BARINGS

PRIVATE EQUITY

Don't Judge a Fund by its Number: What LPs Often Overlook in Fund Selection

INSIGHTS

As many LPs opt to commit limited capital to fewer managers amid today's uncertain economic climate, revisiting key considerations in manager selection and capital allocation may prove worthwhile.

Mina Pacheco Nazemi
Head of Diversified Alternative Equity

Adaline Sparks
Associate Director

The strength of the private markets continues to encourage new firms to enter the private equity asset class. With more general partners (GPs) in the market, the fundraising landscape has grown increasingly competitive. This is particularly true for emerging managers, which are broadly defined as GPs raising institutional funds I, II or III.

With many limited partners (LPs) committing fewer dollars, all GPs are facing tougher economic times. Emerging managers face challenges in competing with established managers and in differentiating themselves from a growing pack of competitors. Notwithstanding those challenges, however, data show that emerging managers have historically delivered better returns to investors, with nearly one-third of emerging managers having achieved top-quartile performance.[1] Often avoided or overlooked by investors, we believe emerging managers merit reconsideration by LPs.

Challenging Common Investor Assumptions

Almost half of all investors choose not to invest in first-time funds and many also avoid funds II or III. Decisions to bypass those funds often are due to some widespread misconceptions about emerging managers, including the view that all such managers are unproven investors with no track record, far too risky, and vastly under-resourced.

1. ASSUMPTION

Private equity markets are flush with dry powder.

REALITY

While capital flows into private equity increased substantially in recent years, private equity dry powder saw a decline in 2022 for the first time in over a decade.[2] Further, the introduction of monetary tightening, surging inflation, and other lingering effects of the COVID-19 pandemic have resulted in a decrease in public market valuations, leaving many institutional investors experiencing the denominator effect, resulting in an overweight allocation to private markets. This has led many LPs to re-balance their portfolios and, in the process, reduce the number of relationships in which they invest. Amid mounting economic uncertainty, many also believe that the largest, most established funds will be the most able to weather the storm.

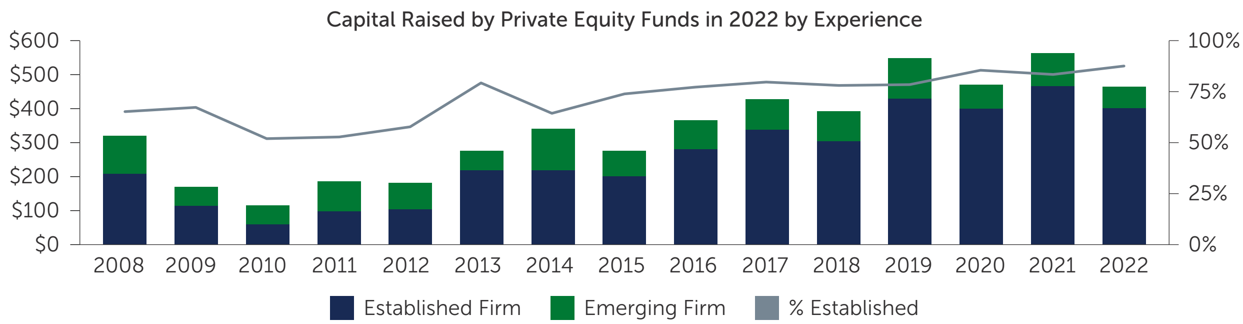
1. Source: Pitchbook. As of March 1, 2023.
2. Source: Pitchbook 2022 Global Private Market Fundraising Report. As of February 21, 2023.

This preference for size has tilted the table toward larger GPs. Despite a decline of 17.7% in the total capital raised by private equity funds in 2022, the aggregate capital raised by established managers declined by only 13.8% **(Figure 1)**. At the same time, capital raised by emerging managers and first-time funds declined 36.7% and 43.5%, respectively, demonstrating the increasing difficulty for emerging managers to raise new capital.[3]

In fact, not only were established managers more successful in raising funds, but the 17 largest private equity funds that closed in 2022 represented 47.5% of total funds raised, topping the share of the largest funds for the last decade.[4]

