NEWS ANALYSIS: STATESIDE

Do managers matter?

Yes, but often macro factors matter more – yet another reason to decline the 'automatic re-up'

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Venture capitalists have a saying that neatly sums up the importance of management talent in early-stage companies: "An 'A' idea with a 'B' team is a 'C'; a 'B' idea with an 'A' team is an 'A'."

Flipping this statement around somewhat, I'd like to propose a new aphorism for LPs who back buyout funds: "An 'A' team in a 'B' market cycle is a 'C'; a 'B' team in an 'A' market cycle is an 'A'."

Contrary to the notion that one should *always* re-up with a "top-quartile" private equity fund manager, LPs and their advisers need to first take a view on the direction of the world, the economy, specific markets, and then find the best private equity teams they can to execute the right strategy within this macro environment.

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In other words, if you think that retail businesses make for attractive buying opportunities right now, find a competent team of retail specialists and back their fund. Don't worry if their last fund wasn't in the "top quartile". How could it have been? Almost anyone who invested in retail over the past five years has a track record that looks even worse than the average private equity fashion emergency.

Coming at this investment aphorism from another direction, the fact that the last buyout mega-fund from Brandname Capital was a top-quartile performer is not sufficient reason to automatically re-up to the next Brandname Capital buyout mega-fund. Among the many factors that helped the prior fund do as well as it did, GP skill is just one. Even if that skill is "pervasive", the macroeconomic environment and market peculiarities that drove the success of the fund are not necessarily pervasive.

Limited partners too often fall into a practice that appears disciplined but is in fact somewhat lazy – only investing in funds managed by GPs whose last fund performed within the highest quarter of its (carefully selected) peer group. At least two investment advisers are putting hard numbers behind the argument that these automatic re-ups are foolish. Peracs, led by Professor Oliver Gottschalg, has done research tracking private equity deal performance by industry cycle which, you'll not be surprised to learn, finds that cyclical economic and industry conditions are highly predictive of the success of individual deals. More predictive, in fact, than the skills – "persistent" or not – of the teams executing these deals (see page 17).

Satyan Malhotra, president of New York-based Caspian Capital Management, takes a withering view of the private equity equivalent of chasing returns. Recent research done by Caspian shows that a buyout GP that manages a top-quartile fund has a less than one-in-five chance of turning in a top-quartile performance on the next fund. It is already hard enough to define exactly what "top quartile" means, but after this task is completed, what LP on earth has the ability to discern which one of the five top quartile managers to walk through the door is going to do it again with the next fund? In truth, you can't predict this just by looking at the manager.

And yet many large LPs have private equity programmes built around the premise that GPs with a certain experience and performance profile should be preferred. It is understandable why this appears prudent – one should only invest with people who have shown they know how to successfully execute the private equity strategies they claim to have mastered. And yet backing those same groups again and again risks producing an outcome at odds with the role that private equity is supposed to play in the portfolio. Not only do GPs not always hit the market cycle just right, but as they grow in size their returns tend to more closely resemble the average. "Over time, funds tend to move to the index road from the alpha road," is how Malhotra puts it.

GPs are always describing private equity as an excellent asset class for seizing upon and profiting from change. True. And so it is the responsibility of the LP to make a call as to which part of the world is about to change and *then* find the right team to profit from it. This can sometimes mean leaving an 'A' team on the way down for a 'B' team on the way up. ■