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The Case for Private Equity Co-Investment Funds

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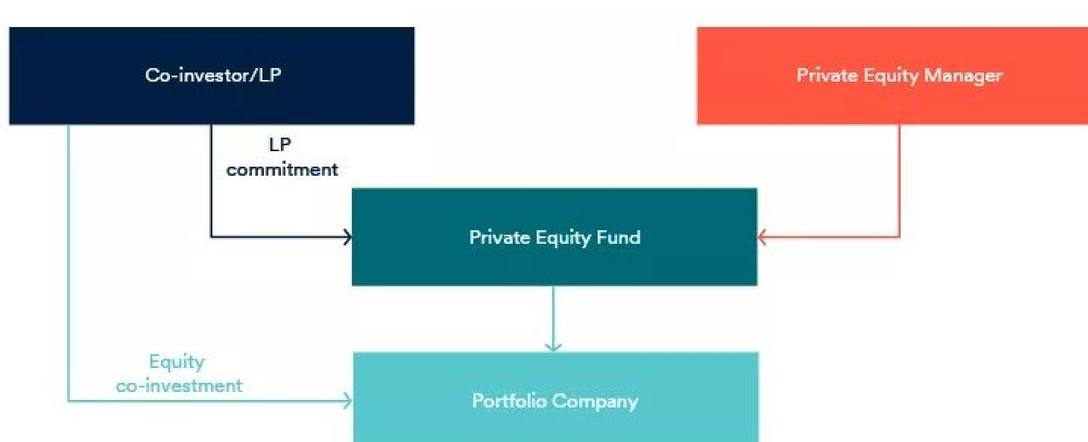
By: Kevin Schmid, CFA, CAIA, Institutional Investment Consulting

Allocating to private equity can provide institutional investors an opportunity to improve the risk-adjusted return of a broad institutional portfolio. As with any asset class, investors should seek to construct a diversified portfolio to mitigate the risk of any single investment; this is particularly pertinent to private equity, where individual private equity funds can be relatively concentrated in terms of number of investments or sector or geographic exposure. Achieving diversification in private equity, however, can be difficult, time-consuming, and expensive. Common approaches include investing in a "fund-of-funds" vehicle or building a portfolio of single fund exposures. Another method that can prove effective is investing in a "co-investment fund," which offers a way for investors to gain access to a wide range of private equity fund sponsors in a cost-effective manner. In this paper, we will explain what co-investment funds are, the structural advantages of co-investing, the current market dynamics that are proving favorable to such investments, and the potential risks that should be considered.

What Is Private Equity Co-Investing?

A private equity co-investment is a minority investment made directly into a company alongside a private equity fund sponsor who is taking a controlling interest in that company. A co-investment fund is designed to build a portfolio of these minority investments, partnering with multiple private equity fund sponsors to build a diversified portfolio.[1]



Private equity fund sponsors may solicit co-investors for individual deals for multiple reasons, including the desire to:

- expand the range of potential investment options by increasing the capital that can be invested in a single deal,
- avoid unwanted concentration risk in their funds, and/or
- strengthen relationships with their investor base of limited partners who can provide co-investment capital.

[1] Using diversification as part of your investment strategy neither assures nor guarantees better performance and cannot protect against loss of principal due to changing market conditions.

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Structural Advantages of Co-Investment Funds

Cost

Private equity has the potential to generate outsized returns relative to public equity markets, but at a significantly higher cost in the form of fees paid to private equity sponsors. An institutional investor can buy an S&P 500 index fund for a few basis points, while the management fee on a private equity fund typically will range from 1.5% to 2.0%. Further, private equity funds also keep a percentage of the profits on their investments above a specified return rate (referred to as a “hurdle rate”) through a mechanism called carried interest; a typical carried interest structure on a private equity fund investment is 20% of the profits over an 8% hurdle rate.

Many investors who don’t have the time, experience, assets, or resources to build a diversified portfolio of private equity funds often rely on fund-of-fund vehicles to gain access to a wider variety of private equity fund sponsors. While fund-of-funds investments do serve that purpose, they also increase the cost burden on an already expensive asset class. An investor in a private equity fund-of-funds will not only pay the management fees and carried interest on all of the underlying private equity funds in which the fund-of-funds chooses to invest, but also will pay an additional management fee and another layer of carried interest to the fund-of-funds manager.

Co-investments, on the other hand, are generally offered by private equity fund sponsors on a “no fee / no carry” basis, meaning that the co-investors do not pay any fees to the private equity sponsor invest in these companies. The reason for that is because the co-investor is providing capital that the private equity fund sponsor needs to complete a given deal, therefore the con-investor is providing a service. In addition, co-investment fund management fees and carried interest fees are materially lower than those of direct private equity funds; the average management fee for co-investment funds our research team has reviewed in 2024 has been 1.0%, with carried interest ranging from 10% to 12.5% on a hurdle return of 8%. Thus, like a fund-of-funds, co-investment funds allow an investor to gain access to multiple private equity fund sponsors, but at much lower fees.

