IS THE RACE *TO THE SWIFT?*

Picking the best private equity funds is clearly vital for investors. But how important is limited partner skill when it comes to generating strong performance? Or does it all just come down to access? Two recent academic papers explore this issue. By Vicky Meek.

As many limited partners continue to increase their allocations to PE, their investment performance in the asset class is becoming an ever more important element of the overall returns they need to meet their obligations and liabilities. Yet what determines how well individual LPs perform across their PE portfolios?

When it comes to making PE fund investments, a group of academics believe they have the answer. In their paper, *Measuring Institutional Investors' Skill at Making Private Equity Investments*, Daniel R. Cavagnaro, Berk A. Sensoy, Yingdi Wang and Michael S. Weisbach look at how LPs' skill levels impact their returns from PE. "There is so much research around mutual funds, and if ever there was an investment type that doesn't have skill, that would be it," says Weisbach. "Yet PE executives really have to know what they are doing and to know the businesses they back to add value. The questions we wanted to address are how investors decide which funds to back, especially given the limited access to some funds, and to what extent is selecting PE funds similar to selecting mutual funds (or to PE investing itself) in terms of skill?"

The researchers' initial analysis showed that skill exists among LPs. When compared with a simulation in which LPs were identically skilled, they found that the differential in actual performance between individual LPs was too great to be explained by chance. They also found that some LPs perform consistently well, while others perform consistently poorly.

They then sought to quantify the impact of skill on performance. Weisbach explains the process: "We ran statistical tests to uncover the extent of skill needed to pick the best-performing PE funds," he says. "Having established that skill is needed, we wanted to work out how much this matters. We had to assume a distribution of ability, because you can't say, for example, that three points of extra ability leads to two percentage points of increase in returns – what, after all, constitutes a point of ability? So the standard deviation is a way of expressing that distribution of ability and the effect this has on returns."

"SOME LPs ARE DEFINITELY SEEN AS THOUGHT LEADERS IN PE. GPs ARE KEEN TO HAVE THESE ON BOARD"

Warren Hibbert
Asante Capital

The academics found that a one standard deviation in skill results in a one to two percentage-point increase in annual IRR, suggesting it has a pretty large effect. “Any investor that can generate an extra 2% in PE returns is making a significant contribution – that usually translates into many millions of dollars,” says Weisbach. He adds that the research team also tested other explanations for outperformance, such as access to funds and risk preference, but they found that the results for skill were far stronger.

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> **Michael S. Weisbach**
> *The Ohio State University*

Digging deeper

The importance of skill in LP fund investment decisions naturally comes as little surprise to those at the coalface – PE practitioners themselves. But it does lead to the question of what constitutes LP skill in today’s market. “Everyone should be able to analyse a track record these days, so you can’t differentiate yourself as an LP that way,” says Rhonda Ryan, partner and head of European PE at Mercer. “So it really comes down to qualitative analysis: How good is the investment team? Are they going to stay together, even if things get tough? What’s the culture like? You also need to be diligent in reference checking, going well beyond the list given by general partners, and then trying to join the dots.”

Investment skill is as much about the funds LPs don’t choose as the ones they do, adds Ryan. “Knowing when to say no is a critical skill,” she says. “Some funds were great in the late 1990s; they’re not so great now. You can’t just look at historical track records because the best may be behind some groups and there may be much better options available today.”

It’s a view shared by Mark Florman, chairman and CEO at Time Partners. “Skill is important in LP returns, and I think there is an interplay here with relationships – these really help with judgment calls. There is only so much that desktop research can tell you, and so you really need to get under the skin of the team to understand who makes the decisions and what drives them. GP decks are so similar, you have to get to what differentiates a firm or team.”

Yet, in contrast to the paper’s findings, they both also stress the importance of access to funds when it comes to returns. As Ryan points out, “in an industry with such a high dispersion in returns between GPs, it doesn’t matter how skilled you are if you don’t have access to the best-performing funds”.

Skill or access?

This relationship between access and skill is the subject of another academic paper that looks at LP performance in PE, venture capital, and private debt alternative vehicles (AVs), such as co-investments, parallel funds, and feeder funds. In *Investing Outside the Box: Evidence from Alternative Vehicles in Private Equity*, Josh Lerner, Jason Mao, Antoinette Schoar and Nan R. Zhang find that LPs with the strongest returns from their overall PE portfolios also do well in AVs, while those with lower overall PE performance fare poorly in AVs. The authors suggest that this, at least in part, is because top LPs are offered preferential access to top AVs and that high-performing LPs have strong bargaining power.

