A buried academic finding proves that individuals, not institutions, create most PE alpha.

From Star to Founder EastRock

The Research You Haven’t Seen on Emerging Private Equity Firms

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ONE OF THE MOST STRIKING STATISTICAL FINDINGS I have read in favor of emerging private equity firms is about as buried from public consumption as it can be. I first read about it four years ago. The following is my long, strange personal journey to bring it to light.

Here is the finding:

When it comes to explaining differences in private equity performance, the individual who leads a given investment is four times as important as the private equity firm where they work.

If you are curious about where the finding comes from, it originally appeared in a 2019 draft academic paper called “Whom to Follow: Individual Manager Performance and Persistence in Private Equity Investments,” which analyzed 4,000 managers across 5,000 buyout transactions.

The paper's conclusion—I'll call it the "4X Finding"—is a very big deal. It confirms what talent-oriented investors have long believed based on experience but generally lacked the data to prove. To state it plainly:

Individuals with outlier abilities, not institutions with reach and resources, are the source of most of PE's alpha.

I wanted to broadcast this insight to the world. The problem? Even though the draft paper was freely available on an academic website (no credentials required), it was marked *"Preliminary working paper – please do not cite or circulate."*

Huh?

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I decided last year to write to the authors. Here is an excerpt from my email: "I would very much like to cite your paper. Is there a final version available, or, lacking that, could I seek permission to cite? Your paper contains fantastic work and I'd enjoy learning more about your research on this topic."

One of the authors responded. He did not address my request to cite the paper but did let me know that the authors planned to present an updated version of the paper, with a slightly changed focus, at a conference in early November.

Me: "Where is the November conference going to take place? If it's possible to attend or join by Zoom, I would like to do that. Are there any interim drafts I might see that you've distributed since the 2019 draft?"

Them: [No response]

Me: [Tried again]

Them: [Crickets]

Then, a month later, the new paper appeared online.

Was the 4X Finding added to the title of the paper, perhaps written in large bold font for all to see and appreciate? Hardly.

Perhaps it was stated clearly in the abstract, as was the case in the 2019 draft? Also no.

A passing mention in the introduction? Nope.

For those tempted to go looking for it, you'll need to skip to section 5.3, paragraph 5.

No wonder I only lasted two weeks in academia (story for another day).

At least the 4X Finding does eventually appear in the paper's final version—which frees me up to cite it!

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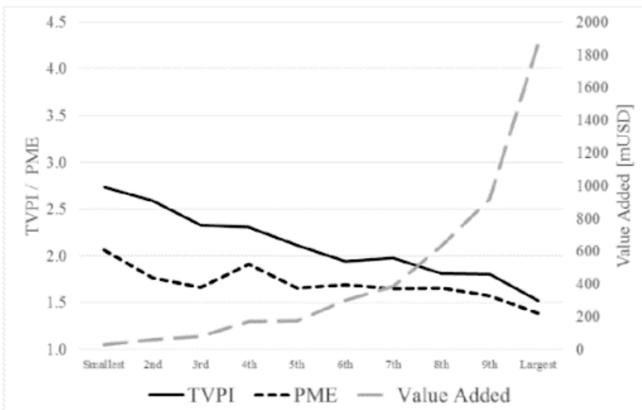
While I lament the burying of the 4X Finding, the new version of the paper contains an unexpected gift—a valuable contribution to the growing evidence that PE fund size, as well as PE deal size, are the enemy of performance.

The data studied is substantial (942 funds, 13,170 deals) and striking.

As an example, consider the following graph, which shows that the smallest AUM funds produced an average TVPI (total value-to-paid in, or what we would call MOIC, multiple of invested capital) of 2.75x, while the largest AUM funds produced a TVPI of 1.5x.

Figure 2: Fund Size and Performance



The authors go on to cut the data a variety of ways and control for a variety of factors, yet the conclusion remains clear: **smaller funds and smaller deals do better than larger ones.**

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What do these two gifts—the 4X Finding and the size/performance data—tell us?

The authors focus on the fact that AUM-gathering PE firms can partially offset the drag on their returns caused by fund and deal size growth by correctly identifying their best people and directing a larger share of firm capital into their deals.

A much larger point, in my opinion, has to do with what the best people at large firms can do once they go off on their own.

Stringing together the authors' findings, and adding a bit of logic, what emerges is a powerful argument that **emerging private equity firms can offer extraordinary, outlier risk/return.**

Here are the key pieces of the argument:

1. **Star individual investors exhibit portable consistency.** The authors find "evidence of performance persistence across deals by the same individual." In footnote 14 (buried again!) they note that performance persistence applies even to individuals who change firms. The upshot: individual track records provide a strong sense of who the stars are. Thorough and competent referencing by allocators can further refine the identification of stars.

2. **Founders as a group skew positively because of self-selection.** While new firms are formed by stars and non-stars alike, stars know they have a much higher probability of success. They are therefore disproportionately represented among those founders who are sending the right signals to the market when they start their new firms.

3. **New, smaller PE firms have smaller teams, which provides concentrated exposure to the work of stars.** This benefit can be amplified if allocators employ a bit of innovation on the structuring side. I'll talk more about this in the future.

4. **New, smaller PE firms focus on smaller deals, which tend to perform better on average.** The authors note that these deals are more volatile — not just to the upside but also to the downside. However, (i) diversification among funds and (ii) diligent manager selection should more than offset the volatility issue given the higher returns.

Bottom line:

1. As an allocator, emerging PE is where you want to be if you have the tools to execute properly.

2. As a PE founder, this is the story you need to tell.

Final comment: I've joked a bit about academia in this article, which hopefully comes off as good-natured prodding rather than criticism. I deeply appreciate the work done by researchers in economics, corporate finance, etc. If you aware of great investing insights produced by academics—even if buried in the tables—please share!

NEWSLETTER
From Star to Founder
Insights from partnering with exceptional investment managers as they launch and build new firms

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