GP Style Drift – I Can't Tell Who You Are Anymore

One very common reason LPs "say" they chose not to re-invest (re-up) in a fund or to completely reject establishing a new relationship with a GP is "style drift," a catch-all phrase that describes managers' deviation from their pre-stated strategy. "Style drift" has been used so frequently in manager-critique situations that its original significance is dimming. "Style drift" might as well change its name to "organizational drift" because managers are now finding the largest descriptive umbrellas to stand under – terms like "solutions provider", "alpha creator", "opportunistic investor", and even the very broad, "asset manager", are now being cleverly chosen as organizational descriptors. Slowly disappearing are the days of narrowly pinpointing a specific expertise. As the private assets industry has evolved, "style drift" has become an almost inevitable investment byproduct that GPs have to creatively explain. For various reasons, LPs have generally been complicit in granting GPs latitude (sometimes flagrant and sometimes completely unabated) away from their originally stated investment approach.

I am sure there are some purist LPs who scrutinize their GPs' every action, but for the most part, I believe the wider LP base grants their GPs a reasonable level of autonomy and grace after thorough due diligence has been completed and subscription documents signed. I also believe that "style drift" is used by allocators as a jettison or rejection tool, mainly in cases of blatant leeway abuse or when numerous other concerning factors about a GP make "style drift" the most elegant and intellectually sound reason for repudiation. Conversely, in the highly competitive deal-making environment where GPs must balance available market opportunities with economic and existential considerations, it can be argued that some mercy should be extended to their plight. All the TAM (Total Addressable Market) assessments, market mapping, narrative refinement, historical precedent, and preferred deal work, pale compared to what will happen in the future. Many GPs try to adapt and mesh their strategies to available investment options, but LPs unsurprisingly get spooked when these adaptation efforts appear to be too much of a stretch in relation to the GPs' skill sets.

Below, I outline circumstances (along with my thoughts) regarding "style drift" that can be understandable, blatant, or necessary (at least from the GPs' perspective).

- **The co-investment sidecar**: Given a fund's total size and underlying deal size parameters designed to ensure a certain level of diversification, it is understandable that some GPs will need to seek additional capital (co-investments) from LPs to close investments. However, the current state of the co-investment environment is mind-boggling. Almost every fund seems to need extra capital to execute deals. Sometimes the total size of co-investment capital deployed mirrors or is an unignorable large percentage of the raised commingled fund and even the GP's total AUM. At times, it is hard to understand how a fund can stray so far beyond its outlined investment and market capitalization sweet spot and yet still claim to be operating within a preferred space. This topic deserves deeper exploration in the future, but I have witnessed some instances of GPs taking extreme co-investment liberties that are shocking, at best. There is an inherent conflict at play here because GPs tend to be motivated by closing deals, while the largest LPs—who typically have more influence—are motivated by co-investment deal flow that usually comes with no fee and no carry - this makes it much easier for everyone to turn a blind eye. In the end, the smaller LPs who want to invest in a fund that sticks to its initial promise are more likely to suffer.

- **We are not leaving that on the table**: At some point, every LP has heard a GP present an argument explaining why it is sensible and potentially lucrative for all to enter an investment segment that is different yet related to its original strategy. The foundation of the argument usually relies on ongoing investment work, honed or newly acquired skillsets and insights, and/or deal flow that, while not meeting all pre-stated criteria, possesses valuable attributes. This takes many forms, but the core goal is not to leave too much on the table. Some examples include: 1) A real estate fund with a flagship strategy targeting "value-add" and "opportunistic" multi-family equity deals informing LPs that it encounters numerous "core" deals, making it sensible to take advantage of them; 2) An early-stage focused venture fund asserting that it invests considerable effort in discovering and understanding young companies, thus justifying participation from a segment of its fund or creating an entirely new fund (labelled "Growth," "Overage," "Reserve," etc.) to pursue later-stage investments in familiar companies while also defending its initial equity stake; 3) An upstream oil and gas fund claiming that it has always been an "energy" organization, so it makes sense to target downstream and midstream energy assets along with all segments of the energy transition wave; 4) A buyout fund emphasizing the number of solid deals it has passed on that require efficient financing, thereby justifying the pursuit of a credit strategy to lend to companies in targeted segments. This list could go on for a while. Some of these divergences are justifiable, particularly those involving a new team or fund vehicle with strict parameters. However, there is also a valid concern regarding the potential for organizational distraction, culture dilution, and the perception of fee chasing.

