

Manager Selection & The Paradox of Skill

Improving decision frameworks with key new insights into private markets performance

By Dan O'Donnell, CFA

1. Introduction

Investors allocate to private markets¹ seeking portfolio diversification and opportunities to enhance expected return relative to traditional² asset classes. However, higher returns are not automatic. Earning the desired return premium requires skillful manager selection, as illustrated in Figure 1:

Figure 1: Return dispersion in fund manager performance³



¹ 'Private markets,' 'private capital,' or 'private investments' are used interchangeably below in reference to institutional pools of capital raised to invest within the private equity, private credit, venture capital, private real estate and real assets categories.

² E.g. Public equities, fixed income, cash, and cash equivalents

³ Source: Blackstone Private Wealth Solutions: "Manager Selection Matters"; public returns data via Morningstar, returns presented are over a five-year period from 1/1/2017 to 12/31/2021 (for open-end funds); public equities (U.S. large blend), public fixed income (U.S. intermediate core bonds). Private returns via Preqin (2016 vintage funds with last reported data between 12/31/2020 and 9/30/2021, North America, closed funds including buyout and private debt strategies).



Source: Morningstar, Preqin

Unfortunately for allocators, the process by which investors source, screen and select managers is growing increasingly complex. First, two decades (and counting) of sustained inflows have fueled explosive growth in firm and fund formation, with an investible universe that now includes tens of thousands of managers⁴. In addition, new research challenges long held conventional wisdom that outperformance tends to persist through time. Specifically, when viewed through the lens that investors must use in real time, top-quartile persistence proves to be much weaker than previously observed. Further, these findings reveal that the modest investable persistence observed in prior decades has degraded as the asset class has matured and competition has intensified. In short, the current landscape offers allocators a rapidly growing universe of skilled managers to choose from, but a shrinking proportion that can sustain outperformance over multiple funds.

These developments are byproducts of the *paradox of skill*, where as the absolute level of skill among practitioners in a field grows, the dispersion of relative skill narrows. In competitions between highly-skilled players with only small gaps in skill between them, luck tends to play an outsized role in determining outcomes. As the skill gap narrows, it becomes increasingly more difficult to predict winners a priori based on skill alone.

Our intention here is to improve allocators' odds of successful manager selection by explicitly accounting for the paradox of skill in investment analysis. We do so by 1) examining key new insights from leading private markets researchers, 2) exploring the paradox of skill and its impacts on investment outcomes, and 3) proposing a practical analysis framework to address those impacts. Our framework includes real-world examples and diligence prompts designed to help allocators identify the opportunities in which outcomes are more likely to be driven by manager skill, and therefore, less by luck.

Key takeaways:

- Manager selection is critical to success in private markets.
- New research findings challenge the conventional wisdom that performance persistence is statistically significant.
- Today, investors have more highly-skilled managers to choose from than ever before, but fewer are sustaining outperformance over the long-term — a phenomenon known as the paradox of skill.
- Below, we outline an analysis framework designed to improve manager selection in markets where the paradox of skill has weakened performance persistence.

⁴ Source: Preqin



2. Data and methods

Our analysis is built upon findings from peer-reviewed articles that leverage research-quality data sets. First, we've partnered with our colleagues at Addepar Research, who use Addepar's unique, anonymized and aggregated data set to glean insights and best practices that help clients to make more informed investment decisions. Currently, Addepar's data set includes more than \$4 trillion in assets across 275,000 unique investor portfolios⁵, in aggregate.

In addition, we examine recently published work from some of the industry's leading researchers: Robert S. Harris⁶, Tim Jenkinson⁷, Steven N. Kaplan⁸, and Ruediger Stucke⁹. Their paper, "Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds,"¹⁰ uses cash-flow data from a leading private markets benchmark provider encompassing a large sample of institutional investors. In aggregate, the data set includes more than 2,300 funds dating back to 1984.

In all cases, returns below are presented net of fees and expenses, and critically, are sourced from recordkeeping and performance measurement systems used by limited partners (LPs) rather than data that can be selectively provided (or not) at the fund manager's discretion¹¹. In future work, we plan to collaborate with our colleagues at Addepar Research to replicate these findings and explore adjacent topics in further depth.

Finally, two key terms for this discussion are defined below:

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

⁵ As of June 2023

⁶ C. Stewart Sheppard Professor of Business Administration, University of Virginia, Darden School of Business

⁷ Professor of Finance, Saïd Business School, University of Oxford and co-founder of the Private Equity Research Consortium ("PERC")

⁸ Neubauer Family Distinguished Service Professor of Entrepreneurship and Finance and Kessenich E.P. Faculty Director at the Polsky Center for Entrepreneurship and Innovation, University of Chicago Booth School

⁹ Director of Quantitative Research, Warburg Pincus

¹⁰ *Journal of Corporate Finance* (Feb 2023). Hereinafter referred to as: Harris et al (2023)

¹¹ Data quality issues and other biases in private markets benchmark data are explored in greater depth in "Private Equity Benchmarks Distort Allocations" (Addepar Research Brief).



- **Public market equivalent (“PME”):** A collection of performance measures¹² 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 2005¹³.

The KS-PME method ‘invests’ the cash outflows of a private markets fund at the total return of a reference index (in this case, the S&P 500) and compares the resulting value to the actual return of the fund investment. The output is a measure of the wealth created (or destroyed) relative to an investment in the reference index, and thereby answers the question: “By how much did a private capital fund investment outperform (or underperform) its public market benchmark?” A fund with a PME of greater than 1.00 outperformed the reference index and created incremental wealth. A PME below 1.00 represents underperformance, where investors would have been better off in the public index.

