



MICHAEL G. KUEBLER, ANALYST, RESEARCH, CLEARSTEAD

FOCUSING ON DUE DILIGENCE FUNDAMENTALS IN PRIVATE CAPITAL MANAGER SELECTION DURING CHALLENGING MARKETS

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The importance of decision making is commonly portrayed in life with the term “life-altering decisions.” While perhaps overused at times, we do encounter a handful of decisions that have an outsized impact on the courses our lives take. Some of these include where we go to school, our choices in friends, where we move to, who we marry, and what career we pursue. The gravity that we place on decision making can be seen in the plethora of literary materials of both a professional and recreational nature dedicated to the topic today. A quick internet search on the topic will lead one to any number of multi-step processes to use in making a decision.

Along with social, emotional, health, and other impacts, life-altering decisions often have financial impacts on our lives. Given the importance of our finances to us, it is not surprising that investment decisions are the subject of a similar amount of analysis and weight. A common term for decisions in investing is “selection.” In public markets, we talk about stock selection: active vs passive, ETFs vs individual stocks, growth vs value, Apple vs Microsoft. These selections go a long way in determining the returns that investors will experience. This was

NEW BOOK BY CINDY STEEB DELVES INTO THE POWER OF FAMILY TRUST COMPANIES

Cindy Steeb, JD, Senior Managing Director of Trust Administration Services at Clearstead has published a book on how families can utilize a family trust company (FTC) to protect their wealth across generations. In the book, *Preserving Multigenerational Wealth: How a Private Family Trust Company Can Promote Family Harmony & Positive Family Dynamics*, Cindy takes a unique approach to the complexities of multigenerational estate planning, offering family-business owners and their trusted advisors a roadmap to addressing family harmony and preserving the family legacy for generations to come.

At Clearstead, Cindy leads family trust company and administration services within the firm’s Private Wealth Management Services, expanding Clearstead’s ability to offer unique and valuable services to wealthy families. Through her expertise, the firm can help families with the assessment, design, implementation and, if needed, ongoing operational assistance of an FTC.

Cindy’s book can be purchased on [Amazon](#).

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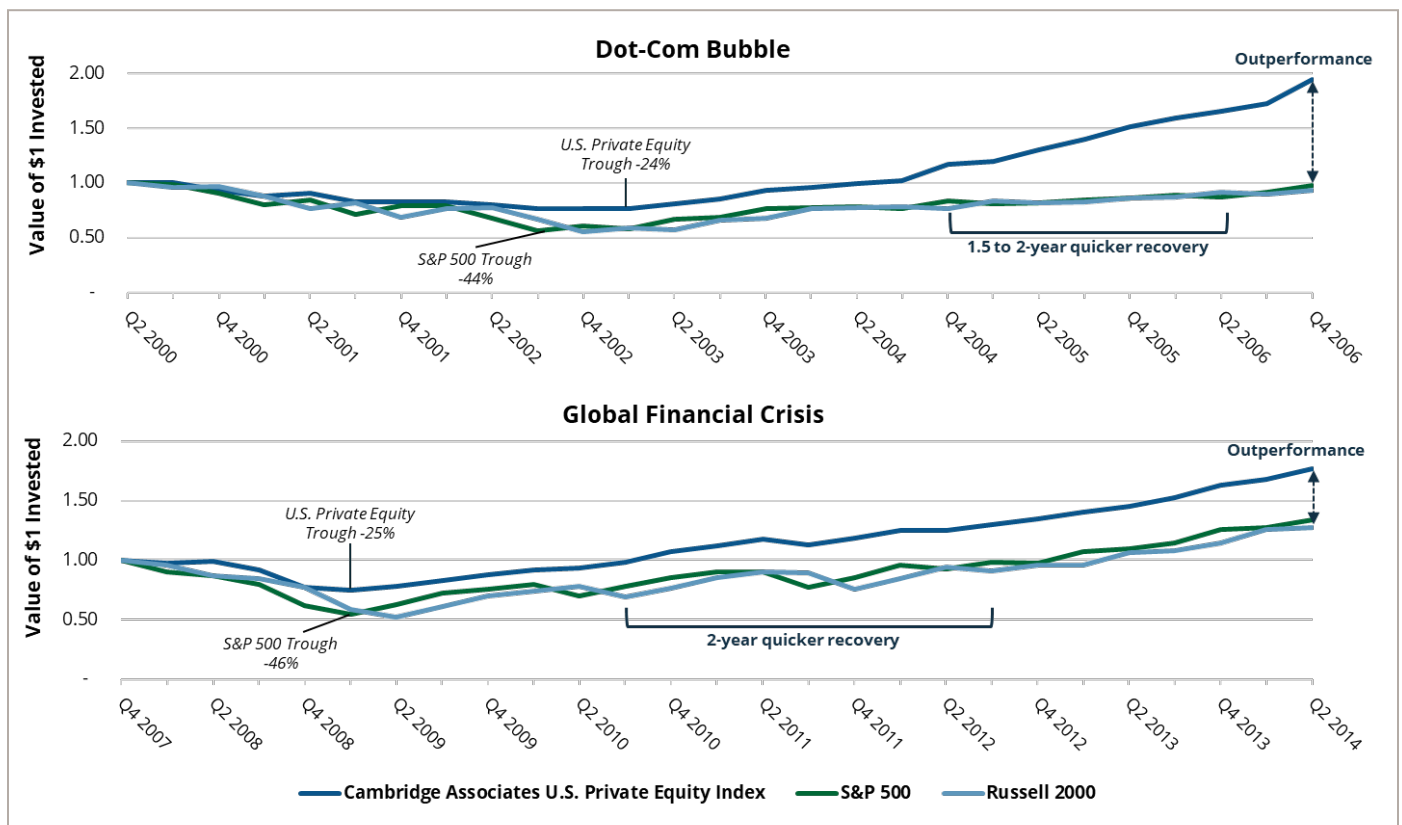
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especially clear in 2022 and 2023 as investor preferences fluctuated not only year to year, but even month to month (and, dare we say, even day to day).

