Revisiting Private Equity Manager Selection — December 2021

OVERVIEW

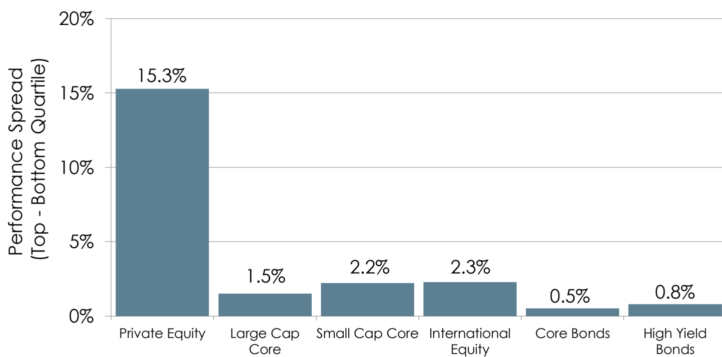
- **Manager selection is critical within private equity, as evidenced by its wide return dispersion versus other asset classes**
- **Private equity manager selection has become more complex over time, increasing the importance of a disciplined process**
- **By staying grounded in key factors with a proven history of success, investors can drive strong decision making and outcomes**

Background

Manager selection is a critical component of success in any asset class, but particularly in private equity, where manager return dispersion is meaningfully wider than in public markets. Over time, the factors influencing private equity manager selection have become more complex. Investors should account for these changes but remain focused on key factors with a proven history of driving positive outcomes.

Importance of Manager Selection in Private Equity

The historical return spread between top and bottom quartile private equity funds has been around 15%, versus less than 3% for global equities, and less than 1% for public fixed income. This allows for greater value-add in private markets, but it also highlights the importance of implementing a thoughtful approach in order to achieve desired results.

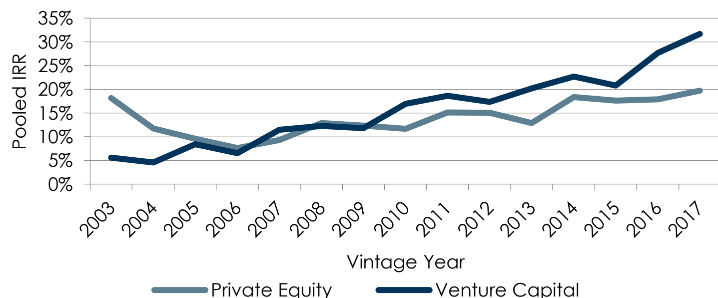


Source: PitchBook, Bloomberg, ACG Research

Manager Selection Has Become More Complex

There are a number of factors that have increased the complexity of manager selection within private equity.

- A rising tide lifts all boats… "everyone is performing well"



Source: PitchBook; Global data as of December 31, 2020; Private Equity includes Buyout, Growth, Diversified, Mezzanine and Turnaround strategies

- Return persistence has declined, making it harder to predict future outperformance based on prior funds
- Managers are raising capital more frequently, so recent fund performance is less reliable for decision making
- Fund size increases have grown in magnitude, which can lead to strategy drift and lower future performance
- There are significantly more managers and strategies to consider than in the past, and many of these have not been directly tested by a prolonged market downturn

Faced with these challenges, it is important for investors to stay grounded in fundamental factors that have a proven history of creating success. This discipline can reduce complexity and lead to better decision making.

Focus on Fundamentals to Create Favorable Outcomes

What are some of the key factors that investors can focus on to remain disciplined in their manager selection?

- Focus on teams that have invested together in both healthy and challenging market environments
- Remain nimble, but avoid trying to time the market

Relative Strategy Performance (1998-2017 Vintages)

Strategy	% of Years With Best Vintage Return	% of Years With Worst Vintage Return
Buyout	35%	25%
Venture Capital	30%	35%
Growth Equity	35%	40%

Source: PitchBook; Global data as of December 31, 2020

- Favor strategies with long-term, consistent risk-return profiles
- Evaluate less efficient markets like small buyout, but appreciate that inefficiency does not always result in higher returns
- Consider co-investments alongside core existing managers, which can benefit returns and future fund selection

ACG's Position

Increased competition and a prolonged bull market have made it more difficult to select high quality private equity managers. In order to remain well-positioned, investors should incorporate changing market dynamics into their decision making while staying true to their core process and beliefs. Doing so can help investors maintain consistent execution and increase the probability of achieving a suitable long-term risk-return profile.

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