CLEARPOINT

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MIKE MCLELLAND, CFA, CAIA, ANALYST, RESEARCH

WHY INVESTORS SHOULD CONSIDER EMERGING MANAGERS IN PRIVATE MARKET ALLOCATIONS

BY MIKE MCLELLAND, CFA, CAIA, ANALYST, RESEARCH

Capital markets remain flush with liquidity, and investors are looking for attractive asset classes outside of traditional public equities and fixed income. Return expectations have normalized from lofty performance in the equity markets as the S&P 500 returned over 14% annualized over the past 10 years through year-end 2021 (Bloomberg). Although bond yields have recently started to creep up, the U.S. bond market is coming off a 40-year bull market with interest rates still sitting at relatively low historical levels. Given the perceived frothiness in public markets, investors have looked to private markets as an outlet for further supplementing portfolios. The appeal of enhanced diversification, strong absolute returns, and potential income generation (through private credit and real assets) helps explain why investors are committing to private strategies at a record pace. Private alternatives have never been more accommodative for qualified investors, with client-friendly terms such as lower direct commitment minimums as well as lower management and performance fees, helping investors to get increasingly comfortable with illiquid strategies.

However, with more complexity, comes additional risk. The illiquidity premium generated by private strategies is highly dependent on manager selection. Relative to public markets, where asset allocation decisions predominately drive

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client, Research and Investment Management, Reporting and Operations, and Administration teams with Allen Dengler, Tyler Campbell, David Mooney, Heather Hughes, and Shereen Abuzahriyeh.

Allen Dengler joined Clearstead as a Director, PCG. Allen was a Sr. Associate at Cerity Partners and before that was a Relationship Manager at PNC Bank. Allen has a Bachelor's degree in Economics from Miami University.

Tyler Campbell joined Clearstead Trust Co. in Portland as a Research Analyst. Tyler previously worked at SS&C Eze where he was an Engagement Specialist – Operations & Market Data. He has a Bachelor's degree from the University of Maine in Finance and Accounting.

David Mooney joined Clearstead as a Performance Analyst. David previously worked at Nestle as a Business Claims Analyst and recently was an Equity Intern at Northcoast Research. David has a Bachelor's degree in Economics from Cleveland State University.

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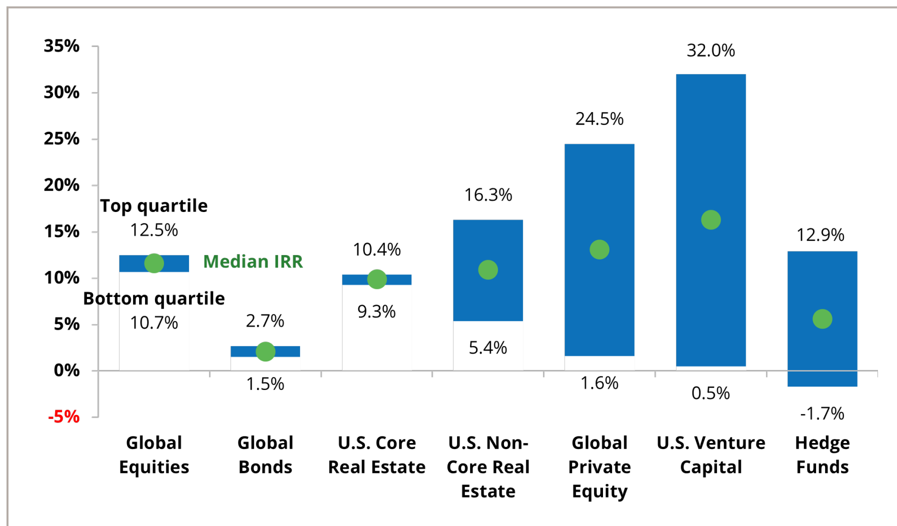
outperformance or underperformance, manager selection is pivotal for private alternatives. There is a significant dispersion of historical returns across private fund managers, emphasizing the importance of due diligence on every strategy. The difference between the top and bottom quartiles for global private equity manager 10-year performance is nearly 23%.[1] The dispersion for venture capital is even wider. Proper vetting of private managers could have a significant impact on portfolios, making the manager selection process critically important.

Private and Public Manager Dispersion

Based on returns over a 10 year window[1]



Source: J.P. Morgan Asset Management Guide to Alternatives, Lipper, NCREIF, Cambridge Associates, HFRI. Global equities (large cap) and global bonds dispersion are based on the world large stock and world bond categories, respectively. *Manager dispersion is based on the annual returns for global equities, global bonds, and U.S. core real estate over a 10-year period ending 3Q 2021. Hedge fund returns are based on annual returns from Nov. 2011–Oct. 2021. U.S. non-core real estate, global private equity and U.S. venture capital are represented by the 10-year horizon internal rate of return (IRR) ending 2Q 2021. Data based on availability as of November 30, 2021. Past performance is not an indicator of future results.