For example, assume that a private equity fund “ABC Fund I” invested \$100 million and returned \$200 million to limited partners, while that same \$100 million invested in the S&P 500 over the same period of time would have grown to \$150 million. The KS-PME value for ABC Fund I would be **1.33** ($\$200\text{m} / \$150\text{m} = 1.33$).

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 time frame, the KS-PME value for ABC Fund II would be **0.80** ($\$200\text{m} / \$250\text{m} = 0.80$).

3. Weakening persistence

The importance of manager selection is hard to overstate. Figure 1 above highlights the much greater variability of returns observed in private capital funds vs. public equity and fixed income funds. In addition, Figure 2 illustrates that while top- and second-quartile private equity managers have consistently outperformed public markets over the long term, third- and bottom-quartile performers generally have not¹⁴.

¹² Other examples include Long-Nickels PME, PME+, Direct Alpha and so on

¹³ “Private Equity Performance: Returns, Persistence, and Capital Flows” Kaplan, Steven N. and Schoar, Antoinette (August 2005)

¹⁴ While the third quartile average PME returns in buyout are slightly positive, the modest return in excess of the benchmark would likely not be sufficient to compensate investors for the higher fee load and illiquidity of a typical buyout fund commitment.



Figure 2: Summary performance by quartile: buyout & venture capital funds¹⁵

	<u>Buyout: Historical</u>			<u>Venture Capital: Historical</u>		
	Avg IRR	Avg MOIC	Avg PME	Avg IRR	Avg MOIC	Avg PME
Top Quartile	30.2%	2.77x	1.78	46.3%	5.25x	2.83
Second Quartile	17.6%	1.98x	1.28	18.2%	2.16x	1.21
Third Quartile	10.3%	1.52x	1.01	6.8%	1.39x	0.78
Bottom Quartile	-1.0%	1.01x	0.66	-6.9%	0.76x	0.42

	<u>Buyout: Post-2000</u>			<u>Venture Capital: Post-2000</u>		
	Avg IRR	Avg MOIC	Avg PME	Avg IRR	Avg MOIC	Avg PME
Top Quartile	29.6%	2.66x	1.70	33.3%	5.18x	2.57
Second Quartile	17.7%	1.88x	1.24	15.6%	2.16x	1.18
Third Quartile	11.4%	1.55x	1.04	7.6%	1.44x	0.80
Bottom Quartile	0.8%	1.07x	0.71	-5.6%	0.80x	0.44

Legend

IRR - Internal rate of return (net of fees and carried interest)

MOIC - Multiple of invested capital (net of fees and carried interest)

PME > 1.00 → Fund outperformed S&P 500

PME < 1.00 → Fund underperformed S&P 500

Source: Harris et al (2023)

Picking the right managers can yield outsized returns, while at the same time, the opportunity cost of underperformance is significant. As a result, private markets manager selections are among the most impactful decisions that investors make.

Historically, allocators have leaned heavily on prior track records to guide the manager selection process. For many years, the research literature has supported that — while not a perfect guide — past performance has offered important predictive power. Harris et al (2023) summarize this approach to manager selection:

“It has long been conventional wisdom for investors in private equity to choose funds run by managers who have performed well in the past, particularly so-called top quartile funds, while avoiding first-time funds. This conventional wisdom is based on the belief that performance in private equity persists across successive funds — typically organized as

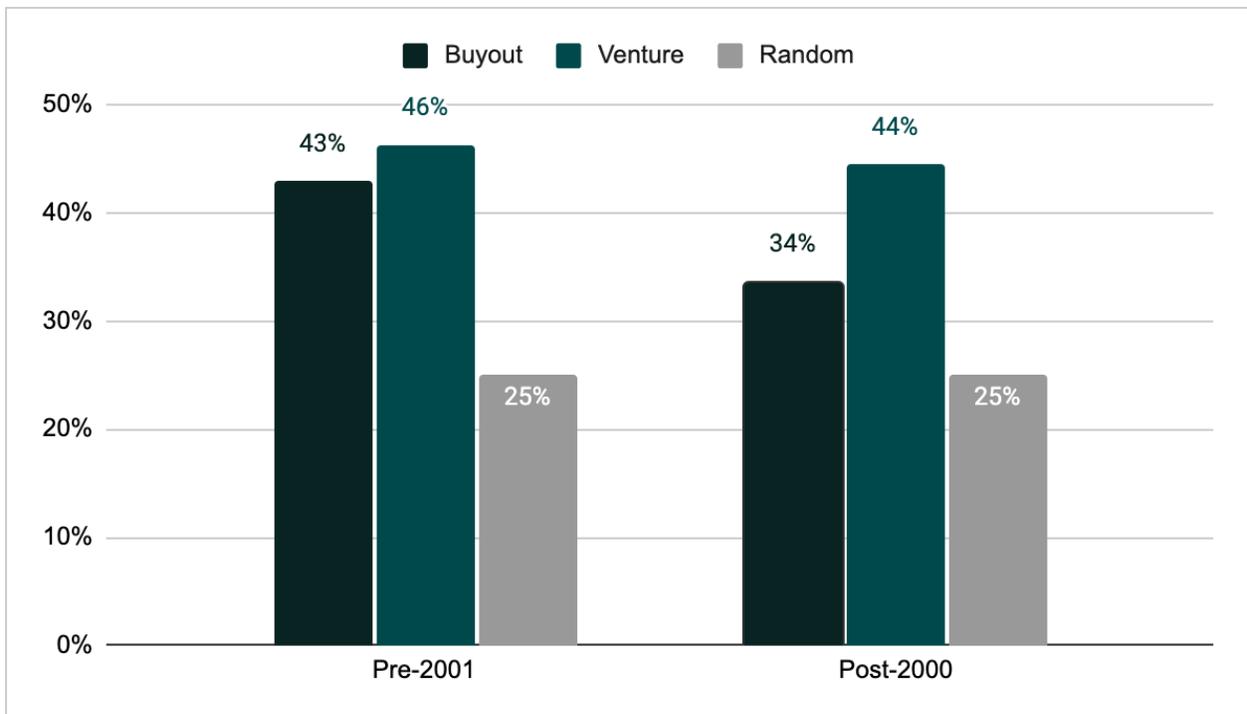
¹⁵ Historical returns include all vintages from 1984 through 2015. Post-2000 vintages include vintages from 2001 through 2015.



limited partnerships — with the same manager (the General Partner or “GP”). Previous academic research, studying largely pre-2000 data for the U.S., has been consistent with this conventional wisdom.”