In private markets, a key area of decision making is manager selection. First, at a high level, there are asset class and strategy selections: private equity, private credit, growth/venture, real assets, industry/size/geographic focuses, etc. Then within an asset class or strategy, the hardest part is the actual manager selection since investors are attempting to determine which fund managers will outperform. In previous ClearPoints, we have discussed the growing importance of manager selection in the current environment, with fund managers struggling to generate exits in existing funds and fundraising for new funds slowing as limited partners (LPs) scrutinize allocation decisions amidst limited liquidity.¹ The manager selection process should always be important but will be subject to a more critical eye in 2024. We will review some of the factors that make manager selection so important, as well as strategies for how to better identify the cream of the crop.

MANAGER SELECTION FACTORS

For qualified investors, private alternatives are an asset class that we often tout here. This is both for their performance as well as diversification benefits. The charts below from a study by Cambridge Associates showing the outperformance of their U.S. Private Equity Index compared to both the S&P 500 and Russell 2000 at the time of the Dot-Com Bubble and the Global Financial Crisis make recurring appearances in materials from our alternatives research team. During both periods, the Cambridge index declined less, recovered quicker, and then continued to outperform in the long run.

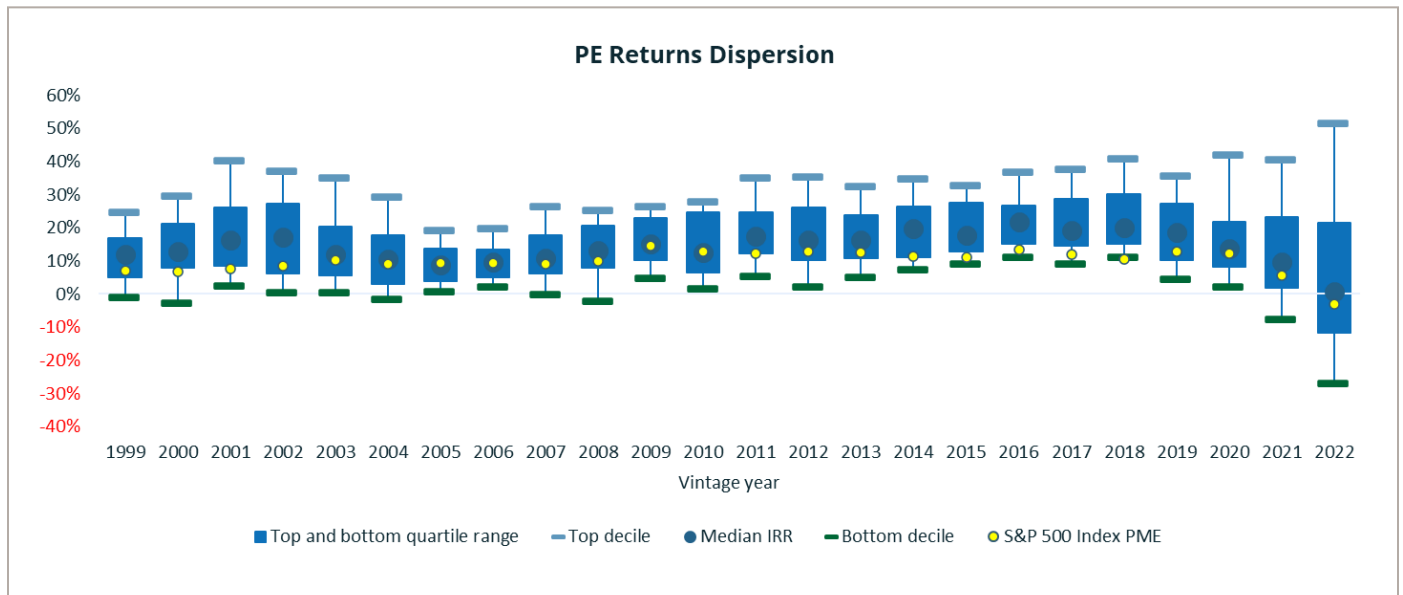


Source: Cambridge Associates as of 12/31/2022, Bloomberg.

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Although, one problem with statistics that show private equity outperformance is that they do not provide nuance and can make it look easier than it is. Investors cannot simply decide to allocate to private alternatives and expect to generate outperformance. This is because dispersion of returns across private equity managers can be wide as the below charts of North American Private Equity IRRs by vintage show, plotted alongside S&P 500 public market equivalents (PME) in yellow.



