Loyalty between Limited Partners (LPs) and General Partners (GPs)

I have written previously about the tension that naturally exists between LPs and GPs. Clear business expectations, psychosomatic land mines, unspoken etiquettes, and a glossary of punishments for nonadherence to implicit and explicit rules complicate this symbiotic relationship. It is logical that providing capital to another party for an extended period will undoubtedly be accompanied by a code of conduct that specifies how the capital should be used, when it should be used, the appropriate level of risk to be taken, the expected return for that capital, etc. The term sheet of a fund or deal typically outlines these conditions. Other aspects, such as mutual respect, human decorum, appreciation, transparency, decency, etc., are not blatantly legally defined but are essential for an LP/GP relationship to thrive.

“Loyalty” is another non-legally mandated expectation between GPs and LPs. If both parties have met agreed-upon expectations of the initial contract, there is an implied belief that the relationship will endure without disruption for the foreseeable future. The problem with this assumption is that each party usually has a different interpretation of the definition of “expectations”. It is my experience that although loyalty between LPs and GPs may occasionally be near- or far-sighted, and may wear high-index glasses, it is never totally blind. Below are some thoughts about potential obstructions on the two-way street of loyalty between LPs and GPs.

- **Should strong economic returns equate to automatic loyalty?**: In the investment community, there is a normalized sentiment that strong economic returns inoculate (or should inoculate) against general investor skepticism and hesitancy to re-up (participate in the GP’s next vehicle/venture). The ultimate show of an LP’s loyalty to a GP is to re-up at or above the previous investment amount in the GP’s subsequent vehicle. However, certain factors may cause the deterioration of loyalty despite proof of strong economic returns. An LP’s fiduciary responsibility to its stakeholders will almost always supersede blind loyalty even if a GP has executed what it promised on paper. Strong current returns and the promise of persistence of these returns never occur in a vacuum. Strategy shifts, organizational turnover, asset-gathering perceptions, product proliferation, reputation degradation, and the availability of comparable (or seemingly better) investment options, are among the reasons for LPs’ loyalty erosion. While it is difficult not to reward a GP who has been good to you by re-upping, investing is always a forward-looking exercise, so even when grateful for what has been done in the past, the focus must always be on future positioning.

- **The belief that loyalty lasts for at least two funds**: Most LPs will develop some loyalty to a fund after completing a lengthy due diligence process that has resulted in a capital commitment. The long-term nature of most private asset investments requires patience to see a thesis come to fruition. The three to five-year investment periods (time designated to invest committed capital) of funds and the 10-plus-year overall fund terms explicitly warn LPs that return goals will take some time to reach. Most private investors I speak to have a two-fund threshold before their once-loyal eyes begin to wander. This is particularly true when the LP’s initial investment was in a GP’s first fund, but I think it can be generally applied regardless of the entry point. The logic behind this is that the LP’s entry point is confirmation that all (to the best of the LP’s ability) factors have been considered and there was a positive inclination to move forward with the investment. Now, the GP takes about three years (give or take) to put the committed capital to work. There is a high likelihood that sometime during the investment period, the GP will raise a subsequent. Based on the LP’s entry point, there is limited information to make a definitive judgment as to whether its investment will be successful. This is because most investments will be very young, and any uplifts in underlying investment values will be paper write-ups (unrealized) which are generally taken with a grain of salt. Barring any extremely bad behavior or very obvious drifting away from a defined investment strategy, most LPs tend to stay the course and commit to the GP’s subsequent fund. As mentioned above, this holds very true when the initial entry was in a GP’s inaugural fund. But even if the initial entry was in a later fund where elapsed time allows for the mining of more information from older past deals, goodwill, reputational risk (of the investor looking transient or fickle), and general thesis adherence, enforces loyalty for at least one more fund. This is not a rule that can be found in any LP's investment policy, but it is a reality.

- **Does legacy active exposure invite second-class treatment**?: This is a point I have made in the past, but it still deserves reiteration. Related to the above point, there will come a time when, for a multitude of likely reasons, an LP chooses not to re-up in a GP’s next fund. Does this mean the relationship is over? I think if committed capital is still active in some shape or form within past funds, the GP/LP relationship still exists. The loyalty flame is probably not in roaring fire form, but it has not been fully extinguished. I think GPs should take a non-re-up as a wager to prove the fleeing LPs wrong. This is a chance to show, through ongoing success, that these LPs made a mistake leaving you. It is not a time to subtly snub absconders with less information, subpar attention, or infrequent visits. Although there is ego at play and rejection hurts, fees are still being paid on historical commitments so appreciation for dollars committed, regardless of how old, plays a big role in building a solid and long-lasting reputation. GPs can remain loyal to LPs who showed early confidence in them even if these folks are no longer actively investing in subsequent funds.

- **Should loyalty be absolute**? There are certain situations where GPs expect absolute loyalty. Generally, this occurs when a manager has achieved such impressive levels of strong, persistent returns that it becomes a "dictator," for lack of a better term. Said differently, the GP gets to a certain stratosphere that allows it to simply demand loyalty. With this power, the GP can dictate fund terms, fundraising timelines, levels of transparency, fund sizes, etc. It is a favorite technique of GPs with this authority to use it to grant an LP access to a desired fund only if the LP accepts exposure to other less desirable fund strategies within the GP's organization. This means the GP is telling LPs that “You either take all of me or you get none of me”. This puts LPs in a prickly predicament because their fiduciary sensibility is telling them to “only invest in strategies that have the best likelihood of a strong return”, but the GP is saying, in not so many words, that “to get access to the strategy that has shown the best likelihood for continued success, you need to roll the dice with these other strategies that are less proven”. Although I used the word “dictator”, it is admittedly a harsh description because LPs are not obligated to invest with the manager at all – you can always just walk away. It is an interesting depiction of being held economically captive. However, if the potential returns of the desired strategy are high enough, many LPs will fall in line. Only a select few GPs get to demand this level of absolute loyalty, but most of the ones that can, wield the power in true capitalist fashion.

The word "loyalty" in any context relating to the GP/LP liaison always sounds like an intentional oxymoron since the relationship is built so much on the economic promises and expectations of a vast group of stakeholders. However, it is my goal to underscore the very human aspects of things that seem like “just business” on the surface.

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