Performance persistence is measured by the frequency at which managers who generate top-quartile performance with Fund N also generate top-quartile performance with Fund N+1. Historically, most researchers have measured persistence using fully realized fund returns or with the most recent available data. Figure 3 summarizes fund-to-fund persistence as measured by this traditional methodology for buyout and venture funds:

Figure 3: Fund-to-fund top-quartile persistence → traditional methodology



Source: Harris et al (2023)

It's easy to see why the conventional wisdom approach took root. According to Figure 3, venture capital funds display clearly significant persistence, and buyout funds also display meaningful persistence, though to a slightly lesser degree since 2001.

However, as Harris and his colleagues outline below, this methodology for measuring persistence does **not** reflect how investors must make decisions in practice:

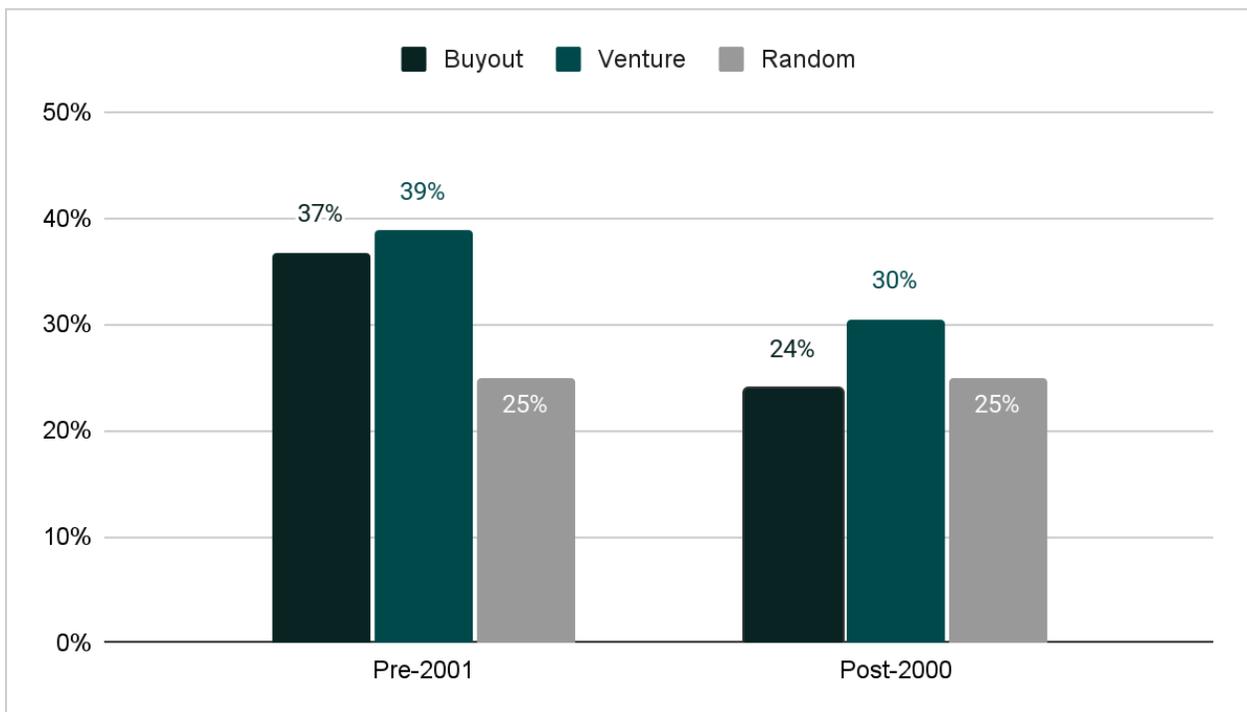


“Most existing papers study the relation between the final or most recent performance of different funds managed by the same GP. Such comparisons typically rely on information that is generally not available at the time that an investor decides to commit to a new fund.”

To account for this, the researchers recalibrated their methodology to reflect the returns presented for Fund N when investors must make a go or no-go decision on Fund N+1 — in other words, *investable persistence*.

Figure 4 illustrates that, when measured with this investable methodology, persistence is weaker than initially believed and has also degraded over time. Venture capital managers repeated top-quartile performance at only a 30% rate since 2001 — compared to the nearly 50% mark observed using the historical method. Buyout managers repeated top-quartile performance by this measure only 24% of the time since 2001 — or roughly what you would expect from assigning quartile rankings at random.