Source: PitchBook as of 6/30/2023; Peer group – North American Private Equity Managers.

What this makes clear—but should come as no surprise—is that not all managers are created equal. Consistent with the Cambridge Associates index graphic showing private equity outperformance, the median IRR here is higher than the S&P 500 PME in 22 of 24 vintages. However, the S&P 500 PME does outperform the bottom quartile in 18 of 27 vintages for the time period shown. While most private equity managers do outperform the PME, a case can be made that the ease of investing in a broad public index and capturing its returns is more attractive than the uncertainty of the ability to find, diligence, and invest in the better private market investment managers. With dispersion between top and bottom quartile IRRs as high as over 32 percentage points, confidence in manager selection is key for returns in private markets.

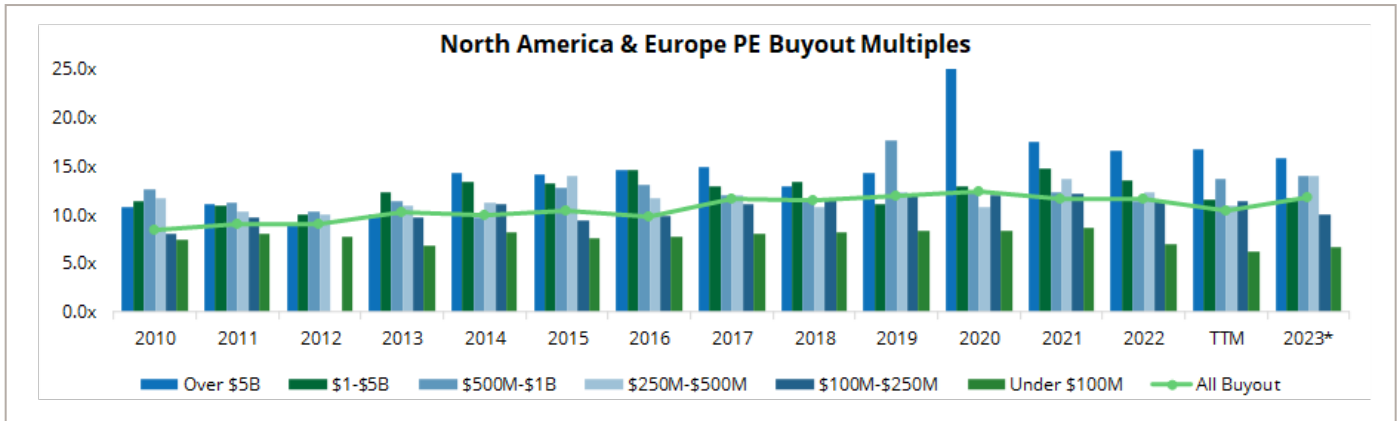
What makes for a good due diligence process that can help improve the odds of selecting managers that could lead to superior performance in a private alternatives portfolio? As a first step, it helps to have a top-down understanding of the market cycle and what the current market environment and opportunities are. This is not intended as an attempt at market timing but more as a starting point for overall asset class and strategy allocations for new investments at any given time. Do interest rate and yield levels make lending strategies stand out? If a distressed or stressed economy is expected, opportunistic credit may be more attractive. The level and pace of technological growth and innovation is important for growth equity and venture allocations. Industry-specific buyout funds can be selected based on either defensive recession-resistant factors or pro-cyclical factors. What does the inflationary environment spell for real asset and commodity prices? Again, we are not trying to time the market nor press a pause button on new commitments with these considerations, but instead deciding where and when to lean in more.

