Manager Selection Quant Screens: First-Time Fund Managers

How do new fund managers compare to established managers?

By Dan Golosovker, Dan O'Donnell, Amar Patel and Dane Rook

Introduction

One of the main reasons why investors allocate capital to private markets is to enhance returns relative to earning risk premia from traditional asset classes, such as stocks and bonds. However, earning higher returns requires picking a great manager. A top-quartile manager has earned a 1.65 KS-PME,[1] whereas a median- or bottom-quartile manager has earned a 1.15 or a 0.65 KS-PME, respectively. These are large relative gaps in performance.

In this paper, we focus on the following topics: (1) identifying quantitatively consistent and empirically validated performance indicators, and (2) debunking conventional wisdom that does not hold up to statistical scrutiny. Both topics are extremely useful in improving manager selection.

With an established manager, a potential investor can observe several funds with full performance histories and repeated outperformance (or underperformance). Conversely, for first-time fund managers, investors may have access to less quantitative information to evaluate their selection, leading to perceptions of riskier funds. Conventional wisdom and heuristics mean that some investors avoid first-time funds altogether, while others are particularly interested in these funds. We show that first-time funds do not perform materially better or worse than the broader set of funds.

[1] A market-adjusted performance ratio based on an investment's performance relative to an index. This performance is net of fees.

Analysis

In Table 1, we illustrate the large gap between top- and second-quartile buyout and venture managers over third- and bottom-quartile performers. This analysis uses a KS-PME metric, which can be considered a market-adjusted performance ratio over the S&P 500 (more details are presented in the appendix). A KS-PME greater than 1 indicates that an investment is outperforming the S&P 500.

Our analysis shows that top- and second-quartile managers incrementally outperformed the S&P 500, while third- and bottom-quartile managers underperformed. Additionally, the gap between the top and bottom quartiles is extremely wide – a full 100% difference in relative performance.

Table 1: Summary KS-PME by quartile: buyout and venture capital funds (2000-2023).

	Buyout			Venture Capital	
	Median	Average		Median	Average
Top Quartile	**1.65**	**1.81**		**2.42**	**4.17**
Second Quartile	**1.20**	**1.22**		**1.31**	**1.33**
Third Quartile	**0.93**	**0.95**		**0.92**	**0.90**
Bottom Quartile	**0.65**	**0.60**		**0.56**	**0.53**

PME > 1.00 → *The fund outperformed the S&P 500*
PME < 1.00 → *The fund underperformed the S&P 500*
Source: Addepar

Picking the right managers can, therefore, yield outsized returns. At the same time, the opportunity cost of underperformance is significant. Historically, top-quartile buyout funds and venture funds have returned 13% and 16% in annualized excess returns over the market, respectively. Meanwhile, the median funds returned 2% (buyout) and 1% (venture) above the market.[2] Consequently, manager selection is among investors' most impactful decisions.