Private fund investors could simply select an experienced fund manager with strong historical performance over multiple business cycles and consistency in its process and strategy. But what if the manager is new, without a track record of investing together or as an independent entity? Private Equity International ("PEI") defines emerging managers as private fund managers that are new to the market and raising first-time institutional funds.[2] Many emerging managers are spinouts from established private alternative investment firms. Others may have operated as independent or fundless sponsors and recently institutionalized their processes. Some institutional investors define emerging managers as funds that are led by diverse teams. Regardless of definition, emerging managers tend to have a shorter track record, which complicates the due-diligence process for limited partners ("LPs"), with many avoiding allocations to emerging managers altogether. Despite these perceptions, emerging managers could serve an important role in allocations to private alternatives and provide several key benefits to investors.

Heather Hughes joined Clearstead as an HR Generalist/ Recruiter. Heather comes to Clearstead from Ohio's Center for Oral, Facial & Implant Surgery where she was the Human Resources Manager. Prior to that, Heather was the HR Assistant and Payroll Administrator at Hawken School. Heather has a Bachelor's degree in Business and Marketing from Miami University.

Shereen Abuzahriyeh joined Clearstead as an Information Technology Associate. Shereen has a Bachelor's degree in Information Systems from Baldwin Wallace and a Master's degree in Information Systems from Cleveland State University.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

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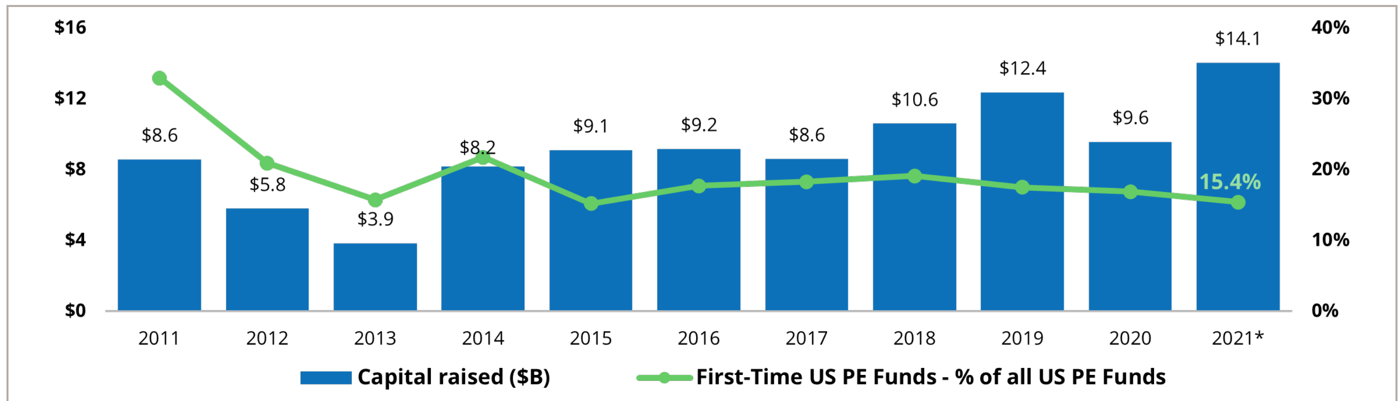
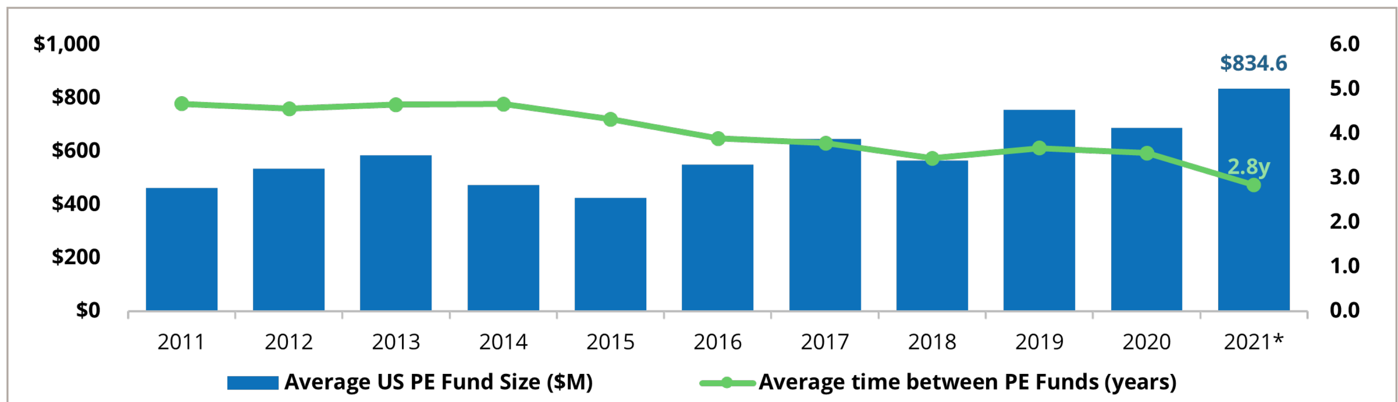
The rationale behind LPs investing in emerging managers is avoiding herd behavior and the tendency of many fund managers to chase the returns generated by the more established managers with strong institutional backing. Private manager fundraising is accelerating rapidly, with mega-funds (strategies with $5 billion or more in committed capital) coming to market at a shorter pace between funds (~3 years) and notable step-ups in size. Contrary to the strength exhibited in private manager fundraising, first-time funds have generally decreased as a proportion of funds coming to market. From 2018 to 2021, first time U.S. private equity managers decreased as a percentage of U.S. private equity funds coming to market to nearly 15%, a figure that continues to trend downward.[3]