Another high-level decision is related to market and fund size. The lower middle market, middle market, and smaller funds that “fish” in this space generally have a better chance of generating outsized returns. The intuitive reasoning behind this is that there could be more room for organic growth and therefore returns with smaller companies, investments, and

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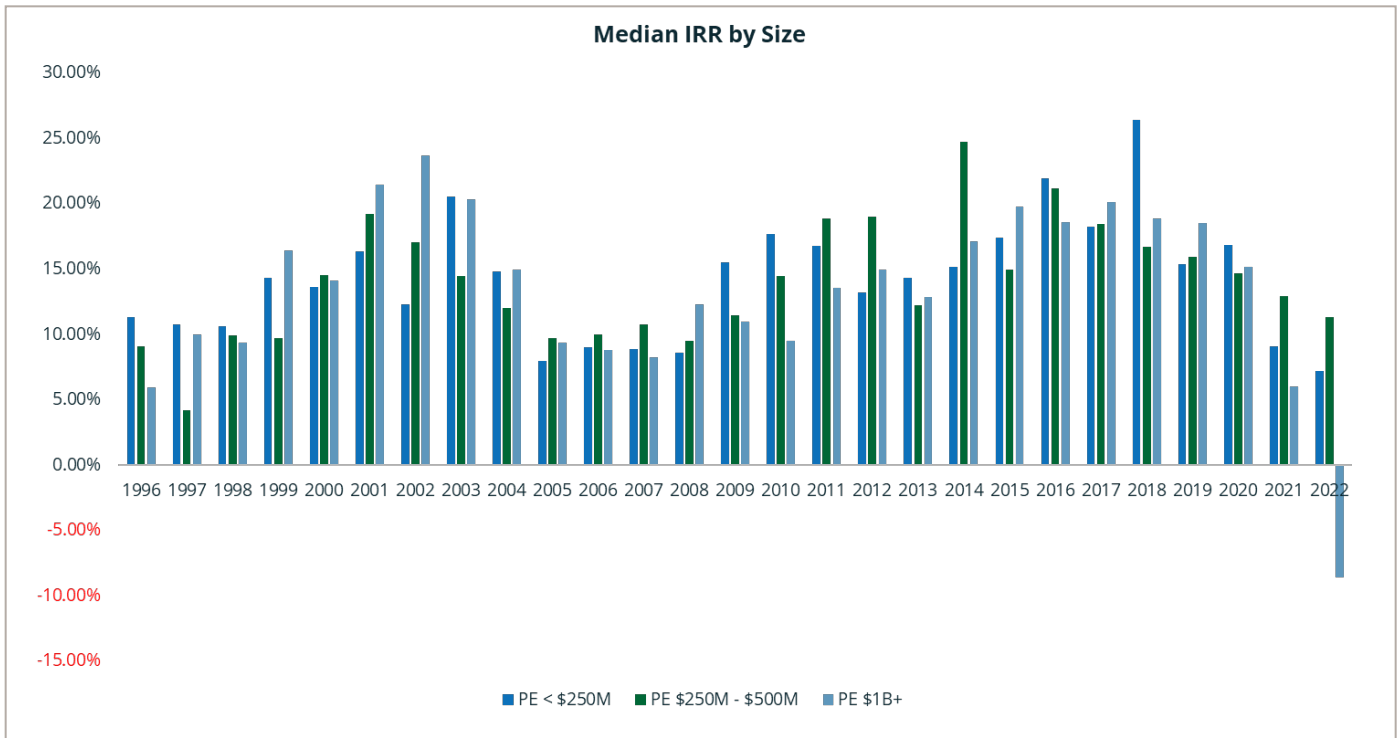
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funds. With larger companies and funds up market, there is more of a limit on the growth that can be achieved. The below chart shows the premium valuations that megadeals trade for relative to the lower middle market. Private equity buyout multiples are lower for smaller company deals and multiple arbitrage represents another opportunity for valuation growth.



Source: Pitchbook Q3 2023 Global M&A Report Summary. *Data as of 9/30/2023.

Similarly for smaller funds, the following chart compares the median IRRs by vintage year for private equity buyout funds below \$250 million and between \$250-500 million in size to funds over \$1 billion in size. In only eight instances of the 27 vintages shown does the over \$1 billion fund group outperform the smaller sizes.