Additional Due Diligence/Selectivity

In addition to fees, another benefit to co-investment funds is the potential to increase returns with additional layers of due diligence and selectivity. The co-investment funds offered by firms with large private markets platforms have access to top tier private equity managers and have robust teams of investment professionals tasked with evaluating and identifying funds that will outperform their peers. Fishing from that pond, the co-investment teams are then tasked with building a portfolio of the best co-investment ideas from those high-quality funds. The co-investment fund teams perform their own due diligence on the target company, in addition to the information they receive from the plan sponsor, before investing in any deal. If a co-investment fund is being managed effectively, the manager is selecting the deals from top-tier private equity funds that best align with those sponsors’ strengths. In addition, unlike a fund-of-funds which is exposed to every company in which the underlying funds it selects invests, a co-investment fund will only invest in one or two deals from a given sponsor, effectively constructing a portfolio of “best ideas.”

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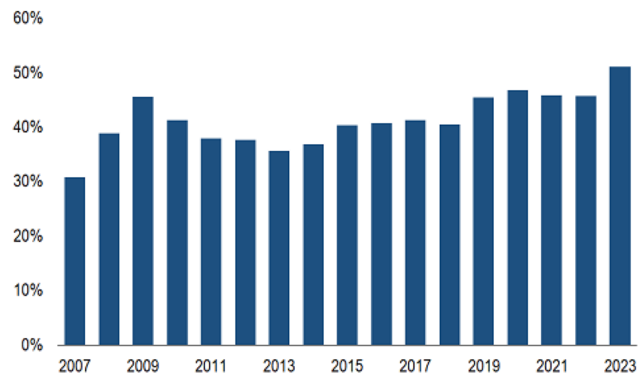
Private Equity Market Environment

Although the overall volume of private equity deals has decreased in recent years, co-investment deal flow has continued to rise, supported by the following factors:

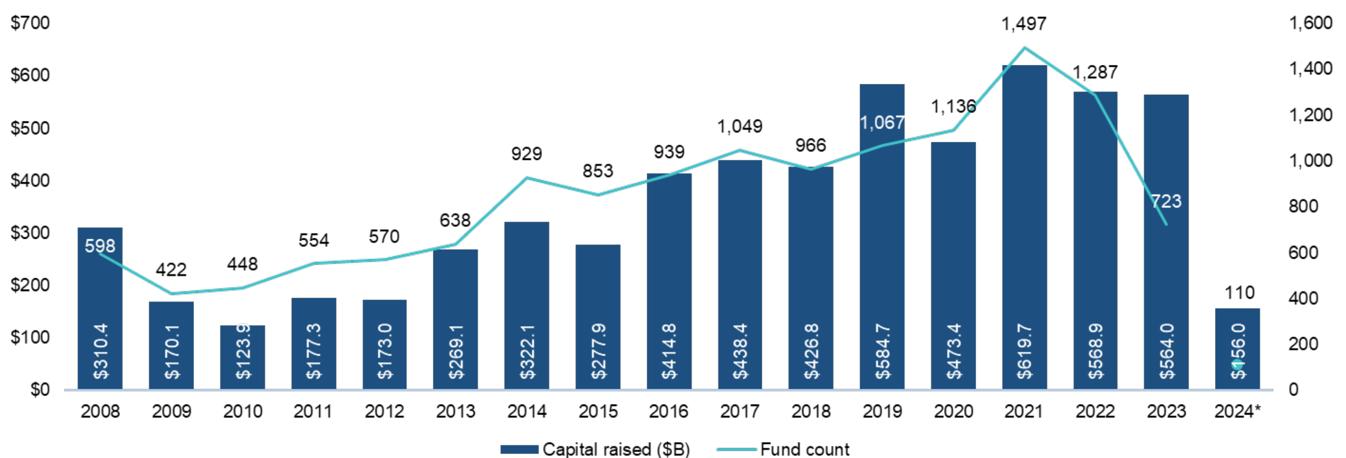
Cost of debt

After more than a decade of historically low interest rates, the cost of debt used for private equity buyout transactions began to increase dramatically in 2022 as the Federal Reserve raised interest rates in a bid to combat inflation. This forced private equity fund managers to rely less on leverage and increase the percentage of equity invested in their deals. In turn, this has provided a tremendous opportunity for co-investment funds to step in and share the increased equity load, rather than the private equity sponsor footing the entire bill alone.



Slower fundraising

Since peaking in 2021, private equity fundraising has slowed over the last couple of years, placing additional pressure on private equity sponsors. Offering co-investment opportunities has become a way for fund sponsors to entice limited partners to invest in their funds. (Many co-investment funds are offered by organizations with large private markets investment platforms, including fund-of-funds vehicles that are a reliable source of capital as limited partners for private equity funds.)