First-Time US PE Funds



Average US PE Fund Size vs. Time Between Fundraising



Source: PitchBook 2021 Annual US PE Breakdown
*Estimated as of December 31, 2021

Given the strength in established manager fundraising, it is reasonable to infer that these managers have generated strong historical performance. Some mega-funds have generated positive performance since the pandemic trough, rapidly exiting portfolio investments at significant markups against rising public comparables. Larger funds deployed record amounts of capital and benefitted from a wave of exits to public markets via initial public offering. There were approximately 107 U.S. private equity deals topping $1 billion in 2021, reaching $335 billion in total, and growing 91% from 2020. Public listings accounted for 38% of domestic private equity exit value with $278 billion realized through public markets in 2021, exponentially higher than the $36 billion of IPO exits in 2019.[3] With robust performance and sooner-than-expected distributions, LPs often recycled the capital into new fund commitments to those same large PE firms and boosted allocations, further augmenting mega-funds.

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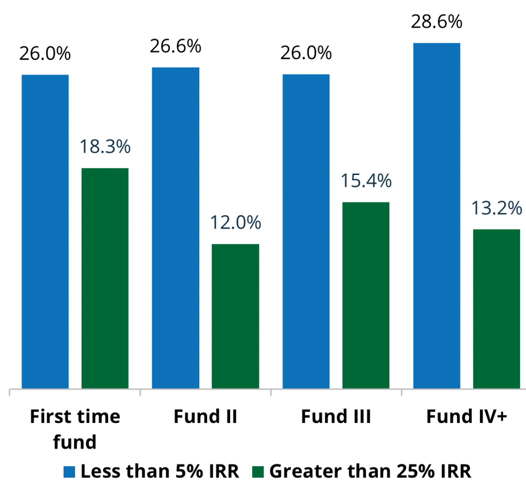
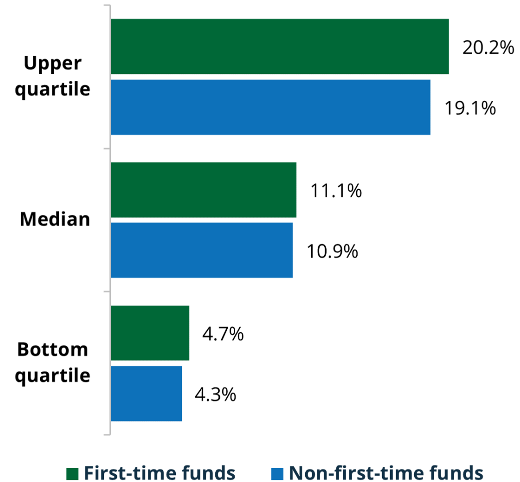
However, large, established managers do not always generate the highest returns relative to smaller, emerging funds. In fact, recent PitchBook data suggests that established managers have slightly underperform first-time funds, have less upside potential, and capture more downside probability over the long term.[4] Analyzing historical fund performance during the Great Financial Crisis further supports the case for heightened downside protection, with mega-funds declining 30.1% while smaller managers dropped 20.5% in 2008.[5] The theory behind this relationship could be explained in a straightforward manner; younger, emerging managers typically have a higher proportion of their net worth tied up in the firm. The fund management's livelihood solely depends on the success of the firm, making them hungrier to generate strong performance early. While established managers are certainly motivated to generate outsized returns, larger deal sizes and strategy broadening could water down performance relative to more nimble, smaller funds.

Return Probability by Fund Number



IRR Quartiles by Fund Type



Source: PitchBook First-Time PE Funds Overview – Q1 2021; Pooled PE Funds (Vintage years 1996-2015). Past performance is not an indicator of future results.