- **Closely related characteristics**: Sometimes, "style drift" resembles "logical expansion", and at times, it truly is. LPs are responsible for verifying the viability and understanding the nuances of this expansion. It is easy for GPs to make statements like, "We invest in mid-size companies in the US, so moving on to tackle similarly sized companies in developed Europe is a logical next step because the rule of law in both regions can be relied upon," or "We invest in multi-family housing, which means we have the expertise to invest in assisted living or college housing since they share some similar characteristics," or "We have developed the necessary skills to invest in the financial sector, so why not expand into the healthcare sector as both are heavily regulated," etc. However, the truth is that numerous nuances—such as the need for a strong on-the-ground presence, cultural sensitivities, operational idiosyncrasies, network quirks, and so on—make these endeavors that are seemingly simple and logical on paper, challenging in reality. LPs should be aware of the various aspects of "style drift" and not be too eager to embrace strategy expansions that appear to be the obvious next step for incremental or sustained alpha.

- **It's complicated – how else do we grow?**: I believe some GPs always strive to do right by the LPs, but they occasionally find themselves in a real conundrum. You raise a fund, clearly stating that you are targeting specific deal sizes within a particular market segment. However, you find yourself stuck as you raise subsequent funds and your team organically grows. You have several options to consider: 1) Maintain small fund sizes while focusing on the quality of deals at the same investment pace; 2) Keep fund sizes small but invest and raise funds more frequently; 3) Raise larger funds and try to persuade LPs that your expertise is upwardly mobile in terms of executing larger deals; 4) Raise larger funds and expand the team size to pursue more of the smaller deals that your initial strategy outlined. Other than the first option, all the others can be in some way labeled as a divergence from the original pitch. In these circumstances, GPs must think hard about refining their narratives, while LPs must be certain about their preferences and what they believe is feasible and sustainable.

- **Quality is inevitably more expensive**: Many managers have been psychologically and subliminally conditioned to incorporate a statement about value discipline in their pitch; in other words, they say they will never “overpay” for an investment. This is great, but it is also like setting a trap for yourself. Some investment strategies are value-oriented by nature, so there is no escaping an emphatic statement about price consciousness with those. Other GPs managing non-explicit value-oriented strategies will still never claim to be the highest bidders for their investments—they consistently emphasize factors such as their speed and efficiency in deal execution, flexible deal structuring, strong rapport with sellers, and reputable references as the reasons they win deals without offering the highest price. Okay, sure. However, when such lines are drawn, LPs are on high alert to verify how price-sensitive a GP has actually historically been. Regardless of the unique reason, any excessively expensive investment raises doubts in LPs' minds about how well a GP has adhered to its original statements. A few of these types of deals in a portfolio can put a GP into “style drift” jail. The most common reason GPs give for paying up for deals is “the quality of the asset”. This is fair, but I believe it is more effective for GPs to clearly connect “asset quality” and “the price they would be willing to pay” at the beginning of LP interactions to prevent sticker shock from becoming an ongoing issue.

- **Continuation funds**: Given the increasing demand for liquidity by LPs and the challenging environment for price discovery (the process through which buyers and sellers engage to establish an asset's current value), I may be among the few who view continuation funds as a form of “style drift." However, while I remain open to being persuaded otherwise, I feel that keeping cherry-picked prized assets for an extended period with modified terms, no matter how fairly structured they appear, compels LPs to make a decision they did not initially sign up for.

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