Investors who believe in active management rely on the past performance of the managers they select. Unfortunately, when it comes to stocks, bonds and hedge funds, there’s no evidence of persistence of outperformance beyond the randomly expected. However, there has been some evidence of persistence of outperformance in the investment/asset class of private equity/venture capital (VC).

But new research challenges those findings and makes a compelling case that advisors and their clients should proceed with caution in those asset classes, investing only when they are confident they have identified a compelling strategic advantage.

My September 12, 2019, article for Advisor Perspectives provided a summary of the research on the performance of private equity. Unfortunately, it was not encouraging – in general, private equity has underperformed similarly risky public equities, without even considering their use of leverage and adjusting for their lack of liquidity. However, the authors of the 2005 study, “Private Equity Performance: Returns, Persistence, and Capital Flows,” offered some hope. They concluded that the evidence suggests that private equity partnerships are learning – older, more experienced funds tend to have better performance – and there’s some persistence in performance. Thus, they recommended that investors choose a firm with a long track record of superior performance.

The most common interpretation of this persistence has been either skill in distinguishing better investments or in the ability to add value post-investment (e.g., providing strategic advice to their portfolio companies or by helping recruit talented executives). The research does offer another plausible explanation for persistence: Successful firms are able to charge a premium for their capital.

**Reputation and the cost of capital**

David Hsu, author of the 2004 study, “What Do Entrepreneurs Pay for Venture Capital Affiliation?” analyzed the financing offers made by competing VCs at the first professional round of startup funding. He found that offers made by VCs with a high reputation are three times more likely to be accepted, and high-reputation VCs acquire startup equity at a 10-14% discount.

Ramana Nanda, Sampsa Samila and Olav Sorenson provided confirmation of a reputational discount in their 2020 study, “The Persistent Effect of Initial Success: Evidence from Venture Capital.” Their findings led them to conclude: “Our investment-level analyses suggest that initial success matters for the long-run success of VC firms, but that these differences attenuate over time and converge to a long-run average across all VC firms. Although these early differences in performance appear to depend on being in the right place at the right time, they become self-reinforcing as entrepreneurs and others interpret early success as evidence of differences in quality, giving successful VC firms preferential access to and terms in investments. This fact may help to explain why persistence has been documented in private equity but not among mutual funds or hedge funds, as firms investing in public debt and equities need not compete for access to deals. It may also explain why persistence among buyout funds has declined as that niche has become more crowded.”

They added: “The picture that emerges then is one where initial success gives the firms enjoying it preferential access to deals. Both entrepreneurs and other VC firms want to partner with them. Successful VC firms therefore get to see more deals, particularly in later stages, when it becomes easier to predict
which companies might have successful outcomes.” It is the access advantage that perpetuates differences in initial success over extended periods of time.

Latest research

Robert Harris, Tim Jenkinson, Steven Kaplan and Ruediger Stucke contribute to the private equity literature with their November 2020 study, “Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds.” They began by noting: “It has long been conventional wisdom for investors in private equity to choose funds run by managers who have performed well in the past, particularly, so-called top-quartile funds, while avoiding first-time funds.” As we have discussed, there is some evidence supporting that belief.

The authors studied the persistence of U.S. buyout and VC performance of the same general partners (GPs) across about 900 buyout funds and about 1,300 VC funds. They analyzed the performance of funds in a particular fundraising (vintage) year using Burgiss’ database. Burgiss classifies a vintage year as the year in which a fund first draws capital from its limited partners (LPs). They examined vintages from 1984 through 2014. They did not include vintages after 2014 because they wanted to give funds sufficient aging to deliver meaningful performance – at least five years. All returns are net of all management fees and profit shares (“carried interest”).

