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PRIVATE EQUITY EMERGING MANAGER FUND-OF-FUNDS
Definitions, Returns and Institutional Motivations

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Note:

As a CFA candidate, and to clearly state any potential conflicts of interest; this paper has been written as part of the Carolina Venture Fellows program. While this paper is academic in nature, the author is also an intern with Parish Capital Advisors, a private equity fund of funds focused on emerging managers.

1. INTRODUCTION

The universe of emerging manager private equity fund-of-funds is both small and relatively young. Swensen's Pioneering Portfolio Management, often considered the modern guidebook to practical institutional asset management, makes short comment on private equity as part of alternative assets as a class, has limited discussion of the role of a fund-of-funds, and the only discussion of emerging is in regards to developing economies.¹ While the role of an emerging manager private equity fund-of-fund, its manager selection process, and observations about private equity style are all of significant interest and could fill several volumes with their nuances, this paper will focus on basic elements of this market. The author will look at existing definitions of emerging managers, discuss their potential for superior returns and conclude with rationales for institutional investors to pursue them as an asset class using a fund-of-funds.

2. WHAT IS AN EMERGING MANAGER? DEFINITIONS.

The term 'emerging manager' is first found in literature searches in 1986.³ The term is often used in very different connotations, as early as the term surfaces, so too does debate over its meaning.⁴ The four central variables that surface in looking at the term are; minority and/or women owned firms, the size of funds under management, the relative experience of the fund team to private equity, and whether or not it is in reference to public or private markets.

Google Hits ²	Term
12,000,000	Iraq
2,550,000	Jennifer Lopez
1,700,000	Emerging manager
357,000	Emerging manager public equity
325,000	Emerging manager private equity
169,000	Emerging manager minority
367,000	Emerging manager women
77,200	Emerging manager hedge fund
82,600	Emerging manager minority private equity

2.1. Minority / Women owned

While the presence of minority and women run businesses has been low throughout the US economy, the investment management business has been extremely difficult to penetrate. Only four of the Fortune 500 are run by an African American CEO, and IBM was recently cited as a top place for women to work despite the fact that only 3% of their manager-level employees are women.⁵ Many institutions defined minority and women-owned funds as emerging in order to address this issue. Obie McKenzie, co-Head of institutional marketing at Merrill Lynch recently said, "If it was not for minority

¹ Swensen, David F. Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment, (The Free Press, New York: 2000).

² All searches were done in English only on June 9 and 10, 2004.

³ Factiva.com was used, their financial database dates back to at least 1951.

⁴ Williams, Terry, "Definition of 'emerging manager' gets murky." Pensions & Investments, (August 21, 1995, V. 23, n17) pg. 29 (1).

⁵ Daniels, Cora, Black Power, Inc.: The New Voice of Success (John Wiley & Sons, 2004) Pg. 33, 46.

trustees, I would not be in this business.”⁶ Unfortunately, the presence of such mandates has not been without controversy about what some have perceived as conflicting fiduciary and societal development goals.⁷ The unfortunate by-product of these controversies has been for emerging managers that fit under this category to be held to higher, less clearly stated, standards.

2.2. Size / Generation of fund

Many institutional investors categorize emerging funds based simply on the Roman numeral beside their fund name. If it isn't a I or a II, it isn't emerging. Still others focus on the amount of assets under management.⁸ If you're investing into buy-outs, more than a certain amount, for example, \$500 MM, isn't emerging. If you're investing into venture capital, \$200 MM is the limit. These constraints exist to address concerns about the ability of funds beyond these limits to earn superior returns (this will be addressed further under Section 3).

2.3. New to Institutional Private Equity

Rookie managers who are new to private equity will often be qualified as emerging, for clear and obvious reasons. It is not unusual for serial entrepreneurs, or individuals who have strung together a series of successful investments to look to raise their first institutional money. This can be a very difficult process, despite the presence of a strong track record and experience.

