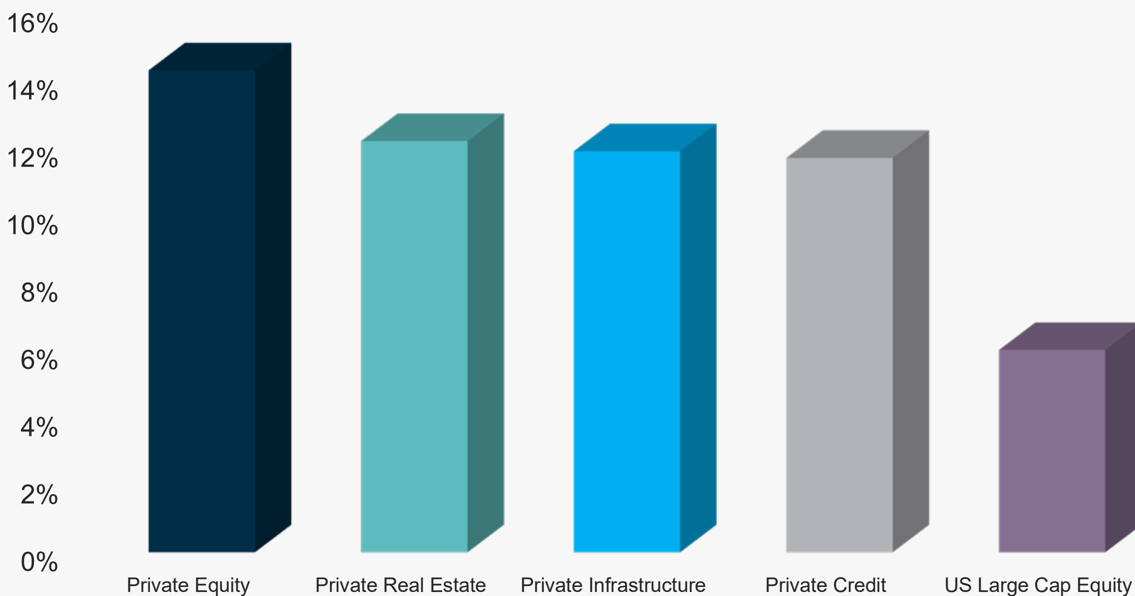
MEKETA CAPITAL

Why Manager Selection is Critical When it Comes to Private Equity Investing

RESEARCH | NOVEMBER 2024

Private equity may potentially play an important role in an investor's portfolio, offering potentially strong returns, increased diversification, and expanded investment opportunity. But a key step to the success of these investments is selecting the right manager. Why? The potential for significant performance variability is far greater in the private markets than the public markets.

Historical data reveals a more than 14% performance differential between the top-performing private equity managers and the bottom-performing managers over the past 10 years (see chart). For comparison, for public US large-cap equity managers over the same period, the performance difference was 6%. Thus, performance dispersion is an important consideration when it comes to private investments and manager selection is critical.



Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

FIGURE 1

Manager Alpha | Trailing 10-Year Interquartile Spread (Vintage Years 2012 - 2021)

Source: Cambridge Associates via IHS Markit, annual Pooled IRR quartiles by vintage year as of 12/31/2023, data pulled 5/2024. Cambridge data is limited and appropriate consideration should be taken given the quality of the data and the small sample size. eVestment data as of 12/31/2023, pulled 1/2024. NCREIF data as of 12/31/2023 from Q4 2023 report. With the exception of Core Real Estate, private markets funds raised Vintage Year 2012 to 2021 (2022 and 2023 excluded as they are too recent). Public markets data for the trailing 10 years as of 12/31/2023. Indices: Cambridge PE & VC Composite, Cambridge Private Credit Composite, Cambridge Infrastructure Composite, Cambridge Real Estate Composite, NCREIF NFIODCE, eVestment US Large Cap Equity Universe, eVestment Emerging Markets Equity Universe. Private market performance presented is net of fees. Public Market performance presented is gross of fees.

What's Driving the Performance Dispersion in Private Equity?

The concept of performance dispersion refers to the range of returns achieved by different investment funds or managers over a specified period. It quantifies the gap between the best and worst performers, indicating the variability - or spread - of returns within a particular investment strategy. In the context of private equity investments, performance dispersion refers to the variability in returns across different private equity funds.

Historical data has shown that skilled active management can add more value in some asset classes than others. While performance dispersion in public equity funds tends to be relatively low due to the speed and transparency of available information which makes these markets highly efficient, that's not the case in private markets. Private equity asset classes have historically exhibited higher performance dispersion as measured by interquartile spreads.[1]*

[1] Quartiles are used to calculate the interquartile range, which is a measure of variability around the median. Quartiles are organized into lower quartiles, median quartiles, and upper quartiles. Along with the minimum and maximum values of the data set, the quartiles divide a set of observations into four sections, each representing 25% of the observations.

While there are roughly 4,500 publicly traded companies in the US today, the number of private companies is far larger – more than 30 million. Because the investable universe is much larger, and since these companies have less readily available financial and operational information, private equity is a less efficient asset class than public stocks. This means that skilled investment managers can potentially take advantage of the larger mispricing opportunities to add value.

Attributes of Top-Quartile Performers

Top-performing managers typically share certain characteristics that contribute to their performance success:

Better Deal Sourcing: Unlike public markets, there are no perfect sources of information about private companies. Relationships and sources of deal flow become critical. An experienced manager with an extensive, developed network may have the ability to source, negotiate, and execute more attractive deals. As their experience and reputation grows, this typically enables them to access and win the most attractive and competitive deals which, in turn, enhances their reputation further, creating a virtuous cycle.

More Favorable Entry Valuations: Experienced managers who can negotiate favorable terms and lower entry valuations as they acquire companies often improve the risk/return profile of their investments. A lower entry point to purchase a high-conviction company likely results in higher return potential while limiting the potential for losses if the investment fails to meet expectations.

Potential for Value Creation: In many private equity investments, new management is brought in to grow or turn around a business. Managers who are skilled at growing or improving a business that then generates higher performance may add value relative to their peers. Skilled managers can potentially enhance portfolio companies by improving their operations, increasing margins, implementing growth strategies, and upgrading management personnel.

Since private equity investments are designed to be long-term investments where capital can be locked up for years, getting the manager selection wrong can be a vexing obstacle to success. Careful diligence of managers is important when pursuing the potential benefits of private equity investing.

Important Information

*There is no complete and reliable data set for private investments. The information is extremely limited, and most data is compiled from funds that elect to self-report and tend to be biased toward higher performing funds. Losses are underreported. Funds included in these measures lack commonality and transparency. Over time, components of the data may change. Funds may begin or cease to be represented based on these factors, thereby creating a "survivorship bias" that may additionally impact the data reported.

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