Figure 4: Fund-to-fund top-quartile persistence → investable persistence



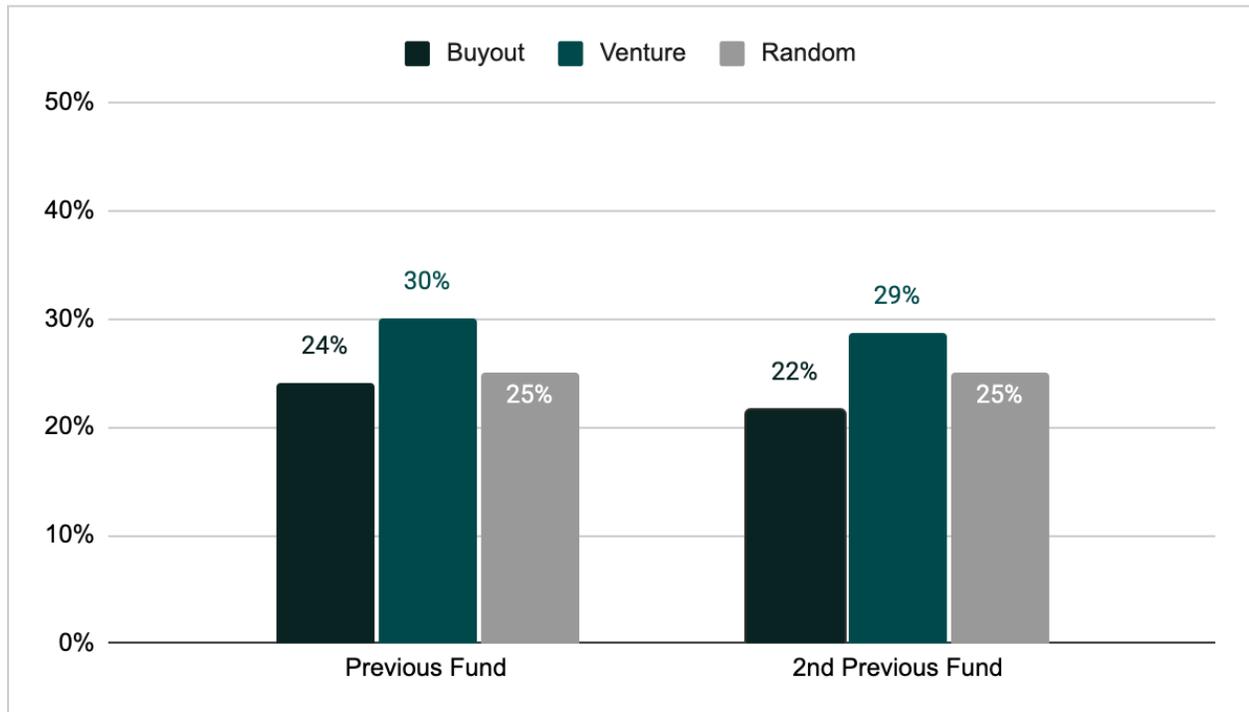
Source: Harris et al (2023)

What about managers with more than one prior fund in their track record? Figure 5 illustrates that when the authors extended their analysis to not just the prior fund, but also the prior two funds,



the results were essentially unchanged — with only modest persistence in venture capital, and no evidence of persistence in buyout returns since 2001.

Figure 5: Top-quartile persistence & prior two funds (post-2000) → investable persistence



Source: Harris et al (2023)

What about looking back even further? Over the past decade, the average time between fund closings is more than three years¹⁶. Looking back to a third or fourth prior fund means looking back nearly a decade, if not more. Of course, the full accounting of a manager’s track record is important. However, given the rate at which firms, competitive dynamics and market conditions evolve, it’s unlikely that these data points would yield more predictive power than the most recent two funds offer.

In summary, the current conventional wisdom around manager selection was largely built upon a methodology that is not actually investable. When researchers updated their model to reflect how allocators must actually make their decisions, it became clear that performance persistence has weakened considerably over the past two decades - which begs the question: What has changed so drastically? Why is it so much harder to predict the winners?

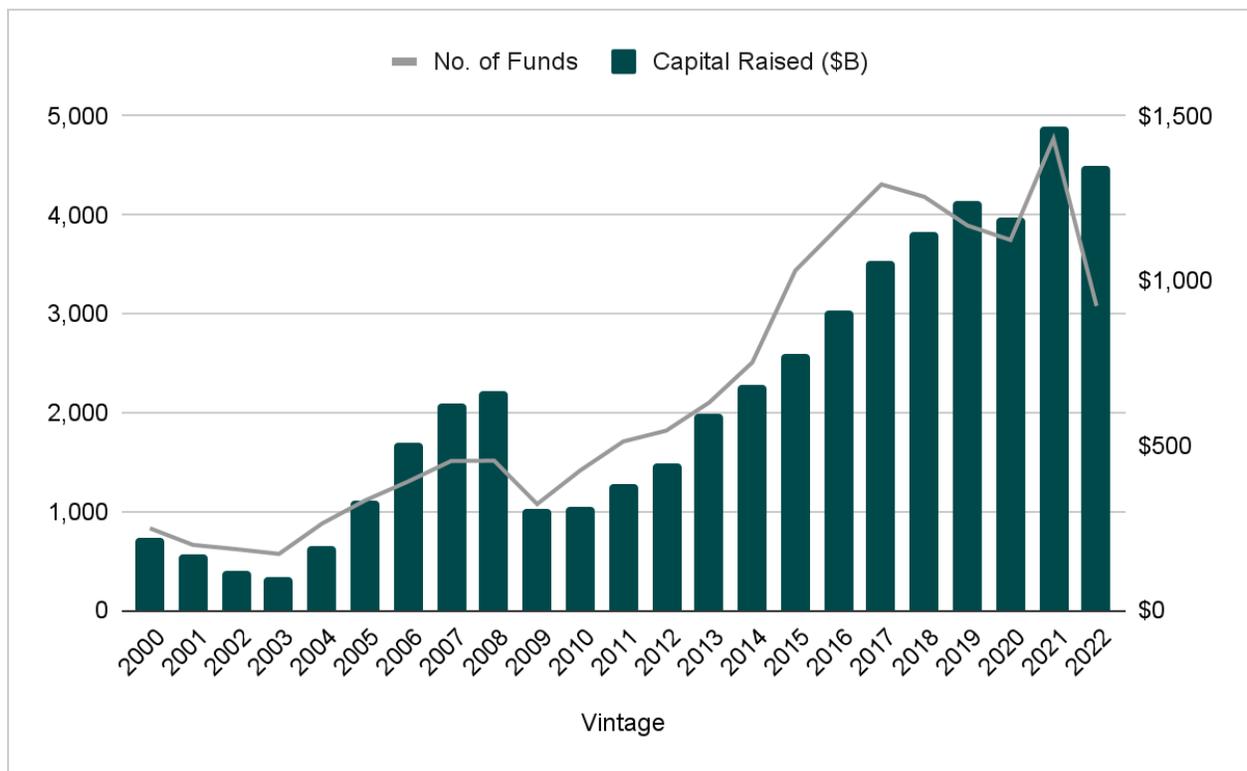
¹⁶ Source: Pitchbook 2022 Annual Global Private Market Fundraising Report