In evaluating novice institutional GPs, a frequent evaluation is made of their role in private equity during the bubble years from 1998 to 2002. Absence from the private equity market during those times frequently qualifies a manager as 'emerging.' Presence, particularly if it was strong, requires accounting for past activities and often a 'mea culpa'.

2.4. Public vs. Private market connotations

While the focus of this paper lies clearly on emerging managers for private equity, the presence of a parallel world of emerging managers in the public equity asset class should not be ignored. This further compounds naming and classification efforts – the recent surge in hedge fund registrations, up 18% year over year for April according to the SEC, comes as managers exit the mutual fund industry in droves, all becoming 'emerging managers' in the public equity sector.⁹

The presence of dueling emerging managers between the two sectors can cause issues for emerging managers in the private equity sector. Emerging fund managers in the public equity sector benefit from an ability to generate quick track records, and from a

⁶ “Merrill marketing chief: Emerging managers should network,” Money Management Letter (May 10, 2004 V. 29, Issue 10).

⁷ “L.A. police sue pension fund” Pensions & Investments (July 12, 1993).

⁸ Schachter, Bart, Hoyem, George and Smith, Brien, “Size Does Matter” Venture Capital Journal (October 1, 2003).

⁹ “Hedge fund manager registrations leap big time”, Alternative Market Briefing (June 3, 2004).

liquid market which would allow an institution to withdraw money after a shorter time horizon (e.g. 3 years) if results are unsatisfactory. Private equity track records are generated over decades, and after three years an institution would find their private equity results at the depth of a j-curve.

Unfortunately, the greater concentration of institutional investments in the public equity market, typically 40 – 70% of assets, vs. 5 – 20% for alternatives as a whole, a fraction of which is actually private equity, means that there is greater infrastructure for understanding emerging managers through the lens of public equities. Such evaluation does not typically fully grasp the difficulties in evaluating private equity managers, let alone those that are considered emerging.

2.5. Emerging Markets

Asset managers in both the public and private equity areas can focus on emerging markets – developing countries that appear to be on the rise. While recent factor models have shown that industry, rather than country, factors dominate individual equity returns, there are still a number of managers that focus on macroeconomic investing. The hope is to make investments in an economy prior to broad economic growth. Most emerging market investments are public, although private equity investments do occur. The benefits of emerging market investing are compounded by strong currency returns, which show strong positive correlations to foreign country currency appreciation.

2.6. Parish definition

Parish plays no role in the public equity markets nor emerging markets. Of the four other variables discussed; size, generation, experience with institutional LPs, and minority / women ownership – size is the lone dimension which will disqualify a fund from further review. A higher generation fund IV or V may be evaluated, provided that the GP has limited experience with institutional investors and a strong track record. As a minority-owned firm, Parish makes an effort to support minority and women owned firms – lack of such ownership does not prevent interest. Per Parish's definition:

An emerging private equity manager is NOT:

- A. Large. VC < \$150 MM. Buyout < \$500 MM.

An emerging manager IS:

- B. Experienced with private equity, either as an investor or entrepreneur.

An emerging manager MAY BE:

- C. Minority or female.
- D. New to institutional LPs.

Schachter and Hoyem best described an emerging manager within venture capital as:

“Emerging manager firms are generally defined as those investing from a first- or second-time fund, limited in size to about \$100 million or less. Emerging manager teams generally lack a group track record (that is, a track record derived on the same platform by the same people), but they bring individual track records built from institutional investment experiences elsewhere. Emerging managers generally bring several years of venture deal experience built on platforms where financial compensation may not have been commensurate with the partner's investment track record. These platforms generally include larger firms or corporate investment groups.... Stated simply, these managers have gained enough experience but have not yet made enough money to dull their hunger and ambition.”¹⁰