Their major contribution was that, unlike previous studies, they examined the performance of a GP’s previous funds at the time the GP was raising the next fund – in addition to considering fund persistence based on ex-post (i.e., final or most recently available at the time of their study) fund performance, they considered persistence based on performance information available to the LPs at the time of fundraising, when the LP must make its investment decision. Following is a summary of their findings:

- Using ex-post or most recent fund performance (as of June 2019), they confirmed previous findings on persistence overall as well as for pre-2001 and post-2000 funds.
- However, when they examined the information an investor would actually have – previous fund performance at the time of fundraising rather than final performance – they found little or no evidence of persistence for buyouts, both overall and post-2000. Thus, for post-2000 buyouts, the conventional wisdom to invest in previous top-quartile funds does not hold. Using previous fund public market equivalent (PME) at fundraising, there is modest persistence, but it is driven by bottom, not top, quartile performance.
- On the other hand, persistence for VC funds persisted even when using information available at the time of fundraising – top quartiles tended to repeat nearly 45% of the time. In contrast to buyouts, when using information available at the time of fundraising, performance persistence existed. However, it had become weak for funds formed after 2000.
- There were wide dispersions in returns between top- and bottom-quartile funds. For example, top-quartile buyout funds had average PMEs of 1.8 compared to average PMEs of 0.7 for bottom-quartile funds.
- There was a large attrition rate for bottom-quartile funds – it is important to ensure that there is no survivorship bias in the data.

The authors also found that for buyout funds, the average net internal rate of return (IRR) across the sample was roughly 14% per annum, outperforming public markets, with an average PME of 1.20 across the sample. VC firms returned about 15% per annum, with an average PME of 1.2. However, the higher returns did not reflect the incremental risks created by the use of leverage, nor did they reflect that the companies in which they invested were typically riskier than the large stocks that dominate public indices such as the S&P 500. And they also failed to consider an illiquidity premium the funds should provide. Without making appropriate adjustments, the comparisons to PME are inappropriate.

Their findings led Harris, Jenkinson, Kaplan and Stucke to conclude: “VC funds of funds earn their fees while buyout funds of funds do not, suggesting that VC funds of funds can identify better performing VC funds ex ante, while buyout funds of funds cannot.” They added: “The stronger performance persistence for VC as compared to buyout suggests that GP skills and networks for successful VC investing are harder to replicate than is true in buyout.”

Takeaway

If you are considering investing in venture capital/private equity, my book, “The Quest for Alpha: The Holy Grail of Investing,” includes a chapter on the asset class, presenting the historical evidence and the risks involved. The chapter contains the following warning from the late David Swensen, legendary CIO of Yale’s endowment fund: “Understanding the difficulty of identifying superior hedge fund, venture capital and leveraged buyout investments leads to the conclusion that hurdles for casual investors stand
insurmountably high. Even many well-equipped investors fail to clear the hurdles necessary to achieve consistent success in producing market-beating, active management results. When operating in arenas that depend fundamentally on active management for success, ill-informed manager selection poses grave risks to portfolio assets."

In his 2005 book, “Unconventional Success: A Fundamental Approach to Personal Investment,” Swenson added these words of caution on buyout funds specifically:

Buyout funds constitute a poor investment for casual investors. The higher debt and the lower liquidity of buyout deals demand higher compensation in the form of superior returns to investors. Unfortunately for private equity investors, in recent decades buyout funds delivered lower returns than comparable market securities positions, even before adjusting for risk. Fees create a hurdle that proves extremely difficult for buyout investors to clear. Aside from substantial year-to-year management fees, buyout funds command a significant share of deal profits, usually equal to one-fifth of the total. On top of the management fee and incentive compensation, buyout managers typically charge deal fees. The cornucopia of compensation ensures a feast for the buyout manager, while the buyout investor hopes at best for a hearty serving of leftovers.

Those who choose to ignore Swensen’s warnings still need to understand that, due to the extreme volatility and skewness of returns, it is important to diversify the risks of private equity. This is best achieved by investing indirectly through a private equity fund rather than through direct investments in individual companies. Because most such funds typically limit their investments to a relatively small number, it is also prudent to diversify by investing in more than one fund. And finally, top-notch funds are likely closed to individual investors. They get all the capital they need from the Yales of the world.

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