4. Intensifying competition

The most significant evolution in private markets has been increasingly intense competition across the ecosystem. Outsized rewards for success and nearly unlimited demand from investors have fueled a fundraising boom that has continued for more than two decades. Annual private capital commitments have grown from approximately \$100 billion in 2003 to a peak of nearly \$1.5 trillion in 2021. From 2000–2009, approximately 1,000 new funds were formed per year. In the decade that followed, that number grew more than 3x to an average of over 3,150 per year and eventually a peak of nearly 5,000 new funds formed in 2021.

Figure 5: Global private capital fundraising (2000-2022)



Source: Preqin

This paradigm shift in competitive dynamics impacts performance persistence at every level of the ecosystem. First, at the transaction level, private markets investing has always been a highly complex and multilayered process. For each investment, managers must source a pipeline of opportunities; screen them efficiently; project returns; underwrite risks; win the deal; perform comprehensive financial, operational, tax and legal due diligence; negotiate terms with counterparties; structure the transaction; collaborate with management; diligently monitor their investment; and facilitate a profitable exit — with most managers needing to successfully navigate



that maze a dozen or more¹⁷ times per fund. A more crowded, more competitive marketplace ratchets up the degree of difficulty every step of the way.

At the firm level, retaining key contributors is a constant struggle. Proven investment professionals are highly talented, highly motivated and highly sought-after commodities. With effectively unlimited demand from allocators for top-quartile private market returns, the most lucrative path for the industry's rising stars is often to spin out from top-performing managers and launch their own firm — frequently taking other key employees, critical IP and attribution for successful investments with them.

Finally, at the broader market level, even when firms can keep a strong team intact, outperformance quickly invites capital inflows that materially impact deal dynamics or even compete away compelling returns altogether. As a result, the current state of play is a rapidly growing pool of capable managers competing in complex games with ultra-high stakes — a perfect storm for the paradox of skill.

5. Paradox of skill

The paradox of skill was conceived by evolutionary biologist Steven Jay Gould, with Michael Mauboussin and Dan Callahan expanding upon the concept in 2013¹⁸:

“In activities where results combine luck and skill, luck is often more important in shaping outcomes even as skill improves. In many competitive interactions, it is the relative level of skill that matters, not the absolute level of skill. In many fields, including investing, the dispersion of skill is shrinking, which leaves more to luck.”

If investment outcomes are ultimately determined by elements of skill and luck in some combination, we can model an investment as the function of a draw from skill distribution and a luck distribution:

$$\text{Variance (Skill) + Variance (Luck) = Variance (Outcome)}$$

¹⁷ In the case of some venture capital or credit strategies, as many as 50 times (or more).

¹⁸ “Alpha and the Paradox of Skill” (Credit Suisse: Mauboussin, Callahan 2013). Mauboussin also addresses the concept in his 2012 book *The Success Equation: Untangling Skill and Luck in Business, Sports, and Investing*



Mauboussin highlights the critical takeaway of this framing:

*“If the variance in the skill distribution is shrinking and the variance in luck is stable, **luck** plays a growing role in shaping results. An absolute improvement in skill, when combined with a relative decline in the range of skill, means that luck is more important than ever.”*

The context for Gould’s original formulation was Major League Baseball (“MLB”) — specifically, probing why no MLB hitter has finished the season with batting average of at least .400 since Ted Williams hit .406 in 1941. Gould argued that the ‘failure’ to reach the .400 threshold was not evidence of declining batter skill, but rather that *improving* skill and athleticism across the sport was fueling a much more competitive dynamic between hitters and pitchers.

Statistics have fluctuated with rule and equipment changes, but historically the league batting average has remained stable within a relatively narrow range¹⁹. Over time, as both hitters and pitchers have gotten bigger, faster and stronger and combined better nutrition with more sophisticated training techniques, the gap between the best and the average professional ballplayer has narrowed substantially. Ted Williams’ .406 batting average in 1941 was 3.5 standard deviations above the league average. An equivalent +3.5 standard deviation performance in 2022 would have produced a .359 batting average — enough to lead MLB by a wide margin,²⁰ but a far cry from .400.

For most of MLB history, the best hitters were easy to identify and persisted as the league leaders over long periods of time. Ty Cobb won the American League (AL) batting title 12 times in 13 years, and Rogers Hornsby won the National League (NL) crown 7 times in 9 years. Ted Williams won six AL batting titles (and likely more if not for two separate intervals of wartime military service that took him off the field for five seasons in his prime²¹). In all, 25 different players won the batting title 3 times or more in their career. So for many decades, even casual observers could make confident predictions about the batting champion before the season started — and usually have been right.