3. RETURNS

3.1. Evidence

The illiquid and non-public nature of private equity makes the collection of evidence supporting superior returns for emerging managers within the sector difficult. Size has been shown to be inversely correlated to returns in the public equity markets, particularly within small capitalization equity managers. Returns of small cap stocks have been shown to be highly correlated with VC returns, offering a bridge towards comparing the results.^{11,12} In a 2002 paper titled, “Perils of Success: The impact of asset growth on small-capitalization investment manager performance” the authors tracked the performance of small capitalization public equities by dividing the universe of managers into quintiles based on size. Smaller funds outperformed larger funds persistently over the seven year period across all sectors and styles. The authors also demonstrated evidence in support of two hypotheses, the first that “the more assets under management, the lower the subsequent excess returns” and secondly that, “the greater the *increase* in assets under management, the lower the subsequent returns.”¹³ Assuming these results can serve as a proxy for the private equity market, the link between assets under management and returns is clear.

Literature pertaining specifically to private equity does provide some evidence that a larger asset base and more funds under management does not forecast superior returns. Schachter and Hoyem state, “87% of the VC firms with at least four funds produced a top quartile fund for only two of those funds. Just 4% of those with six funds or more produced top-quartile funds for only three of those funds. It would appear that

¹⁰ Schachter, Bart and Hoyem, George, “How to Select an Emerging Venture Manager,” Venture Capital Journal (March 1, 2003).

¹¹ Chen, Peng, Baierl, Gary and Kaplan, Paul, “Venture capital and its role in strategic asset allocation: Long-term risk-return characteristics,” Journal of Portfolio Management (Winter 2002: V.28, i.2) pg. 83(7).

¹² Barry, Christopher B., “Venture Capital” AIMR Proceeding on Alternative Investing, (August 1998).

¹³ Christopherson, Jon, Ding, Zhuanxin and Greenwood, Paul, “The Perils of Success: The impact of asset growth on small-capitalization investment manager performance” The Journal of Portfolio Management, (Winter 2002), pg. 42. Italics have been added.

venture firms don't scale in either size or duration.”¹⁴ This evidence clearly shows that larger, repeated funds, do not have an increased likelihood of consistent top quartile returns. While the benefits of smaller funds appear to be largely accepted as conventional wisdom, the benefits of a quantitative study supporting this effect would be much appreciated within the institutional asset management world.

3.2. Operating rationale

Having demonstrated that smaller funds consistently outperform larger funds, it is important to develop an understanding of the reasons why, in order to ensure that in pursuing emerging managers these qualities are consistently sought after. The literature cites two primary reasons; managers' pursuit of wealth and active management.

3.2.1. Wealth seeking

Managers who are not wealthy have greater incentive to work harder and earn money for the Limited Partners. Larger funds are indicative of managers who are “fat, dumb and happy” for two reasons; they are a greater source of fee-based revenue, and they imply past success. General Partners in the private equity sector typically take fees from 1.5% to 3.0%, most often 2.0%. The original role of these fees was to cover operating expenses, which are significant, while the partnership makes investments and assists with the development of portfolio companies. In this spirit, many of these fees are reduced when exits start to occur, with the expectation that GPs' cash needs should be met from their carry. As assets under management increase, the percentage contribution of the 2% management fee to the GPs' wealth grows out of proportion to the returns they will earn from their carry. An outstanding depiction of the conflicting role of management fees and carry is outlined in Ben Warwick's Searching for Alpha, in which the author performs a similar analysis for public hedge funds.¹⁵ The effect of fees on management incentive is further compounded as new generations of funds are raised – if Fund III is still earning fees, which should cover operational expenses, where do the fees for Fund IV go? The implications for the manager of a Fund IX are clear, their incentives are now closer to that of a large institutional asset manager, and as the fees grow in importance, operational risks like benchmark hugging, group think and linear perception should create a drag on the fund's returns.

3.2.2. Active management

Private equity is the most actively managed of all asset classes. The level of involvement a GP has with portfolio companies far outweighs the time another group may spend trading – unfortunately the long time span of investments and illiquid market makes this assertion difficult to comprehend. The author would argue that these very

¹⁴ Schachter, Bart and Hoyem, George, “How to Select an Emerging Venture Manager,” Venture Capital Journal (March 1, 2003).