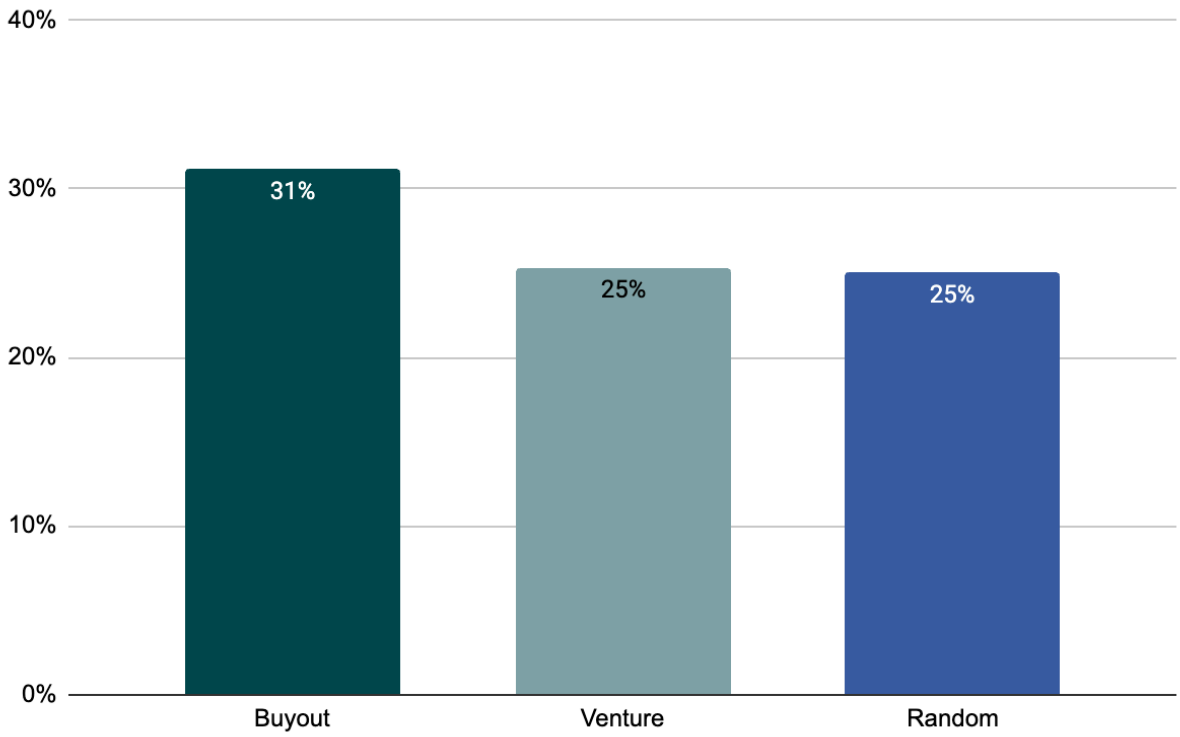
We focus on understanding first-time fund managers' performance. Some allocators may wholly avoid these managers, while others are specifically drawn to them. For some investors, first-time and emerging managers are often perceived as riskier. For others, particularly institutional

[2] Excess returns reported are the median IRR spread, which is calculated by taking the actual fund IRR and subtracting the Long Nickels Public Market Equivalent (LN-PME), which is the theoretical return in the SP500 based on the actual cash flows of the private investment.

investors, including first-time fund exposure is part of a strategic approach to generating additional alpha (above and beyond the alpha generated from investing in established funds).

We test first-time funds' performance using the Addepar data set and observe how often a first-time fund finishes in the top quartile for buyout and venture funds (Figure 2).[3]

Figure 2: First-time funds' top-quartile frequency → traditional methodology (2000-2023).



Source: Addepar

As Figure 2 illustrates, the likelihood of a first-time buyout fund finishing with top-quartile returns is 31% — or a little better than a random draw. (Each quartile has an equal chance of 25%). For venture funds, this probability falls to 25%. In other words, little evidence suggests that first-time funds are more or less likely to finish in the top quartile than their peers.

Conclusion

[3] The excess returns reported are the median IRR spread, which is calculated by subtracting the Long Nickels Public Market Equivalent (LN-PME) from the actual fund IRR. The LN-PME is the theoretical return from the S&P 500 based on the actual cash flows of the private investment.

We see no evidence to support the notion that first-time funds perform materially better or worse than established funds. However, beyond performance histories, other factors may be relevant when deciding to invest in first-time funds. Some investors may choose to avoid these funds due to the additional operational burden of performing due diligence on a new manager. Other investors may have too many existing relationships with GPs in order to commit any capital to new funds. Still other investors, particularly public institutions, may be less affected by these issues and particularly interested in supporting diverse or otherwise overlooked opportunities.

References

Harris, Robert S., Jenkinson, Tim, Stucke, Rudiger and Kaplan, Steven N., "Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds" *Journal of Corporate Finance*, February 2023. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2304808

Kaplan, Steven N., and Antoinette Schoar. "Private Equity Performance: Returns, Persistence, and Capital Flows." *The Journal of Finance* 60, no. 4 (2005): 1791–1823. www.jstor.org/stable/3694854.