Source: PitchBook as of 6/30/2023; Peer group – Global Private Equity Managers by size.

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After broader asset class, strategy type, and market size decisions are made, the rubber really hits the road with specific fund manager selection. We will touch on analyzing historical performance in the next section, but there are other characteristics of a manager that are worth digging into for key insights in the hope of finding outperformers. What are the leadership and investment team members' backgrounds? While work and investing experience is important, views into their childhood, family, and key life experiences can serve as a window into uncommon positive and negative insights. What motivates them? Beyond economics and financial returns, it is helpful to know where an investor's motivations come from and what previous roadblocks they have overcome in life. What values do they prioritize? This will inform their investment decisions and how they will work to drive value for their investments. In addition to understanding the individual team members, team dynamics are important to review. This includes understanding the level of back office and administrative support that allows investment teams to focus on investments. What is the chemistry like at the firm and how is compensation structured? Searching off the beaten path and digging for answers to probing questions is more likely to overturn true outliers.

DIGGING INTO PERFORMANCE ANALYSIS

Returns are the name of the game in investing. While the important phrase "past performance is not indicative of future of results" is true, historical returns naturally are at the top of the list of things that easily catch the eye of a potential investor early in the due diligence process. While returns are generally easy to compare across managers with similar strategies on an apples-to-apples basis, there are some tactics for digging beyond the numbers displayed in a manager's pitchdeck. Fees are an easy first step. While looking at net returns when comparing how managers or funds account for fees, it is still necessary to review and evaluate the fees for current funds. Has the manager changed its fees from previous funds? How do they compare to similar managers? With all else being equal investors should seek lower fees, though higher fees can be justified for strong managers with higher return expectations. A good framework to use when analyzing fees and fund terms is the alignment of interests between GPs and LPs. An appropriate incentive structure keeps smart, experienced managers with high integrity focused on navigating the fund with investors' best interests in mind.

There are also other methods to dig into returns to differentiate manager performance. Not all returns are created equal. Questioning managers on how returns within the portfolio have been generated will help tell you how skillful they are at managing their portfolio. Do they have a portfolio management / value creation team and plan? How much EBITDA growth is created at their portfolio companies? What is the breakdown of revenue growth versus cost cutting in contributing to the EBITDA growth? Do they focus on organic or inorganic growth? Alternatively, how much is multiple expansion contributing to returns? This will help evaluate the team's skill at growing and improving companies to generate returns in a consistent fashion, agnostic of the current market cycle. The Institute for Private Capital performed an analysis on a dataset provided by the StepStone Group of 2,951 fully-exited buyout transactions from 1984 through 2018 to create an attribution breakdown of value-creation contributing factors to returns. The table below from the study shows that, while the average MOIC (multiple on invested capital) has declined over time, the biggest positive change in contribution share is seen in market multiple expansion.² This means returns are increasingly dependent upon multiple expansion, so true differentiation can be found in managers who can achieve more operational value creation.

Value Creation Percent Contributions by Sub-period								
Period	Revenue Growth	EBITDA Margin Expansion	Market EBITDA Multiple Expansion	GP EBITDA Multiple Expansion	Market Leverage	GP Excess Leverage	Deleveraging	MOIC
All periods	36%	6%	12%	7%	16%	30%	-7%	2.65
Pre-2000	36%	6%	-6%	-6%	15%	46%	9%	2.87
2000-2007	35%	2%	0%	12%	15%	37%	-2%	2.78
2008-now	37%	10%	25%	3%	17%	22%	-14%	2.52

Source: Binfare, Matteo and Brown, Gregory and Ghent, Andra and Hu, Wendy and Lundblad, Christian and Maxwell, Richard and Munday, Shawn and Yi, Lu (2022). Performance Analysis and Attribution with Alternative Investments, Institute for Private Capital white paper.

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Leverage is another differentiator. The use of subscription lines to initially fund investments and delay the timing of capital calls can juice the IRR of a fund without doing anything to the actual multiple of cash returned. Leverage at the company, individual transaction, and fund level can also improve returns but at higher risk. Out of two funds with identical returns, the one that uses more leverage has done so with more risk and less operational and fundamental improvements to the businesses.

How a manager generates exits can also be a signal for the quality of their returns. Are they overly reliant on the IPO market to get liquidity? Are they more diversified with a proven ability to a history of attracting both both strategic and financial buyers for portfolio companies? In real estate, do they need to sell upmarket to larger peers as buyers, are they aggregating individual investments into larger portfolios to sell, or are they looking at public markets for either IPOs or to sell to public REITS? While there are positive and negative associations for each type of exit, it is better to see a manager with a proven ability to exit investments in multiple ways regardless of the current state of capital markets.