¹⁵ Warwick, Ben, Searching for Alpha: The Quest for Exceptional Investment Performance, (John Wiley & Sons, Inc.: 2000), pg. 46 – 49.

characteristics make valuation events all the more important, giving further motivation for active management by private equity GPs.

As active managers, the time of private equity GPs serves as a constraint on their returns. The authors of “Size Does Matter” put it best, “Smaller funds can afford to write small checks for a project and focus very keenly on that company. Most investors agree that it is only possible for a single partner to sit on up to five active boards of directors. In the bubble it was common to find managers sitting on 10 or more boards.”¹⁶

Surely then, to manage a large pool of assets, we need only assemble a larger group of people. This creates concerns about internal communication and an incentive for free riders to emerge. In an area where money is made through the sheer effort and will of managers, compromising the integrity of the group’s dynamics is a recipe for disaster.

4. INSTITUTIONAL INVESTOR MOTIVATIONS

“Ironically, institutional clients with resources that might prove useful in picking managers are the most likely to embrace passive investing. Their size inhibits mobility and knowledge feeds their skepticism.”¹⁷ - Robert D. Arnott and Robert M. Lovell Jr.

4.1. Risk and Return

The primary objectives at any level of asset management are to increase the amount of return for a given level of risk, or to decrease the risk for a given level of return. Chen, Baierl and Kaplan conclude that within private equity, VC is indeed a high return, high risk asset class that has demonstrated low correlations to large cap public equities.¹⁸ Terhaar, Staub and Singer view alternative assets as a method to enhance return, with the risk mitigation benefits coming mostly through the illiquid nature of the asset class. They make the interesting observation that is the diversification of alternative asset classes increases, their correlation with public equity markets should increase.¹⁹

When evaluating institutional managers’ motivations for using a fund of funds for investing into emerging private equity managers, the potential increase in returns must be a primary driver. Fees earned by such a fund of funds must be balanced in order to maintain the return objective that the institutions are pursuing.

4.2. Diversification

Diversification has long been the battle cry of fund-of-funds managers, particularly during their emergence as a distinct class within the public hedge fund sector.

¹⁶ Schachter, Bart, Hoyem, George and Smith, Brien, “Size Does Matter” Venture Capital Journal (October 1, 2003).

¹⁷ Arnott, Robert D. and Lovell, Robert M. Jr., “Monitoring and Rebalancing the Portfolio” Managing Investment Portfolios: A Dynamic Process, 2nd Edition (1990) Chapter 13, pg. 13-38.

¹⁸ Chen, Peng, Baierl, Gary and Kaplan, Paul, “Venture capital and its role in strategic asset allocation: Long-term risk-return characteristics,” Journal of Portfolio Management (Winter 2002: V.28, i.2) pg. 88.

¹⁹ Terhaar, Kevin, Staub, Renato and Singer, Brian, “Appropriate policy allocation for alternative investments” Journal of Portfolio Management, (Spring 2003) pg. 3 of 9.

An investor who has enough money to make an allocation to an alternative asset class, but where that money is not enough to diversify among several managers, bears additional style, concentration and operational risks by placing all of the allocation with a single manager. An investor with \$20 MM to spread across emerging managers could only make 4 investments if there was a \$5 MM minimum investment size. By putting that investment with a fund-of-funds invested across +30 investments, the \$20 MM could be diversified to a much greater extent.

4.3. Rebalancing

Style drift is a primary concern in evaluating any asset manager. How can an institutional investor know that the manager will continue to invest along the style that they have outlined? As private equity, and particular early-stage venture capital, money managers matured, their style drifted. VCs stopped investing in pure start-ups and began investing in early stage businesses. Buy-out shops moved from purchasing family run businesses with \$10 MM in EBITDA to large divisions of public companies. This change in style was due to a change in knowledge-base with the maturation of portfolio companies, a growth in assets under management, and an increasing awareness of the manager's activities that prevented them from following previous strategies. These three characteristics acted in concert to create a positive feedback loop that changed the nature of private equity.

