As LPs, How Punitive Should We Be To GPs?

There is undeniable exhilaration when an LP/GP relationship is consummated with an initial commitment. The future holds so much promise. The union feels like a whiteboard with boundless possibilities. Everyone is on their best behavior. Everything is fresh and innocent and devoid of negativity. This honeymoon period can last weeks, months, or even years (in cases where capital deployment is ultra-precise and super-deliberate). Although no returns have been crystallized during these early days, the autonomy of the driver's wheel could not be more firmly in the hands of the GP or sponsor. Trust is at an all-time high. The GP/sponsor is destined to lead us to the promised land. Management fees for 10 years, locked in. Deliverance (eventually) of 2x+ MOIC, locked in. Placement agent's (if one was used) commission, locked in. "Best-decision-ever" self-deceptive mirror affirmations, locked in. Buckle up!

From an LP's perspective, after the initial commitment is made and after the my-new-GP-can-do-no-wrong stupor has worn off, things start to get real. We start to learn the GP from the inside. We start to understand the GP's general cadence and degree of responsiveness, thoroughness, bedside manner, transparency, real-time alignment, inclusiveness (i.e., seeking LPs' points of view), etc. This process can be at breakneck or molasses-like speed. Every action or inaction tells an explicit or subtle story. For LPs, due diligence is unending, so lessons about a GP are being learned with every interaction (or non-interaction). I can imagine that this period must also be a little confusing and frantic for the GP because how does one satisfy the weird demands and quirks of every one of your LPs? I suppose the positive view is that once the subscription documents are signed, it is clearly understood that the GP has full control (with broad pre-determined investment parameters) over stewarding the committed capital.

All else being equal (ceteris paribus), an LP's power peaks just before an initial commitment and also at the point when prior experience with a GP must be factored in for a potential re-up. These points in time are always very pivotal for any investor who takes fiduciary duties seriously. In my career, these moments were made even more exciting and nerve-racking because the investment leaps were usually done on behalf of an endowment or foundation.

Despite my somewhat digressive (but I believe helpful as a foundation) introduction, my goal is to discuss "GP scorecards" and try to reach some conclusion on how strict LPs should be when grading GPs. I have struggled with this for many years because there are so many moving pieces when assessing a fund - the quantitative aspects could all line up, but qualitative assessment tends to be an unending loop of "what ifs". The part I struggle with the most is how punitive to be with GPs who are seemingly doing all the right things (with proof) but still fall short of expectations and targets. Of course, a manager who infinitely misses targets deserves a weak grade, but what about the ones who hit targets sometimes, and, despite all their lessons learned, evident rigorous processes, seemingly talented team, and other bells and whistles, still have inconsistent track records? I think every fund manager can be forgiven for a weak fund (or two), but how should LPs think about multiple below median funds and a few outstanding ones in a GP's track record? If a GP is doing all the right/desirable/expected things, why is the proof not showing up in returns? I know this is a slippery slope that I am attempting to ascend, but other than what I discuss below, I am all ears to learn from others on this topic.

- **Recency bias is real**: Many LPs will attest that the latest vehicles from the GPs they are evaluating typically demonstrate better performance than older funds. Actually, many LPs will sweepingly dismiss (or at least

discount) the performance of younger vehicles. The reasons for the porosity of the performance metrics of young private assets funds are well known to all: j-curve ramifications, high unrealized portfolio portions, valuation leeway, etc. Although LPs tend to be skeptical of recent performance, GPs, even the ones that acknowledge the reasons for skepticism, will always try to stress why their recent strong numbers should be viewed differently. In addition to accentuating remarkable portfolio company-specific metrics/trajectories, GPs will typically also provide a laundry list of rigorous new or tightened processes, selectivity criteria, resources (people and/or data and/or systems), etc., with timelines that correspond to recent performance. In the midst of the hailstorm of fragile recent information, my advice is for LPs to stay strong and try to adhere as close as possible to what looks and sounds like facts and not just opinions.

- **Should we factor in luck, if yes, how?**: In the biographies and testimonials of the most successful people who have ever lived, there is almost always a mention of luck. This luck is portrayed in many forms – serendipitous proximity to a particular resource, a teacher who uncannily nurtured a student's obscure obsession, parents who encouraged the freest of thinking, a benefactor who took an irrational chance on an individual, and so on. We are all also accustomed to the saying "make your own luck" or the more hard-hitting "luck is when preparation meets opportunity". So which is it, can this be applied to the performance of investment managers? Were the great performing funds due to good luck or skill? And were the poor performing funds due to bad luck or incompetence? From experience, managers will typically attribute good performance to skill and bad performance to crappy luck. Once again, an investment analyst has to get into the weeds to be able to confidently discern luck (a rising tide lifting all boats, or fortuitously catching a favored sector wave, or by chance exiting at the very right time, etc.) from skill (operational value creation).