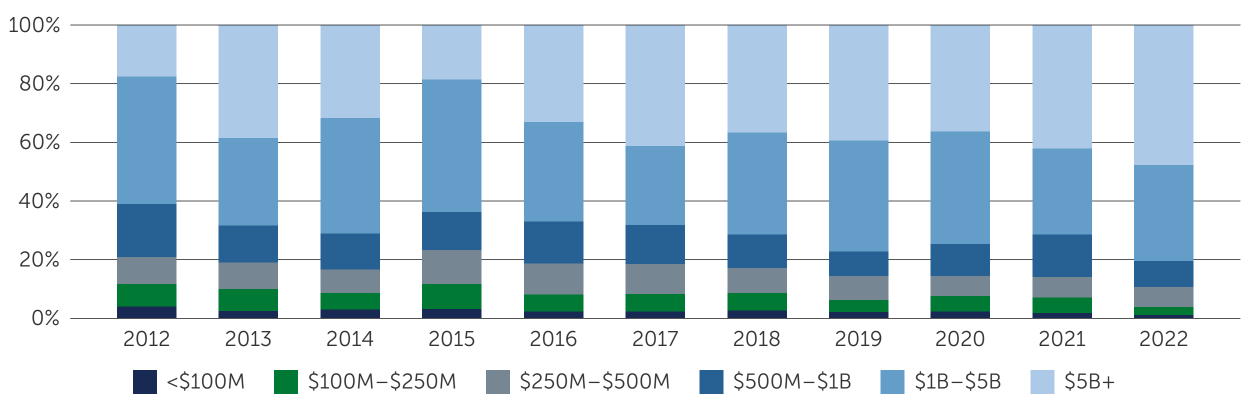
As a result of LPs aggregating capital toward established managers, private equity funds with assets of $1 billion or more accounted for approximately 80% of all capital committed to private equity in 2022 **(Figure 2)**. Although these large funds have dominated the market in terms of sheer dollars raised, the large cap market is highly saturated and competitive. Lower middle market funds (defined as funds under $500 million) represented approximately 11% of capital commitments raised in 2022 compared to the 21% of capital commitments raised a decade ago in 2012, despite having the potential to generate outperformance relative to the larger end of the market **(Figure 3)**.

Figure 1: Capital Raised by Established Managers Declines Less Than Emerging Managers



Source: Pitchbook 2022 Global Private Market Fundraising Report. As of February 21, 2023.

Figure 2: Private Equity Fund Value by Size



Source: Pitchbook 2022 Global Private Markets Fundraising Report. As of February 21, 2023.

3. Source: Pitchbook 2022 Global Private Market Fundraising Report. As of February 21, 2023.
4. Source: Pitchbook 2022 Global Private Market Fundraising Report. As of February 21, 2023.

2. ASSUMPTION

Larger funds are positioned to generate stronger returns.

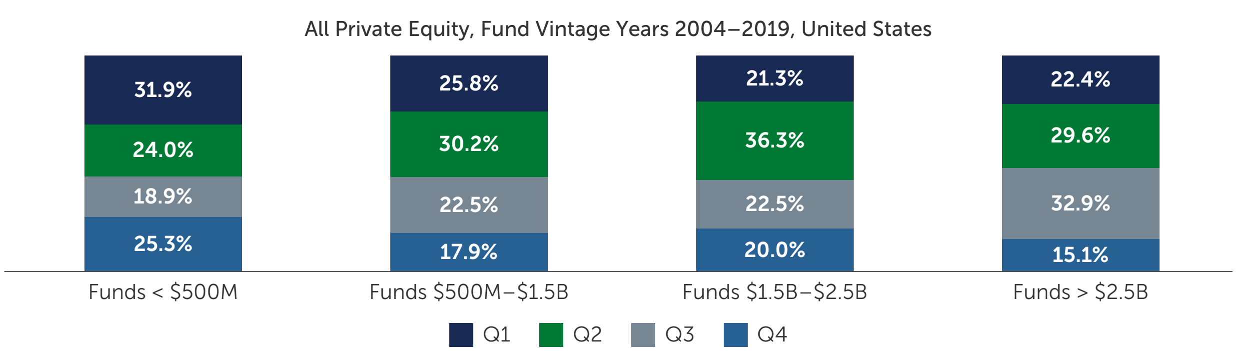
REALITY

As private equity funds in general grow larger and more established, performance tends to gravitate toward the mean versus the upper or even bottom quartile. Investors who assume that investing in the biggest funds will deliver the best returns may well be disappointed. In actuality, the performance of those funds is more likely to be mediocre, often landing in the second or third quartile.[5]