Today, batting average leaders rarely persist from year to year. Of those 25 players with at least 3 career batting titles, 24 have retired, and the NL has seen 21 different batting champions over the past 23 years. A few dozen players could conceivably lead the league in batting average in any given year, and the ultimate winner is frequently decided by a handful of lucky (or unlucky) bounces over the course of a six-month season.

¹⁹ From 1876 to 1948, the league hit for .266 on average compared to an average of .258 from 1949 to 2022.

²⁰ Jeff McNeil of the New York Mets led MLB with a .326 batting average in 2022.

²¹ Williams served three years (1943–45) in the U.S. Navy and Marine Corps during World War II and returned to active duty during the Korean War (1952–53). He was the AL batting champion in 1957 and 1958 after returning from duty at ages 39 and 40, respectively.



As in MLB, the modern private markets investment professional has become a stronger caliber of ‘athlete’ as the industry has matured. Relative to their predecessors, fund managers are more expertly trained, more experienced, more specialized and have more resources at their disposal. Fierce competition for capital, talent and assets has accelerated the rate at which firms must evolve just to keep pace. Over the past two decades, attributes that managers once held up credibly as differentiators — talent from top universities, apprenticeships at elite institutions, sophisticated analysis techniques, industry advisors, operational playbooks and so on — have become table stakes in many segments of the market.

The net effect is an abundance of highly-skilled managers in absolute terms, but increasingly narrow gaps between the sophistication, resources and acumen of the best investor and the average one — as evidenced by the material weakening in top-quartile persistence. As in pro baseball, the standouts were once easy to identify, while today there is substantial churn among the names at the top.

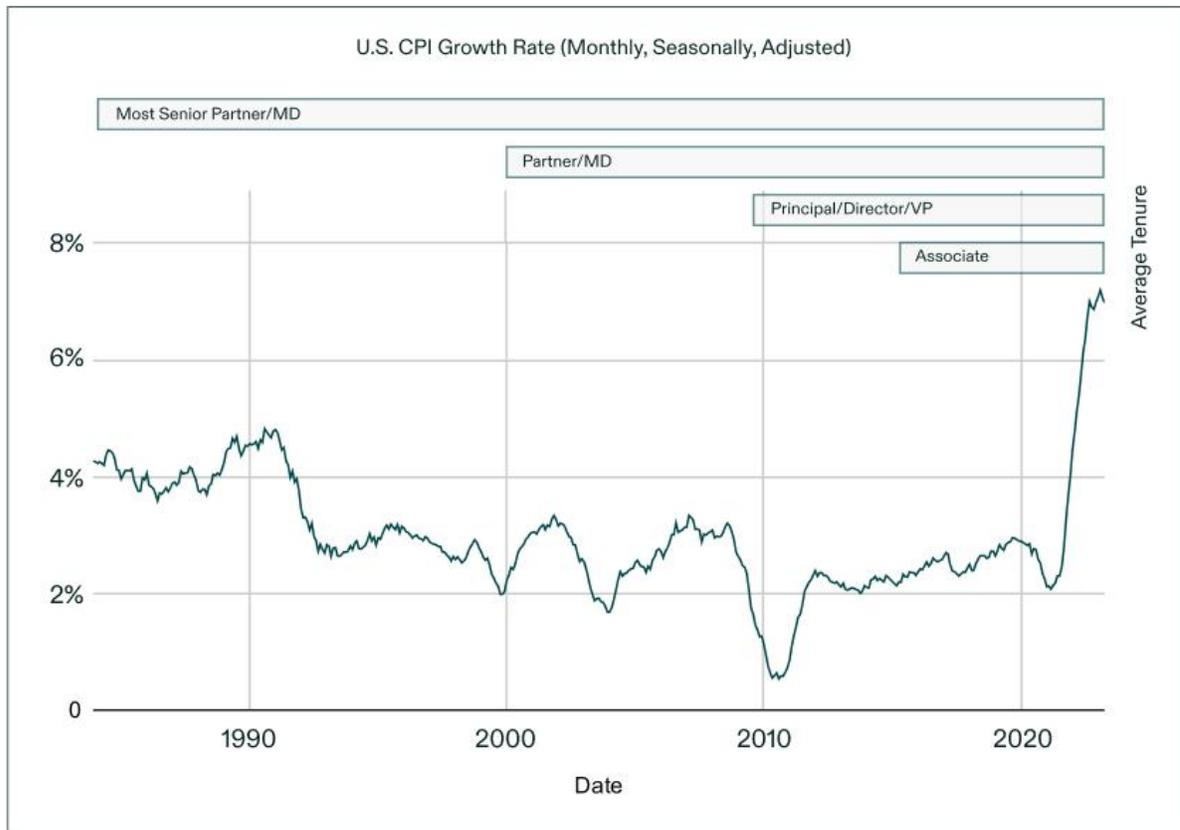
6. The allocator’s dilemma

For allocators, the key practical consequence of the paradox of skill is that traditional manager selection frameworks may fail to narrow the universe to an actionable number of target candidates. With tens of thousands of managers seeking capital, many thousands will be able to boast top-quartile performance²², and given the aforementioned fundraising boom, the growth of that universe continues to accelerate. Complicating the matter is that very few, if any, of the investors leading firms today have practical experience with the current macroeconomic landscape — in particular, the one-two punch of rising interest rates and an inflationary environment.

²² Source: Preqin



Figure 6: PE professionals average tenure vs. CPI growth rate²³



Source: FRED, Bain & Company

As a result, allocators face a dilemma: Conventional wisdom dictates that allocators should focus on finding and backing top-quartile managers. However, thousands of managers can now check that box, and the discernible differences between them are growing narrower. In addition, close examination of the data tells us that top-quartile persistence at this point is essentially negligible. On top of that, the shifting macro landscape could render managers' past performance an even *less* reliable predictor of future returns.

