Momentum Killers

In the movie Heat (1995), Robert De Niro's character says to Al Pacino's character "Don't let yourself get attached to anything you are not willing to walk out on in 30 seconds flat if you feel the heat around the corner". Although it may sound melodramatic and self-aggrandizing, most well-trained investment analysts share this attitude. It is not an easy stance to take, especially with cognitive biases such as "anchoring", "recency", and "confirmation" constantly wreaking havoc on one's psyche. How do you walk away from something you have been working on for months? Relationships have been formed, vast spreadsheets have been built, the idea has been socialized internally with key decision-makers, etc. – how does one just stop everything? Also, how often are you allowed to approach a peak and then just back out? What does this ceasing of festivities do to one's reputation (internally and externally)?

Luckily, many allocators have investment guidelines that exalt "intellectual honesty/integrity". Through my years as a research analyst, I have come to view "Intellectual honesty" or "intellectual integrity" as catchall phrases that aim to protect investors from the most primal of human urges such as "fitting in" or "avoiding embarrassment". It is my hope that the managers I commit to go through the same (if not more) turmoil when considering portfolio investments. In the private assets ecosystem, quantitative issues kill potential investments early. It is the qualitative issues that tend to fester and gradually force prospective investors to answer the most critical of questions: Are you leaping or not? And if you are leaping, what level of cushioning are you factoring into your decision in case you fall?

Providing a concise explanation of why analysts typically jettison investment ideas that are supposedly experiencing positive momentum is more difficult than it sounds. Although I would love to give GPs a neat bullet-pointed breakdown of what they can do to avoid being left at the altar, the reasons are so interconnected, and at times, nebulous, that a "scenario" format is likely to be most effective.

Scenario 1:
When a seemingly positive process is halted, there are often worry-inducing breadcrumbs that build up with time to form a discernible loaf of real concern. At its essence, due diligence involves the gathering of information, the formulation of hypotheses with this information, and finding intelligent ways (scientific and unscientific) to verify these hypotheses. As much as it is a game of tangible facts, due diligence is also a mental exercise.

For example, if an analyst finds that pieces of critical information are missing during the initial pitchbook review, he/she would dutifully inform the GP, and most likely the GP would apologize and provide the needed information. This oversight is easily logged as an understandable (and even forgivable) lapse of judgment by the GP. Experienced analysts, however, are trained to give the benefit of the doubt, but keep mental notes of anything that appears irregular. Spidey senses start to tingle a bit more aggressively if, during the initial meeting, email/phone communications, follow-up meetings, or the onsite visit, some key pieces of information continue to be absent. However, continuing to lean further into the "benefit of the doubt" stance, an optimist's (or even a realist's) view could be that there are plausible explanations for these ongoing slips, namely the learning of each (LP and GP) other's idiosyncrasies and styles. Don't forget that mental notes are still being taken, and the paragraphs under the "info omission" topic are getting unignorably longer. Now the analyst gets to the "reference calls" stage of due diligence, and when questions around transparency of information are asked about the GP to on- and off-list parties, answers such as "they will eventually give you the information you want but you have to be very specific about how you ask" or "they don't volunteer much" is what is heard back. The barely noticeable simmer of caution is now growing into an apparent boil of apprehension. Although everything else seems to be in order, and the investment

opportunity is still attractive, this nagging issue around the withholding of information is gradually becoming an albatross. While it is difficult to scientifically forecast how this incessant problem may affect a long-term investment, the potential permutations of negative outcomes are alarming. It is at this point that the due diligence process halts as a result of a mix of intellectual honesty adherence and an intensified sense of fear of the unknown. It is important to note that the “omission of information” in this scenario is interchangeable with a wide variety of pesky acts including “the depiction of value creation”, “deal attribution discrepancies”, “disrespectful tone of how GP team members speak to each other”, “attitude towards past mistakes”, “persistent team member turnover woes”, etc.

Scenario 2:
Here, an analyst proceeds through all the due diligence steps with commendable enthusiasm but then realizes at the end that he/she was somewhat blinded by a charismatic presenter, great-sounding returns prospects, enticing charts, and an accommodating economic environment. It is exhilarating to work on an investment idea that seems to have all the hallmarks of a rare gem. It is extremely difficult to recover from the intoxicating momentum created by things seamlessly falling into place at the early stages of due diligence. “Confirmation bias” is also known to brazenly gatecrash the party when spirits are high, and the individual glory of finding a winning idea takes over the psyche. But sometimes, sheer thoroughness of research, devil’s advocate points from trusted colleagues, or “too good to be true” panics, snaps the analyst out of the stupor. Upon further clear-sighted work, it is uncovered that the idea is “B+” at best and that there are “A” players in the ecosystem that were missed/ignored due to a self-inflicted tunnel vision approach that was implemented too early in the due diligence process.

Scenario 3:
The instances that fall into this category are more obvious and make the termination of a due diligence process easier to justify. Punitive fund terms found in the small print of legal reviews, key team members leaving during the fundraising process, credible reputation-damaging lawsuits/accusations uncovered during background checks, the telegraphing to an LP of a suboptimal fund allocation amount, a shift in the economic/regulatory landscape that negatively impacts the strategy’s core thesis, the recognition that a fund will likely not hit the minimal amount to make its strategy viable, etc., are all very reasonable justifications for LPs to abandon due diligence (even if there was positive momentum).

Takeaways:
An unceremonious ending without reward is never the favored outcome for any endeavor. This sentiment rings even truer when a GP and LP feel like the courting process is reaching a “commitment” climax. At the latter stages of due diligence when unrecoverable time and resources have been expended, parties are palpably disincentivized to abandon ship. An LP's decision to end proceedings at this juncture involves a great deal of soul-searching and courage – it should not be taken personally. There will undoubtedly be some awkwardness within the relationship, but professionalism will ensure a cordial atmosphere. If the connection built is genuine, there may be opportunities to engage and try again in the future. With most relationships in life, no matter how familiar you think you have become, clear communication can make unexpected news less painful.

Anthony Kwesi Hagan
Founder and Head of Research, Freedomization™
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