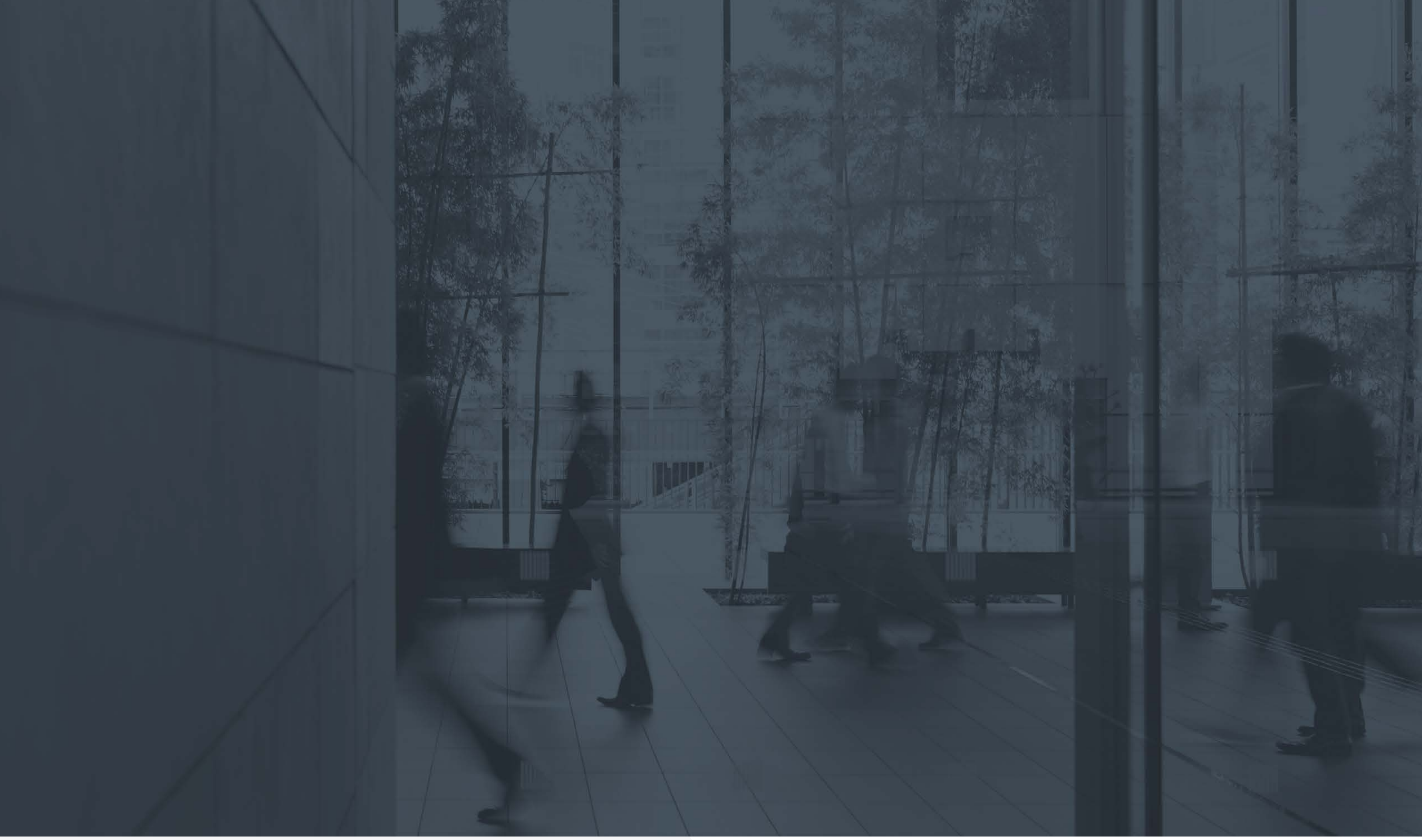
Crapshoot: Picking Private Equity Funds Can Be a Roll of the Dice

Better understanding the randomness of PE performance

Private equity is a vast and growing asset class with over 9,000 fund managers around the world. With estimates topping $9 trillion in assets by 2025, private equity is challenging the public market's supremacy as a source of capital for the world's leading companies.[1]

Despite this popularity, portfolio managers who invest substantial amounts of time seeking, interviewing, and carefully selecting private equity managers are often disappointed with lacklustre results. Even with the strictest due diligence and highest levels of conviction, picking winners remains a random proposition in the private equity asset class.

[1] Preqin



Selecting a PE Manager May Seem Simple

One would think the task of choosing a private equity manager is straightforward for portfolio managers. Compile a network of managers that invest in a given space. Review pedigrees and check boxes for education and experience in private equity.

Spend time discussing and understanding the manager's edge, their ability to source opportunities, and their ability to make operational improvements in their portfolio companies. Ensure the firm's back office and middle office procedures meet essential standards of risk management and best practices.

Past Performance Is NOT Indicative of Future Results

If not earlier in the process, an investor's attention will then shift to the manager's track record. Naturally, most would gravitate to managers who have done well. But for many, the realization that past performance isn't a strong indicator of future performance in private equity or venture capital comes too late.

If you have invested with a manager whose recent vintage produced top quartile results, the odds of the fund under consideration generating top quartile performance are only 24%.

24%
Buyout

At the time of fundraising, if the prior fund is a top quartile performer, what are the odds that the subsequent fund will be in top quartile?

30%
Venture Capital

48%
Buyout

At the time of fundraising, if the prior fund is a top quartile performer, what are the odds that the subsequent fund will be in the top two quartiles/ an above average performer?

54%
Venture Capital

Altogether, it's about even odds that the investment will result in first, second, third, or fourth quartile performance. The odds that the next fund is in the first and second quartile are in fact less than 50%. Put another way, **it is more likely that the new fund will be an underperformer.**

Venture capital (VC), on the other hand, shows some signs of return persistence – but still very weak. A top quartile fund has a 30% likelihood of being followed by a top quartile fund and about a 54% likelihood of being in the upper two quartiles.

Venture persistence makes some sense as these managers benefit from the virtuous cycle of VCs with strong exits that tend to attract greater numbers of entrepreneurs with the next generation of ideas seeking capital.

Source: Harris, Jenkinson, Kaplan, Stucke, Has Persistence Persisted in Private Equity? (November 9, 2020)

Replicating Success in PE Is Difficult

Success begets … competition. In private equity, managers may execute successfully on a business strategy or investment thesis, such as a roll-up of some fragmented industry, but often these managers become a victim of their own success. PE strategies are more easily replicated by other firms and entrepreneurs – as ideas get copied and capital floods in, opportunities to repeat success quickly evaporate.

Clearly, there are exceptions to this rule. A small subset of managers has consistently produced top performance in their funds. However, for this reason, these managers are hard to access and are consistently oversubscribed despite high investment minimum thresholds. These managers typically accept funds from investors who have been long-term supporters before allowing new investors in, a luxury for the few that reinforces the undemocratic nature of the industry.

Diversification Delivers the Promise of PE

PE is an attractive asset class, and for good reason. The industry has generated eye-popping returns from deals that have splashed across newspaper headlines for years.

However, what is not obvious is the challenge managers have with replicating their success. Return persistence is weak in the industry, leaving many investors disappointed with their experience in private equity, and, for most, top performers are virtually impossible to access.

The true differentiator for investors seeking private equity exposure is diversification. Diversification across managers and strategies is the most compelling antidote to gambling that any one manager can deliver the promise of private equity.

Enhance Your Portfolio Performance With Diversified PE Funds

Learn how Overbay overcomes the challenges of private equity with global diversification across hundreds of companies and varied sectors.

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