the growing business, but Toronto also has a cluster of deeply respected players. Brookfield Asset Management recently launched a secondaries division. Northleaf Capital Partners, which specializes in mid-market private equity, recently hired away the Canada Pension Plan Investment Board's head of private equity to run its secondaries arm. And Whitehorse Liquidity

Partners, one of the best-known names in secondaries, was founded by a former head of secondaries at CPPIB.

The rapid growth of the secondaries market is reminiscent of the global rush to alternative investments around 2015. At the time, low-cost exchange-traded funds were taking the shine off of mutual funds. To deliver outsized returns that justified their higher fees, institutional money managers started pouring money into non-publicly traded asset classes such as real estate, private debt and infrastructure.

This flood of money also made its way into private equity funds, which prompted more sales. Secondaries trading started growing after the 2008-09 global financial crisis. Trading volume then picked up significantly in 2017 and 2018, according to data from Jefferies Group LLC, a New York investment bank, peaking at US$88-billion in 2019 before the COVID-19 pandemic hit.

Trading has also picked up because private equity norms are changing. The secondaries market used to be dominated by institutions such as pension funds and university endowments that needed to diversify their assets. “If they’re overweight in a geography, or in a certain sector, they can use the [secondaries] market to manage their portfolios,” said Michael Flood, Northleaf’s private equity head.

This type of activity now makes up roughly half of secondaries trading volumes, according to Northleaf. The other half is driven by general partners of private equity funds who are “looking to hold their prized assets longer,” Mr. Flood said.

Historically, fund managers had very little flexibility. They would use the capital they raised to invest in a portfolio of private companies. By the seven-year mark, however, they would have to sell the holdings – often by taking the companies public – to return capital to fund investors.

But with private markets growing in size, it is possible to hold onto private investments longer – in fact, some companies may never need to go public. Yet fund investors often still want their money back, so the fund manager will help facilitate a secondaries trade so the fund can stay invested in prized assets.

The secondaries market is now also so sophisticated that there are different types of trades. In addition to buying and selling fund positions outright, some secondary managers offer deferred purchases that buy part of a fund position, while others sell private preferred shares, which is Whitehorse’s specialty.

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