An important measure to look at for past and existing funds is DPI (distributed to paid-in capital) to help judge a manager's ability to generate real (in your pocket) returns. While the commonly marketed performance measures like MOIC and TVPI (total value to paid-in) include the unrealized value from investments, DPI only measures what has been distributed back to LPs. MOIC and TVPI reflect current valuation marks of investments and portfolios, which can deteriorate during slow or down markets that negatively impact valuations. DPI is realized and shows what investors have already received. This distinction has become incredibly important to LPs in recent years in the face of liquidity strains. A look at the median TVPI and DPI of various vintages of global private equity funds and global venture capital funds in the below table from Pitchbook data can show the difference when considering actual realizations.

Vintage Year	Global PE Median TVPI	Global PE Median DPI	Global VC Median TVPI	Global VC Median DPI
2003	1.67x	1.63x	1.11x	1.11x
2004	1.63x	1.63x	1.05x	1.02x
2005	1.50x	1.43x	1.30x	1.28x
2006	1.47x	1.45x	1.33x	1.12x
2007	1.51x	1.44x	1.86x	1.69x
2008	1.58x	1.53x	1.47x	1.09x
2009	1.63x	1.51x	1.83x	0.93x
2010	1.57x	1.27x	1.64x	1.40x
2011	1.79x	1.46x	2.04x	1.56x
2012	1.69x	1.38x	2.12x	1.24x
2013	1.75x	1.22x	2.07x	1.13x
2014	1.91x	1.18x	2.31x	1.18x
2015	1.83x	1.13x	1.89x	0.47x
2016	1.83x	0.88x	2.15x	0.60x
2017	1.64x	0.54x	1.92x	0.26x
2018	1.54x	0.29x	1.84x	0.05x
2019	1.33x	0.13x	1.39x	0.00x
2020	1.23x	0.05x	1.24x	0.00x
2021	1.08x	0.01x	1.04x	0.00x
2022	0.96x	0.00x	0.89x	0.00x

Source: PitchBook as of 6/30/2023; Peer group – Global Private Equity and Venture Capital Managers.

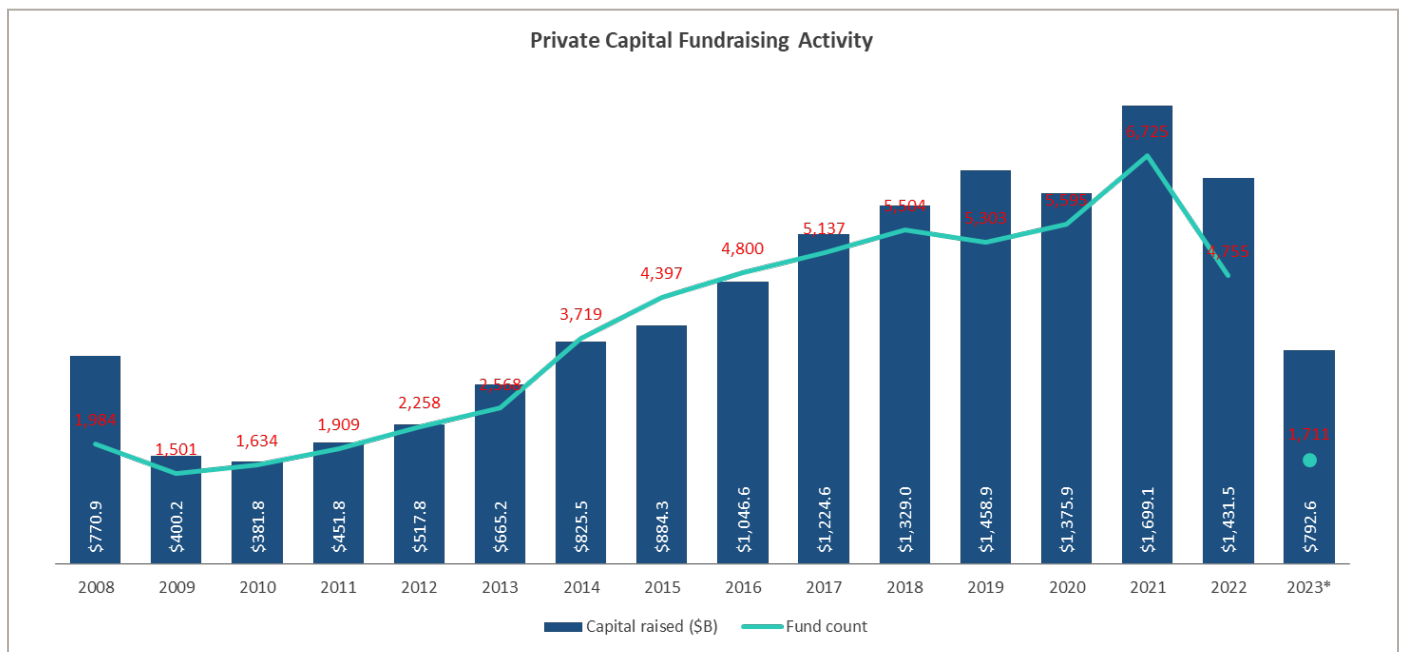
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In more recent vintage funds, as initial value is created in the portfolio marking up TVPI, the gap to DPI will generally be the widest as early realizations are rare. Over time, this gap will collapse to zero at the end of the fund. Hopefully, this is achieved predominantly through a rising DPI as realizations are crystallized and distributions are made as opposed to TVPI coming down. This is not to cast doubt on MOIC and TVPI performance marks, but to raise awareness of the importance of looking for DPI. High multiples in performance marks do not tell the whole story. Managers with high historical performance marks while also quickly producing DPI in a consistent and sustainable fashion should be top of mind.

