Too Good To Be True

Almost everybody has heard these sage words of advice from a parent, guardian, coach, pundit, teacher or mentor: "if something sounds too good to be true, it probably is". In the world of finance, this assertion particularly forms the bedrock of the psyches of investors. Instinctively avoiding opportunities that seem just too simple or too apparent to have not already been exploited, generally fall into the categories of "that's pure common sense" or "duh" or "no sh*t, Sherlock". Yet, most GP pitches and LP investment committee memos insinuate a sense of obvious things that need some unique combination of foresight, people, knowledge, research, information and guts to unlock. And yes, you guessed correctly, the manager in question holds the keys to the treasure's unlocking. A detailed explanation of the work that guards or obscures a "no-brainer opportunity" infinitely fuels the 'enticement-that-leads-to-curiosity-and-then-leads-to-chance-taking' game between GPs/sponsors and LPs/investors.

Humans seem hardwired to seek out or try to experience things that are exclusive (not being exploited by the masses). However, people are also drawn to things that they can understand. These two tendencies are at odds with each other because if many people understand an opportunity, exclusivity goes out the window. With investing, overly complex plays with many moving parts tend to alienate potential investors, and obvious opportunities quickly get the alpha sucked out of them. So how should a fund manager or sponsor walk the fine line between "exclusive" and "relatable"? The answer squarely lies within the narrative that is forth – a clear and concise narrative about how a manager/sponsor is uniquely (and relatively exclusively) equipped to exploit an opportunity can be the difference between patronage and outright rejection. Never ones to be accused of a lack of ingenuity, GPs have developed several ways to position themselves in the thin gap that is bordered by exclusivity and relatability – I list a few below.

- **Our approach simplifies the complex**: Some GPs acknowledge the complexity of their chosen field of endeavor but then describe how their systematic approach to problem-solving mitigates it. This is a savvy way to ease the anxiety of prospective LPs who may be hesitant to delve into something they don't fully understand. The GP simplifies the complexity by illustrating it in common terms, while subtly asking prospective LPs to look past the intricacies and have confidence in the team and approach. This tactic can garner LP attention if there is a clear and relatively long track record of a GP's success with the strategy.

- **Networks and access are our edge**: The ability to access high quality deals can be a powerful differentiator for GPs, especially when a GP can also demonstrate a high selectivity bar. Some managers bypass all the talk about markets and competition and just stress that their networks and access puts them ahead of most of their peers when it comes to investment selection. It is almost like their deals are pre-vetted and there is a tacit understanding of exclusivity. This exclusivity is usually earned from association with a certain revered investment pedigree and/or tangible historical investment success in a particular field. For obvious reasons, any investment missteps by GPs who proclaim access and networks as their superpower will be judged more harshly than those by their peers who don't make such claims. Additionally, threading this needle in a believable way with LPs takes a lot of tact because networks and access can be nebulous, and hence, difficult to underwrite.

- **We use information available to everyone else differently**: Some GPs admit that many others target their chosen investment space, and even acknowledge the degree of competition they face when securing a deal. However, they declare that their edge is based on unique insights from readily available information or some other human, cultural, or likability attribute that makes them stand out. LPs will have a hard time verifying this because most of the usable information will be after-the-fact, and parties who can be used for references will inherently be biased.

- **We are early – others lack the foresight**: Time (or being earlier than the crowd) is a common tool used to justify exclusivity. This works well in private assets because most funds have a three to five year investment period used to find and invest in deals. So, if the manager is able to secure capital and be ready to strike when this impending opportunity happens, its foresight would have paid off – in other words "a first mover advantage". The issues here are 1) many investors have been burned by opportunities that never materialized, 2) sometimes the opportunities materialize but not at the scale promised 3) the time it took for the opportunity to materialize allowed others to be just as prepared for it 4) there is a cost associated with capital laying dormant waiting for opportunity materialization. I have seen this play out many times in regard to certain geographical regions (mostly in the emerging markets) and certain new technologies. Investors generally tend to be wary about "time" as an exclusivity marker.

- **The space is so inefficient that many can win (for now)**: GPs also convey an acceptable mix of exclusivity and relatability by emphasizing the overall inefficiency of their target markets. In this argument, the key idea is that by participating in a broadly inefficient market, there are enough spoils to go around regardless of the number of players - this is closely related to the above point about being early. As an example, investors focused on small buyouts or those who specialize in finding deals in highly fragmented markets will emphasize the abundance of deals with low-hanging fruit in regard to value creation. This is all well and good, but LPs still need to know that there is a coherent method within the madness.

- **We are just smarter than most**: "Our investment team is made up of Nobel Prize winners, PhDs, elite engineers, ex-CEOs, etc." Investment analysts have heard some variation of these words from at least one or a few GPs. This subtle (or blatant) flex is meant to convey an unmistakable message – "we have a high quality team that most of our peers cannot compete with." Confidence is always a good thing, and having an esteemed investment team provides assurance to LPs for the risk being taken, but the proof will always be revealed in the pudding. I have seen many elite (on paper) teams fail and many assumed average (on paper) teams succeed. My advice to GPs is that if intellectual firepower is what you choose to use as your strength, prepare for the added bestowment of infallibility/perfection which will be almost impossible to shake off.

GPs may not like narratives carrying so much weight. However, the time constraints, human psychology, and categorization (in some form or another), that exist within investing, make these narratives quite necessary. GPs will typically convey a hybrid (or some variation) of the above narratives but must remember that thorough LPs will meticulously measure telegraphed personas with ongoing actions and outcomes.

Anthony Kwesi Hagan
Founder and Head of Research, Freedomization™
November 3rd, 2024