Authors

Dan Golosovker, Head of Applied Research at Addepar (dan.golosovker@addepar.com)
Dan O'Donnell, Private Placement Director at Addepar (dan.odonnell@addepar.com)
Amar Patel, Research Analyst at Addepar (amar.patel@addepar.com)
Dane Rook, Head of Research at Addepar (dane.rook@addepar.com)

Appendix

Definitions

Performance persistence: The frequency at which managers who generate performance in a quartile of a peer universe with Fund N also generate the same quartile performance with Fund N+1. Statistically significant persistence in the top quartile would entail top-quartile-to-top-quartile frequency above the 25% that would result from assigning quartile values via a purely random draw. Where persistence measurements are presented as percentages below, they answer the following question: "How many managers in the top quartile of this cohort were also in the top quartile with their prior funds?"

Public market equivalent (PME): A collection of performance measures used to compare a private investment directly to a public market benchmark index. The PME metric used in this analysis was devised by Steven Kaplan and Antoinette Schoar (KS-PME) in the work of Kaplan and Schoar (2005).

- The KS-PME method "invests" the cash outlays to a private market fund at the total return of a reference index (in this case, the S&P 500), and it compares the resulting value to the actual return of the fund investment. The output measures the wealth created (or destroyed) relative to an investment in the reference index. Thus, it answers the following question: "By how much did a private capital fund investment outperform (or underperform) its public market benchmark?" A fund with a PME greater than 1.00 outperformed the reference index and created incremental wealth. A PME below 1.00 represents underperformance, suggesting that investors would have been better off with a public index.
- For example, assume that a private equity fund, ABC Fund I, invested $100 million and returned $200 million to limited partners. Meanwhile, that same $100 million, if invested in the S&P 500 over the same period, would have grown to $150 million.
- The KS-PME value for ABC Fund I would be 1.33 $200m / $150m = 1.33. If ABC Fund II also returned $200 million on $100 million of invested capital, but $100 million in the public index would have grown to $250 million during that timeframe, the KS-PME value for ABC Fund II would be 0.80 $200m / $250m = 0.80.

Data Tables

Table 2: Fund-to-fund track-record analysis → traditional methodology vs. the approach of Harris et al. (2023)

	Buyout						Buyout, Post-2000 Funds: Harris et al (2023)			
Previous	Current Round Quartile				Previous	Current Round Quartile			
Round Quartile	1	2	3	4	Round Quartile	1	2	3	4
1 (-)	29%	26%	27%	19%	1	34%	25%	26%	16%
2 (-)	17%	29%	32%	22%	2	22%	21%	36%	20%
3 (-)	19%	33%	21%	26%	3	22%	35%	25%	18%
4 (-)	21%	31%	23%	25%	4	14%	22%	24%	41%
Not Available (-)	23%	24%	26%	27%	Not Available	25%	25%	22%	29%
1st-time (-)	31%	21%	19%	29%	1st-time	31%	20%	22%	27%

	Venture						Venture, Post-2000 Funds: Harris et al (2023)			
Previous	Current Round Quartile				Previous	Current Round Quartile			
Round Quartile	1	2	3	4	Round Quartile	1	2	3	4
1 (***)	41%	28%	15%	17%	1	44%	26%	19%	10%
2 (*)	30%	31%	25%	14%	2	23%	28%	30%	20%
3 (-)	21%	21%	26%	32%	3	14%	37%	31%	18%
4 (*)	16%	20%	31%	33%	4	8%	23%	27%	42%
Not Available (-)	20%	26%	27%	26%	Not Available	17%	21%	30%	33%
1st-time (-)	25%	23%	23%	29%	1st-time	30%	22%	17%	31%

Harris et al. (2023) are results from the publication.

Sources: Addepar and Harris et al. (2023)

For each of the transition probabilities from the previous round quartile to the current-round quartile, we ran a chi-squared goodness of fit test against the null hypothesis of random transitions.

The asterisks *, ** and *** represent statistical significance at the 10%, 5% and 1% levels, respectively. No statistically significant evidence suggests that the transition probabilities in a buyout are not purely random, while in venture we see evidence particularly for funds in the top-previous round quartile (significant at the 1% level).

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