DEDICATED DUE DILIGENCE RESOURCES FOR GROWING PRIVATE MARKETS

While we remain positive on private markets and their ability to achieve positive relative returns, we recognize the challenge of conducting thorough research and due diligence in private alternatives. Finding the true outperformers is especially difficult as we say goodbye to a time of easy markets. It takes a real dedication of time and resources to navigate the vast pool of private capital managers. While private market fundraising slowed recently in 2022 and 2023 as markets retrenched, the number of private capital funds raised each year more than quadrupled from 2009 to 2021 as shown in the graph below with Pitchbook data. Even the slowdown in 2022 was more than three times 2009's numbers. This growth adds complexity to the research process with even more funds to sift through to find those that could outperform.

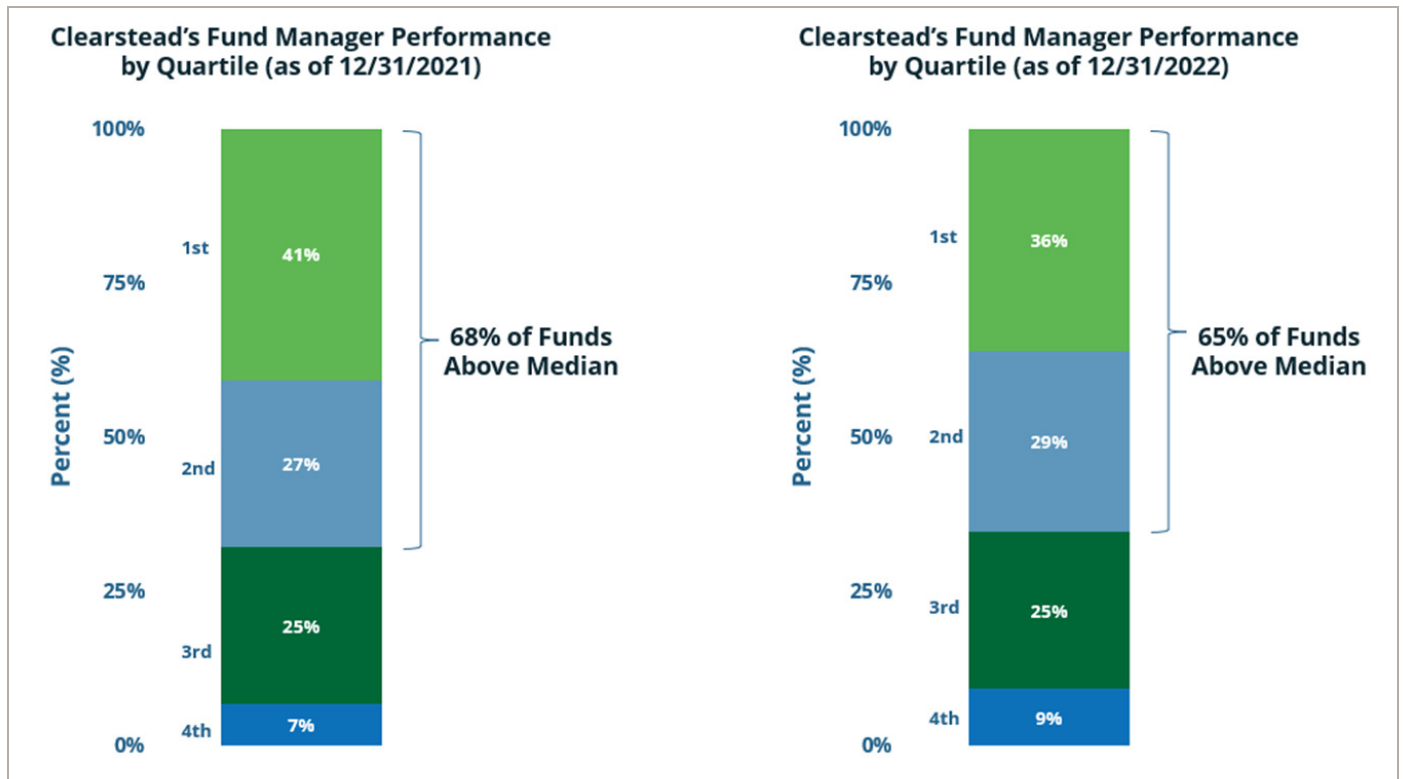


Source: Pitchbook Q3 2023 Global Private Market Fundraising Report. *Data as of 9/30/2023.

Clearstead's research team includes several investment professionals dedicated to private capital manager due diligence. The team's focus on alternatives, experience, and relationships provides access to high-quality private capital managers with the expertise to search for above average managers. At the end of 2021 and 2022 respectively, a total of 68% and 65% of Clearstead approved alternative fund managers were above median performers with a meaningful portion of them (41% and 36% respectively) falling in the top quartile based on Pitchbook Global Benchmarks. As we look to the economy and market in 2024,³ our advisors and research team stand ready to assist clients in building and managing their portfolios with diligent expertise in the growing space of private markets. (Please see disclosures below.)

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Source: Pitchbook Global Benchmarks as of Q4 2022 for as of 12/31/2022 performance and Pitchbook Global Benchmarks as of Q4 2021 for as of 12/31/2021 data, Clearstead approved alternative fund managers from 2010-2020.