When institutions first placed money with private equity investors, did they do so because of the manager's track record, or because of a belief in the asset class and potential for high returns? There were no track records, thus a fundamental belief in the asset classes' characteristics had to play a significant role in the original allocation. As these managers matured, we find that the institutional investor no longer has access to the asset class which prompted their original decision. Their managers, and their assets, have drifted towards later stage businesses. Carl Thoma, a noted private equity manager, acknowledges this drift, "Some of that special spirit that caused our sector to bloom and create a lot of great companies in America is now turning into money managers with less focus on how to create lasting value."²⁰

Public equity market research shows the benefits of a rebalancing strategy to be approximately 40 bps. per year.²¹ The benefits of rebalancing in an illiquid market with very long time horizons would vary due to pricing and transaction costs, but return benefits of 40 bps. per year are clearly significant when evaluating an asset base of billions of dollars. Investors that do not choose to rebalance within a private equity portfolio are by default making a decision to pursue a buy and hold strategy. Institutional managers should recognize that decision and its fundamental assumptions about their risk tolerances and market expectations for the asset class.

²⁰ "A Study on The Human Capital Aspect of Venture Capitalists" Prepared for Information-Technology Promotion Agency, January 19, 2004, Ignite Associates, LLC, Redwood City, CA. Carl Thoma, Co-Founder and General Partner, Thoma Cressey Equity Partners, pg. 38.

²¹ Arnott, Robert D. and Lovell, Robert M. Jr., "Monitoring and Rebalancing the Portfolio" Managing Investment Portfolios: A Dynamic Process, 2nd Edition (1990) Chapter 13, pg. 13-20.

4.4. Resources

The largest institutional investors are the state pension plans. As employees of the state, they are subject to many of the same potentially bureaucratic constraints that are a fundamental part of the U.S. Government. Investing into any new asset class requires time, knowledge, and a culture that rewards the risk taken. The constraints of a state plan typically make it more difficult for such a system to develop. By using an outside manager, state plans can get access to emerging managers and overcome these concerns.

4.5. Future access

Today's emerging managers will be tomorrow's Kleiner Perkins and Summits. Investors who wish to participate in such large funds need to support these investors now, otherwise there will be no seat at the table for them when the time comes. While the hand-off for an LP in a fund-of-funds to make a direct investment into a fund at a later date may not be simple, it at least affords them the chance to do so. In theory, an emerging manager whose initial round consisted solely of emerging manager fund-of-funds could only accept money from all the fund-of-fund LPs by increasingly the fund size dramatically – only under this extreme scenario would access become an issue.

4.6. Incentive alignment

Consultants are an entrenched part of the pension and institutional asset management world. They take fees for advice, whereas a fund-of-funds manager is compensated for results. The difference in incentive when evaluating an emerging manager is clear. The consultant and the manager will both make the same steps to evaluate the manager, both perform rigorous due diligence, but the consultant will make a decision and walk away from the transaction. The fund-of-funds manager will spend the next ten years working with the new manager and helping them emerge – it is clear where the stronger incentive to understand the opportunity lies.

5. CONCLUSION

Definitions of what qualifies a manager as emerging are increasingly focusing on size.²² Research and operational assumptions support a belief that smaller, emerging funds should create superior returns for investors. With 90% of the defined benefit plans in the U.S. alone currently underfunded, representing a \$350 billion funding gap, the motivation for institutional managers to address this issue by pursuing higher returns is clear.²³ The ability of fund-of-funds to provide superior returns to institutional investors through access to emerging managers should enable significant growth for this sector in the coming years.

²² Jacobius, Arleen, “‘Good Start’: Private equity creeps back, at expense of real estate,” *Pensions & Investments* (May 31, 2004, V.32, n.11).

²³ Cobert, Beth F., Palter, Robert N., and Urban, Elizabeth A., “U.S. pension funds: Mind the gap” *The McKinsey Quarterly* (May 2004 n.2).