The research builds on previous work by Lerner together with Victoria Ivashina and Lily Fang (*The Disintermediation of Financial Markets: Direct Investing in Private Equity*) that analysed direct investments by seven LPs. In this later paper, however, the dataset is far richer – it is drawn from custodial information from State Street covering more than 100 of the largest LPs. “We can see every dollar flowing in and out of funds, co-investments and special purpose vehicles,” says Lerner. “It allows us to capture between 5% and 10% of PE activity over four decades.”

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> *Time Partners*

AVs are an important area to study, given the rise of co-investments and other investments being made outside main funds. Indeed, the paper shows that by 2017, almost 40% of PE capital was raised through AVs. Yet, despite the lower or non-existent fees and carried interest often associated with these vehicles, the research shows that even average AVs underperform the main funds of the GPs sponsoring them. “LPs can’t view AVs as a cure-all,” says Lerner. “Co-investments won’t necessarily boost returns or make up for poorer performance elsewhere. Fund investing is a tough enough game; co-investments are even harder.”

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> **Geoffrey Geiger**
> *USS*

Is bigger better?

So what does the paper tell us about LP skill and how it relates to other factors such as LP ticket size, reputation and access? It is often said, for example, that larger investors can have significant advantages over others in terms of GP access and invitations to high-quality co-investments. Yet Schoar says the research suggests this is not always the case. “We find that the sheer size of a limited partner is not predictive of performance,” she says.

Indeed, the size and quality of the team matter far more than investment ticket sizes, say some. “The size of annual PE allocation has very little correlation to the budget for paying the investment team,” says Warren Hibbert, managing partner at Asante Capital. “There may even be an inverse correlation, as some LPs with the most capital to deploy have the lowest team budget and end up aggregating their capital across fewer mega-managers, rather than selecting the best from thousands of GPs.”

Instead, it appears that a combination of access – LPs need to see the best opportunities to do well – and skill leads to outperformance. *Investing Outside the Box* looked at results according to whether LPs had discretion over AV investments. “We found the biggest differential in performance between the top and worse-performing LPs for the AVs where LPs had discretion,” says Schoar. “There is definitely something about sophistication and skill that accounts for some LPs’ better performance.”

Even more interestingly, the paper also looked at the AV performance of top and lower-tier LPs when investing in the same fund. The authors found that top LPs still outperformed the rest. “It has long been a mantra of the PE industry that as long as you get into the top-quartile funds, then you’re all set,” says Schoar. “Yet our paper shows that, even when looking at a given GP, there is still a difference in performance among top and lower-tier LPs in AVs. This matters because AVs are attracting increasing amounts of capital.”

And it’s perhaps here that the interconnection of access and skill shows most. The paper suggests this is down to preferential access for top LPs, who have the most bargaining power. Yet it could also equally demonstrate Ryan’s earlier point that skill is about knowing when to say no to an opportunity.

> “IN PE YOU REALLY NEED TO LOOK AT WHAT OPPORTUNITIES ARE AVAILABLE AND DETERMINE YOUR EXPOSURE FROM THAT – YOU CAN’T FORCE ALLOCATIONS”
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> **Antoinette Schoar**
> *MIT Sloan School of Management*

Opening doors

For Geoffrey Geiger, head of PE funds and co-investments at USS, co-investments have, on average, outperformed the underlying funds they invest in. He says achieving this requires an appropriately staffed and skilled investment team, which in turn opens access to good opportunities. “Securing the best co-investments is down to access and the relationships you build with GPs,” he says. “You are more likely to be shown good deals and offered a decent allocation if you are seen as a reliable, professional and predictable partner with the capacity to act quickly.”

Indeed, having a reputation for skill – being a savvy investor – is a sought-after characteristic for GPs where access may be an issue. “Some LPs are definitely seen as thought leaders in PE,” says Hibbert. “GPs are keen to have these on board.” He adds that this is a function of team size, experience and talent.

"The Ivy League endowments are typically at the top of the list – they are able to pay market rate compensation to retain the brightest academics and investors their systems produce. They tend to focus on GPs that can generate the highest absolute risk-adjusted return globally."