Nonetheless, the burden will remain on allocators to deliver top-quartile results to their stakeholders. The data shows us that screening for strong track records is necessary, but no longer sufficient, to consistently select outperformers. So, what other variables can investors use to identify the managers most likely to keep hold of a top-quartile perch rather than fall back to the pack? Said differently, how can investors identify those opportunities where outcomes will be driven relatively more by manager skill and relatively less by luck?

²³ Source: FRED data, Bain Global Private Equity Report 2023



7. Improving decision frameworks

By explicitly addressing the paradox of skill within their analysis, investors should increase their odds of accessing managers who can sustain outperformance over the longer term. When making decisions under the conditions we observe in private markets — complex systems, rapid rate of change and slow feedback loops — investors are well-served to ground their analysis process in first principles. Therefore, we pair each of our proposed analysis dimensions — 1) market inefficiency, 2) edge resilience, and 3) holistic alignment — with its foundational first principle. Discussion of each dimension below also includes practical examples and questions designed to guide allocators' diligence efforts.

Market inefficiency

Foundational principle: *Alternative investments exist to generate **alpha**.*

As a measure of active return relative to a market return, alpha measures an investor's ability to identify and access assets that have been mispriced by the broader market. However, the greater the number of sophisticated actors — fund managers, independent sponsors, strategic buyers, family offices and so on — hunting in a given market segment, the less likely that segment is to be a consistent source of mispriced assets. In addition, target company executives, investment banks and start-up founders have all become more proficient and experienced counterparties, making price discovery increasingly more efficient. Given the fee load of private market funds, managers who are not consistently uncovering mispriced assets are more likely a very expensive source of beta rather than alpha.

So, allocators face a choice — continue to parse the increasingly narrow gaps in skill between investors in ultra-competitive markets, or focus their attention on finding less competitive arenas. From “Alpha and The Paradox of Skill” (2013):

Jim Rutt, formerly both the chief executive officer of Network Solutions and chairman of the board at the Santa Fe Institute, recently gave a talk about his experience in business. He mentioned that he played a lot of poker when he was young, became pretty good at it, and made some money. Rutt assumed that the best way to ensure continued success was to improve his skill, so he worked diligently at honing his game by learning the probabilities for each hand and studying other players for clues about the strength of their position. At that point, an uncle pulled him aside and doled out some advice. “Jim, I wouldn't spend my time getting better,” he advised, “I'd spend my time finding weak games.”



At this point, not many investment games are truly ‘weak,’ but there will always be segments and niches that are relatively less efficient and less competitive than others. Allocators would be well-served to prioritize highly-skilled and well-positioned managers targeting these pockets of inefficiency. These managers — often those focusing on smaller deals — are likely to benefit from the fierce competition for quality assets among well-capitalized investors up-market and find themselves in an alpha-rich sweet spot: inefficient price discovery at entry and efficient price discovery at exit.

Examples:

- Regulatory barriers to entry
 - Assets may only be acquired by approved buyers or certain types of entities
 - Aerospace, defense, government services, pro sports franchises²⁴
- Technical complexity
 - Owning or operating business or asset requires a degree of specific technical or sector expertise that discourages generalist or ‘tourist’ investors
 - Healthcare, biotechnology, energy, deep tech/hardware, digital infrastructure
- Structural capital gaps
 - Strategies targeting assets and/or market segments that are underserved by institutional lenders or asset managers
 - Asset-based lending, litigation finance, royalties, secondaries, hybrid debt/equity strategies

Key diligence questions:

- What is the source of inefficiency? Is it temporary? Or likely to persist?
- Do managers have the ability to underwrite opportunities and gain conviction at their own pace? Or do competitive dynamics drive accelerated timelines and high risk of FOMO decision-making?
- What mechanism(s) are preventing more efficient price discovery?
- Who is typically on the other side of this trade? Why is this manager at an advantage?
- How frequently are counterparties selling for non-fundamental reasons? Why?
- Who are other natural buyers of these assets? Why aren’t they a threat?
- Is the buyer universe up-market increasing or decreasing? Why?

Edge resilience

²⁴ Barriers here are those imposed by the league governing bodies rather than a government regulator per se, but are functionally very similar.



Foundational principle: *Markets are only growing more competitive and complex.*

For managers who find success, the hard work is often just beginning. Paraphrasing Jeff Bezos: “Your excess return is my opportunity.” Given the amount of capital chasing top-quartile returns, successful outcomes are virtually guaranteed to attract new entrants and intensify competition for the best opportunities. As a result, while establishing a profitable investment edge is harder than it’s ever been, maintaining it might be even more difficult. Managers looking to build truly durable advantages should be clear-eyed and transparent about the need to defend their position in the face of accelerating competition, complexity and uncertainty. Allocators looking for resilient edges should seek out managers with a history of adapting quickly and fighting process inertia, even (or especially) where they are finding success.

Examples:

- ‘N of 1’ platforms
 - Possess unique advantages that competitors can’t replicate on any time horizon
 - Purpose-built to underwrite specific risks with unique capabilities and resources
- Solutions-oriented capital
 - Source of edge is bespoke, flexible approach that works outside confines of structured competitive processes
 - Avoid competing on price by competing on speed, certainty, structure, flexibility or other critical decision factor
- Prudent innovators
 - Managers who continuously, thoughtfully iterate on their approach and do not wait for a crisis to catalyze innovation
 - Individuals and firms with a track record of identifying mispriced opportunities before others and underwriting novel risks in a systematic, repeatable way

Key diligence questions:

- Is the managers’ edge people-centric? Process-centric? Or something else?
- Are there specific procedural or structural obstacles to investing in this segment that the manager can unlock?
- Are there specific risks that this manager is uniquely qualified to underwrite?
- What does this manager look like through the eyes of a portfolio company, investment bank, or lender? Do they blend in with their peers? Or stand out?
- Are advantages in this segment likely to accrue to the scale players? Or smaller, more nimble players? Why?
- How easily could this platform be replicated in one year? Three years? Five years?