Larger funds are tasked with investing in larger deals during the investment period, which could create challenges as managers are effectively put on the clock to deploy capital in deals with enough upside potential to generate strong returns for LPs. However, it could be more difficult to drive significant upside on larger investments through value-add improvements (a large company likely has sufficient technology, processes, and infrastructure). Larger deals could have more competition among other established managers, which could lead to deploying capital at unattractive entry multiples and effectively hindering deal-specific upside potential. Equity check sizes continue to increase, with the average private equity deal nearly doubling to $409 million between 2013 to 2021,[6] as fierce competition has driven entry multiples higher with sizable managers under pressure to deploy record amounts of dry power.

Emerging managers, who lack the fundraising power of established managers, tend to focus on a smaller opportunity set where larger managers generally avoid. It can be a perceived waste of time and resources for larger fund managers to focus on small check sizes, given each deal would be negligible relative to the overall fund size. This allows emerging managers to invest in less competitive deals, often as the first institutional capital for portfolio investments. Less competition typically translates to lower multiples, and a lack of prior financing opens the door for potential value-add and operational upside, presenting a heightened opportunity for multiple expansion at exit.[7]

As alluded to earlier, large, established managers run a heightened risk of style drift to stay competitive, effectively diluting fund mandates. With many emerging managers being spinouts of established alternative investment managers, teams can

specialize in niche markets and verticals in which their former firms used to solely dedicate efforts. Pairing smaller deal sizes with experience in highly specialized markets could lead to additional upside with emerging managers.

Lastly, emerging managers often grant favorable terms (co-investment potential) and discounted management and performance fees to anchor investors and early supporters, further aligning the interests of LPs and fund managers. This is compared to many established managers who are publicly traded, which adds shareholders to the mix vying for alignment of interests. As more mega funds go public, assets under management and management fees play a bigger role in driving returns for shareholders. Publicly traded private managers are aggressively adding and expanding strategies to deepen existing LP relationships and generate additional fee income. Emerging managers are in a feast-or-famine scenario where the sole dedication to one strategy could determine their careers.

Emerging managers are worth considering for private manager allocations. These strategies could deliver specialized diversification across less competitive deals and fit niche buckets within client portfolios. While finding the next established managers may be part of the motivation for emerging manager allocations, there are clear quantitative and qualitative potential benefits with these managers. There is a place for private fund managers of all sizes and specializations from a total portfolio context, and LPs could benefit from knowing what strategies are currently fundraising. Leaving no stone unturned could help augment portfolios with additional diversification benefit and begin meaningful relationships with fund managers who will not forget about early adopters.

Sources:

(1) J.P. Morgan Asset Management Guide to Alternatives. Global equities and global bonds are based on the universe of world large-cap stock and world bond categories. Manager dispersion is based on the annual returns for global equities, global bonds, U.S. core real estate over a 10-year period ending 9/30/2021. Hedge fund returns are based on annual returns from Nov 2011-Oct 2021. U.S. non-core real estate, global private equity and U.S. venture capital are represented by the 10-year horizon IRR ending 6/30/2021.
(2) *Private Equity Fund Investment Due Diligence: Strategies for Evaluating and Selecting Top Performing Fund Managers.* (2016). Private Equity International.
(3) PitchBook: 2021 Annual US PE Breakdown
(4) PitchBook: First Time Funds PE Overview – Q1 2021
(5) Hamilton Lane. Norville, G. (2016, January). *Does Fund Size Matter? Comparing the Performance of Small and Large Buyout Funds.*
(6) PitchBook: 2021 Annual Global M&A Report
(7) Pantheon. Carnelli Dompé, A, & Ferri, D. (2019, September). D*o Small and Mid-Market Buyouts Outperform?*

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Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

February 28, 2022		1M	3M	12M	YTD
US Large Cap	S&P 500	-3.0%	-3.9%	16.4%	-8.0%
US Small Cap	Russell 2000	1.1%	-6.6%	-6.0%	-8.7%
Developed Intl	MSCI EAFE	-1.8%	-1.7%	2.8%	-6.5%
Emerging Intl	MSCI Em Mkt	-3.0%	-3.0%	-10.7%	-4.8%
Real Estate	NAREIT	-3.9%	-3.2%	20.6%	-11.3%
Core Fixed	BarCap Agg	-1.1%	-3.5%	-2.6%	-3.2%
Short Fixed	BarCap 1-3Yr	-0.4%	-1.3%	-1.6%	-1.1%
Long Fixed	BarCap LT G/C	-2.5%	-8.1%	-2.8%	-7.3%
Corp Debt	BarCap Corp	-1.9%	-5.1%	-3.3%	-5.0%

Source: Bloomberg

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