Information is intended exclusively for the use of the person to whom it has been delivered by Clearstead and is not to be construed as a recommendation or advertisement, reproduced or redistributed to any other person. The data shown compares the manager reported performance of all Clearstead approved private alternative funds from 2010 to 2020 to the Pitchbook Global Benchmarks median performance category. Based on this data Clearstead determined the number of recommended funds that were in each quartile. The alternative manager performance used is actual, net of investment manager fees, but gross of Clearstead advisory fees, third-party administration fees and any other transaction fees. The deduction of Clearstead advisory fees, third-party administration fees and any other transaction fees would have the effect of decreasing the investment performance results. No representation is being made that a client invested in these investment managers will achieve the performance results shown. There is no assurance that the results shown will produce similar results in the future. Past performance is not an indicator of future results. Clearstead disclaims any liability for any direct or incidental loss incurred by applying any of the information listed. All investment decisions must be evaluated as to whether it is consistent with each investor's specific investment objectives, risk tolerance, and financial situation.

Source:

- (1) ClearPoint: "The Changing Private Equity Landscape: General Partner-led Secondaries & Net Asset Value (NAV) Lending. How Will They Weather an Impending Storms?"
- (2) Binfare, Matteo and Brown, Gregory and Ghent, Andra and Hu, Wendy and Lundblad, Christian and Maxwell, Richard and Munday, Shawn and Yi, Lu (2022). Performance Analysis and Attribution with Alternative Investments, Institute for Private Capital white paper
- (3) ClearPoint: "2024 Outlook"

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Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.

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MARKET BENCHMARK RETURNS

January 31, 2024		1M	3M	12M	YTD
US Large Cap	S&P 500	1.7%	16.0%	20.8%	1.7%
US Small Cap	Russell 2000	-3.9%	17.6%	2.4%	-3.9%
Developed Intl	MSCI EAFE	0.6%	15.8%	10.0%	0.6%
Emerging Intl	MSCI Em Mkt	-4.6%	7.0%	-2.9%	-4.6%
Real Estate	NAREIT	-4.8%	16.0%	-3.8%	-4.8%
Core Fixed	BarCap Agg	-0.3%	8.2%	2.1%	-0.3%
Short Fixed	BarCap 1-3Yr	0.4%	2.8%	4.2%	0.4%
Long Fixed	BarCap LT G/C	-1.5%	16.8%	-1.0%	-1.5%
Corp Debt	BarCap Corp	-0.2%	9.9%	4.0%	-0.2%

Source: Bloomberg

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