- What are the obvious threats to this manager's position in the market? What are they doing to combat them?
- Is this manager's edge more likely to grow or to decay over the investment period? Why?

Holistic alignment

Foundational principle: *Perfect alignment of LP and GP interests is the holy grail of investment governance.*

We define holistic alignment as the end-to-end alignment of a firm's capital formation, organizational behavior and investment platform for the ultimate benefit of limited partners. Historically, assessment of LP-GP alignment has focused on key economic terms in the LPA²⁵ — size of GP commitment, carried interest waterfall and fee offsets — among others. For our discussion, we take best practices around economic alignment and fund governance²⁶ as givens. With an overabundance of options, investors should not need to compromise on economic or governance terms that are not LP-friendly.

In fact, there are many other dimensions along which investors can and should look to align with stewards of their capital. Investing is ultimately a judgment business, and outcomes largely hinge on the discretion of the human beings making these judgment calls. Over the 10+ years of a fund's life, firms and their individual contributors make thousands of discrete decisions, but even the most thorough LPA can't contemplate all possible circumstances or scenarios that might arise.

As a result, allocators should think deeply about all aspects of a manager's program — including, but not limited to — how much capital they raise (and from whom), career arc(s) of key professionals, how managers attract and retain talent, ownership structures, carried interest allocations, succession plans and how they incentivize and govern their portfolio companies.

Examples:

- Emerging managers
 - Often formed by talented investors in their prime who are betting on themselves
 - Clarity of vision, mission and economic incentives across the organization
 - Managers raising Fund I's in today's market are typically much more sophisticated, experienced and accomplished than predecessors.

²⁵ LPA: Limited Partnership Agreement, each fund's primary governing document

²⁶ E.g. Limited Partner Advisory Committee (LPAC) oversight, investment limitations, no-fault divorce, key person triggers and so on



- Growing base of evidence that Fund I's tend to outperform²⁷
- Smaller capital base and therefore more likely to offer no-fee, no-carry co-investment opportunities to limited partners who support them early
- Ecosystem builders
 - Offer exclusive access to peers, talent and/or resources that portfolios companies couldn't otherwise secure
 - Affiliation with the manager provides founders or executives with non-economic benefits that are significant to them (e.g. personal status, 'alumni' networks and so on)
- 'Finishing schools'
 - Strategies that extract advantaged economic terms in exchange for providing sellers and/or management with more than one 'bite of the apple'
 - Growth equity → providing the first institutional capital to bootstrapped companies that need a capital partner but don't want to cede control of a high-growth company
 - Lower-middle market buyouts → acquiring family/founder-owned companies where sellers roll a majority of their proceeds with an eye toward an even larger liquidity event in three to five years
- 'Keystone species'²⁸
 - Entities with privileged access in one area because they provide mission-critical capital or solutions to market participants in another area
 - PE secondaries and co-investment funds → firms that raise and deploy large amounts of primary capital into funds as LPs are frequently anchor investors whose continued support is crucial to a firm's future prospects. As a result, they are very frequently the first to see compelling secondary and co-investment opportunities.

Key diligence questions:

Firm level

- How does the manager's capital formation approach align with the opportunity set?
- Are senior team economic incentives aligned with the value they're creating today and going forward?

²⁷ For example, Harris et al (2023) find that in prior to 2001, first-time buyout funds generated top-quartile PME performance only 19% of the time, but that number grew to more than 30% in the post-2000 sample. In other words, over the past two decades, allocators were more likely to achieve top-quartile performance by backing a buyout Fund I (30% were top quartile) than backing a manager whose prior fund was top quartile (24%; see Figure 4). In future work, we plan to explore the merits of backing debut funds from experienced teams in more thorough detail.

²⁸ National Geographic Society: "A keystone species is an organism that helps define an entire ecosystem. Without its keystone species, the ecosystem would be dramatically different or cease to exist altogether."



- Is the senior team as active, engaged and driven as they were when they achieved their prior success?
- Which other individuals are driving material value? Do they have clear paths for growth within the firm? Are they 'flight risks'?
- Does the core team's career runway align with my horizon as an investor?
- Are the incentives structured to reward value creators going forward? Is there sufficient carry allocation available for strong performers to access as they develop and advance?

Portfolio company level

- Why might a company choose to partner with this manager when they are not the highest bidder?
- Does the manager's capital solution create multiple ways for sellers to win? Or are sellers optimizing for a one-time cash out?
- Does this manager have the expertise, perspective or resources that would be compelling to even the most sophisticated operators in their field?
- Do governance structures incentivize open and honest communication from portfolio companies to surface potential issues quickly?
- Do market participants have compelling incentives to make the manager their first call?

8. Conclusion

"Discrepancies — and hence opportunities — in securities originate most often when events move faster than quotations." —Ben Graham

As private markets competition continues to intensify, events are moving faster than the conventional wisdom for manager selection has evolved. Our intention is not to discard conventional wisdom entirely, but to help investors recognize and capitalize on opportunities that this fast-moving landscape will originate. There will undoubtedly be firms that outperform in highly-trafficked, highly-competitive sectors in the coming years. However, the data tells us that — even picking from a cohort of top-performers — it's very difficult to identify who they will be ahead of time. Our framework is designed to help allocators prioritize more favorable 'games,' where managers can express their skill in less efficient, and therefore more alpha-rich, opportunity sets that ultimately drive more successful investment outcomes.



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