Building that reputation takes time as well as resources, as Lerner points out. "It's clear that some LPs are more attractive to GPs than others," he says. "Some of this can be down to financial firepower, but it's also a combination of: staying power – that the LP is in private markets for the long haul; continuity of the team, which can really matter when you're raising your next fund, because you really want existing LPs to re-up; the LP's sophistication and level of understanding of PE; and whether the LP is seen as 'smart money', because that can really help attract other investors to your fund."

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Mercer

This all really matters to LP performance at a time when access to the best-performing GPs and, by extension, their co-investment opportunities, may be more constrained than usual because of the pandemic. "There will be a flight to the familiar in the short to medium term as LPs have been unable to meet new GPs," says Florman. "We'll see a lot of re-ups and larger ticket sizes in situations where LPs already know GPs, because they will have a higher conviction on those opportunities than on new ones."

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Josh Lerner
Harvard Business School

Quite how this will affect LP performance will only be known several years down the track. Yet the findings from the two papers serve as good reminders that PE investing is very different from other types of investment: pressure to deploy capital can result in negative outcomes because LPs really have to discriminate between GPs with the potential to perform well and the rest if they are to generate strong returns. "The most successful LP strategies tend not to treat PE like an asset class," says Schoar, drawing on this and her previous research. "Unlike fixed income or public equities, where you have a target allocation and then find investment opportunities to reach that allocation, in PE you really need to look at what opportunities are available and determine your exposure from that – you can't force allocations."

Indeed, Lerner says the overall lesson from the two papers is that "LPs are not created equal and skill is an important differentiator – I'd argue that skill and bargaining power are two sides of the same coin. In private capital, unlike in mutual funds, where you get your money from makes a big difference. It's clear that some LPs are just more savvy and this plays out not just at fund level, but also at the AV level."

THE RESEARCH

In *Measuring Institutional Investors' Skill at Making Private Equity Investments*, Daniel R. Cavagnaro, Yingdi Wang (both of California State University, Fullerton), Berk A. Sensoy (Owen Graduate School of Management, Vanderbilt University) and Michael S. Weisbach (The Ohio State University) set out to examine the extent to which LPs' skill affects their returns from PE.

Using a sample of 27,283 investments made by 1,209 LPs between 1991 and 2011, the authors first examine whether differential skill exists. They simulate the distribution of LP performance on the assumption that all LPs are identically skilled and then compare the results against actual performance data. The comparison reveals that more LPs do consistently well or consistently poorly (above or below median performance, respectively) in selecting PE funds than would be the case if there were no differential skill. "Some LPs appear to be better than other LPs at selecting GPs who subsequently earn the highest returns," the paper says.

The paper finds that a one standard deviation increase in LP skill leads to a one to two percentage-point increase in annual IRR for the LP's PE investments. After testing a number of other explanations for outperformance, such as risk preference, political pressure to invest in certain types of funds and access constraints, the authors conclude that skill is an important factor in LP performance and that the difference in performance is "economically meaningful".

In *Investing Outside the Box: Evidence from Alternative Vehicles in Private Equity*, Josh Lerner (Harvard Business School), Jason Mao and Nan R. Zhang (both of State Street Global Exchange) and Antoinette Schoar (MIT Sloan School of Management) examine the performance of LP investments in alternative vehicles (such as co-investments, parallel funds, and feeder funds) with a view to understanding why some investors outperform others.

The researchers use custodial data from State Street on 108 LPs, capturing US$500bn of commitments and 20,000 investments, to analyse cash flows between the LPs and GPs. They find that AVs accounted for almost 40% of capital raised by PE firms by 2017 and that better-performing managers – based on past fund performance using public market equivalent (PME) measures – offered higher-performing AVs than those offered by poorer-performing GPs, but that AVs overall perform worse than the main funds of a GP.

They also find that LPs with better past performance across their entire PE portfolio had above-average performance in the AV investments and that they often outperformed the main fund of the GP sponsoring them, while LPs with worse past performance invested in AVs with lower PMEs. The authors suggest this reflects a combination of access and skill. Top-tier LPs are almost three times more likely than lower-tier LPs to be offered AV investments by top-tier GPs. But they also note that the outperformance of the top LPs is strongest in discretionary vehicles, where the LPs' skill matters. "The sophistication of an LP within the PE space becomes more important as partnerships offer a gamut of different vehicles," the research says.