- **Moving from relative to absolute**: I have attended many internal due diligence tail-end meetings where a GP's semi-consistent track record is discussed. Everything else checks out—the GP's differentiation has been confirmed, its unique value proposition verified, and there is a comfortable consensus on the presence of desirable qualitative factors. But there is still a nagging problem - an inconsistent track record. For example, assume you are performing due diligence on a manager raising its fifth fund. The first fund, which is fully realized, is a top quartile fund, the second one is a third quartile fund, the third fund, which is about seven years old, is currently straddling the line between second and third quartile, and the fourth fund, which is about three years old, is a top decile fund. Oh, and about three years ago, the manager initiated an overhaul of internal processes, which included increasing the rigor of portfolio company selection, adding internal staff dedicated to operational improvements, and broader sharing of economic incentives. It goes without saying that the GP attributes its youngest fund, currently tracking in the top decile, to the tightening of its internal processes. LPs, on the other hand, are typically more skeptical about this correlation, but because all other things check out, and confirmation bias has started to crystalize, an interesting thing almost always happens – the conversation moves from relative to absolute. I think this happens because there is a psychological need for insurance or the presence of some downside protection. You hear things like "their worst fund (Fund II) is still generating an 11.3% net, so if that is the worst case scenario, I am okay with that". GPs with inconsistent track records, cleverly leave breadcrumbs stressing absolute performance all through their marketing material and also dexterously touch on it during meetings. When an LP has done the work and still likes the GP, those breadcrumbs come in handy as mitigants to hard-to-explain-away concerns. Well played GPs (with inconsistent returns)!

- **A contiguous view of performance**: In continuation of the immediately above point, I have heard both private markets GPs and LPs use the “one uninterrupted fund” argument to subdue concerns of inconsistency. When applied, this concept smooths out returns. The notion is to view initial investment dollars (and their subsequent returns) as perpetual – so using the above manager raising its fifth fund as the base example, an investor would be shown a synthetic calculation of capital invested in the first fund and its subsequent returns reinvested in all subsequent funds. This makes Fund I to IV one continuous (somewhat open-ended) vehicle. One return percentage will then be generated from this. Usually that percentage is very decent and would be welcomed/cherished by most investors. The GP then smartly makes a cautionary point for LPs not to market-time vintages because it is hard to predict which economic environment will be the most conducive to their chosen investment strategy. If the case is convincingly made, the conversation shifts from inconsistencies in returns compared to a benchmark to “you will achieve strong overall (absolute) returns if you stay the course and participate in all our vehicles.” Brilliant!

- **How can judgment be underwritten?:** Two weeks ago, a well-respected allocator with powerful proprietary tools/systems capable of granularly analyzing the investment history of buyout funds, mentioned to me that despite their ability to dissect the performance nuances of portfolio companies, there was no foolproof way to underwrite a GP’s judgment. This was a very honest and vulnerable admission, and it underscored something most LPs can identify with but are still hesitant to say out loud. If LPs were to go around brazenly expressing ineptitude in the assessment of judgment, this would make everything else we say sound like pure guesswork. The judgment assessment portion of due diligence will forever remain a black box. How does one accurately assess the impact of decisions made and ones not made by a GP? How does one put a weight on and compare the massive minor and major decisions that go into creating a successful fund/deal? Is the GP having an anti-portfolio (things they missed that they should have done) enough to show their awareness of their own omissions? I believe that the job security of analysts in an era of AI efficiency primarily depends on the continuous development of our judgment assessment skills.

The evaluation of GPs by LPs remains a complex and multi-faceted process fraught with challenges and nuances. While quantitative metrics provide a solid foundation, the qualitative aspects, including the assessment of judgment and the influence of luck, add layers of intricacy that cannot be overlooked. It is imperative for LPs to maintain a balanced and discerning approach, acknowledging both the achievements and shortcomings of GPs. The journey from initial commitment to potential re-ups is marked by continuous learning and adaptation, necessitating a flexible yet rigorous evaluation framework. Ultimately, the goal is to align with GPs who demonstrate not only the capability to deliver strong returns but also the integrity and strategic foresight to navigate the unpredictable landscape of private markets.

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