Source: Pitchbook, Data as of December 31, 2023

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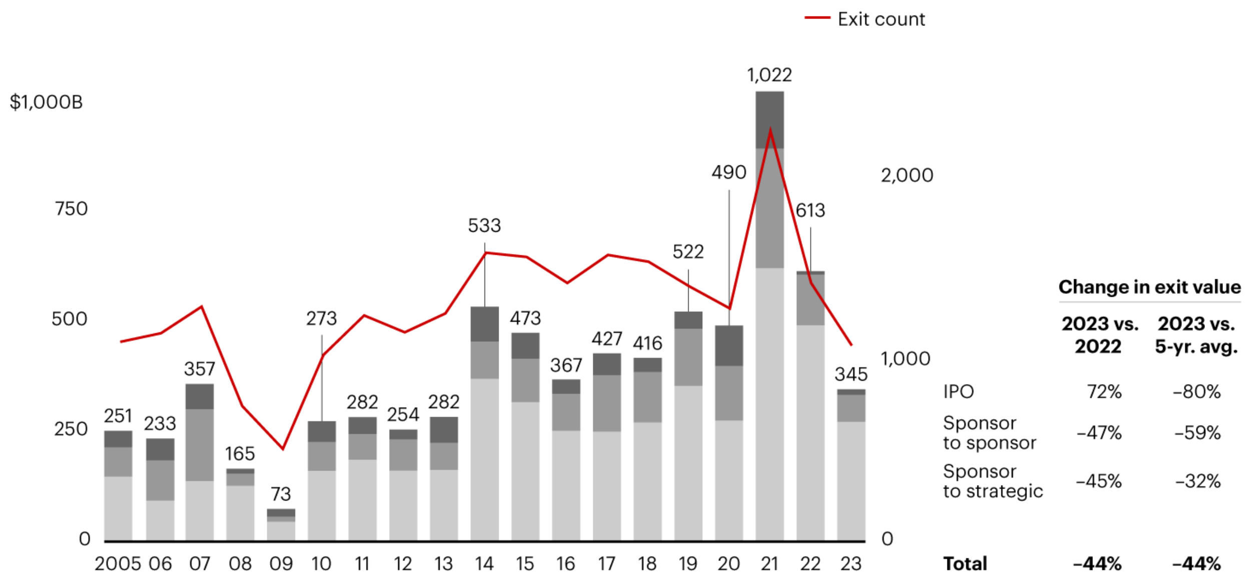
Lesser exit activity

Exit activity has also slowed since 2021, which has prompted many traditional players in the co-investment space like large pension funds to leave the market. This has reduced competition for co-investments and has allowed co-investment funds—which, unlike large pension funds, are able to raise additional capital—to capture a larger share of the available co-investment deal flow. Co-investment funds also generally can move more quickly in the due diligence process, making them a more reliable source of capital and more likely to get the first call from a private equity sponsor.



Source: Bain Capital, data as of March 31, 2024. Top (Dark Gray) represents IPO, Middle (Moderate Gray) represents sponsor-to-sponsor, Bottom (Light Gray) represents sponsor-to-strategic

Risks Associated with Co-Investment Funds

Notwithstanding their advantages, co-investment funds are still private equity investments, so all the associated risks of such still apply.

- Like most private equity vehicles, a co-investment fund will have a three-to-four-year investment period in which the fund will gradually call capital, followed by a harvest period for the next several years during which capital is returned to investors. Co-investment funds will typically have a ten-year target life, with the option for additional one-year extensions as warranted. Co-investment funds also will experience a performance “J-curve”, in which the returns of the fund can be negative on a net-of-fees basis early in the life of the fund as the manager is building the portfolio. However, the J-curve in co-investment funds relative to traditional private equity funds or fund-of-funds is mitigated somewhat by the lower management fee of a co-investment fund. In addition, many co-investment funds now offer fee arrangements that only charge the management fee on invested capital rather than on committed capital.

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- An additional risk to a co-investment fund is that the fund does not have the same operational control over underlying companies as the fund sponsor, because the co-investment fund is taking a minority interest. As a result, the co-investment fund is reliant on the sponsor to effectively manage the investment and navigate the exit and ultimate return of capital. Therefore, it is extremely important to select a co-investment fund that has demonstrated the ability to select quality managers with whom to invest alongside, as well as the ability to independently evaluate portfolio companies prior to investment.
- Finally, any co-investment vehicle would be subject to macroeconomic and idiosyncratic risks that might negatively impact the fundamentals of the underlying companies, as well as any market dynamics that might result in valuation compression or decreased exit activity that could lower returns.

Investor Considerations

Co-investment funds are worthy of consideration by an institutional investor that has a target allocation to private market investments. In a highly expensive asset class, co-investment funds may offer investors the ability to achieve diversification across a spectrum of private equity sponsors at a considerably lower cost, as well as the opportunity to outperform the overall asset class through multiple layers of due diligence and aligning with sponsors to invest in companies that best fit their strengths.

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