Alternatively, smaller funds typically allow managers to be more nimble investors and invest in less-efficient corners of the markets where the size of large/mega funds often precludes their ability to participate. By focusing on companies that are likely to benefit from the small cap effect—the much-noted underestimation of small companies' growth potential and value—smaller managers are poised to identify companies that have the potential to outperform. Further, GPs investing in the lower middle market often benefit from more attractive valuations due to lower competition as larger private equity firms move up market, thus leading to generally more attractive valuations and capital structure. Additionally, lower middle market opportunities tend to provide a wider set of value creation levers as founder and family-owned businesses tend to be less financially and managerially sophisticated. This creates significant opportunity to institutionalize and professionalize their operations and invest in growth opportunities.

The lure and risk of investing in lower middle market funds is evident from **Figure 3**. Historically, funds under $500 million had a tendency to over-index to the top quartile and the bottom quartile. Despite large-cap funds representing the vast majority of capital raised in 2022, also evident is that larger, more mature funds are delivering middling returns over time as the likelihood of hitting "home runs" decreases. Therefore, we believe that investing in smaller funds positioned to execute transactions at the smallest end of the market provides a compelling opportunity to generate top-quartile returns—but the potential for outperformance requires heightened attention to manager selection.

Figure 3: Quartile Performance Distribution by Fund Size



Source: Barings and Pitchbook. As of March 1, 2023. Data set includes primary funds (i) employing buyout, growth, diversified private equity and turnaround/distressed strategies; (ii) with vintages between 2004 and 2019; and (iii) domiciled in the United States. Funds must have performance data and fund size to be considered. Sample set includes 1,085 funds.

5. Source: Pitchbook. As of March 1, 2023.

3. ASSUMPTION

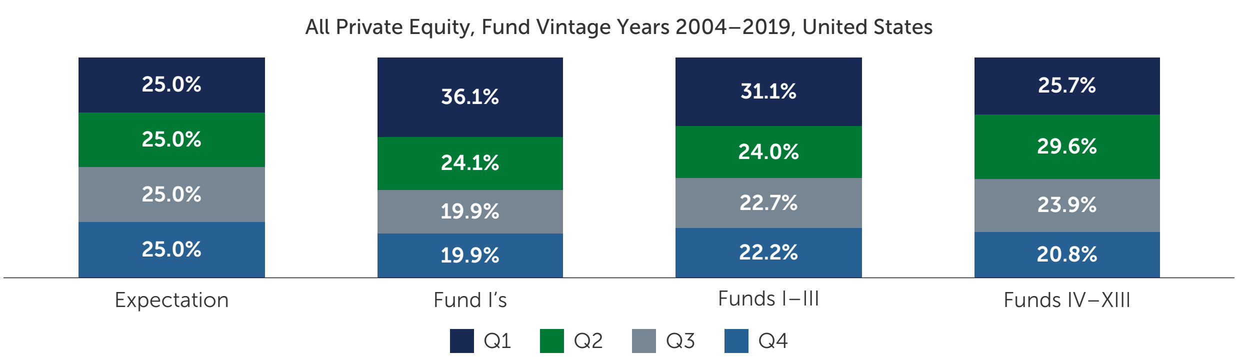
An established brand name manager is typically the safest choice.

REALITY

The performance of established managers actually has been trending toward the median. For the largest and most mature funds (Funds IV–XIII), data have shown that performance often declines over time, resulting in the relative performance of more of these funds falling into the middle quartiles **(Figure 4)**. Previously focused on fewer companies and spending 100% of their time on them, larger GPs now find themselves overseeing multiple funds in various lifecycle stages (fundraising, investing, portfolio management and exiting). With many partners moving up and teams moving on, the original track record associated with a brand name often can no longer be attributed to the current management executives.

Rather than being a way to sidestep risk, we believe investors' widespread avoidance of emerging managers may be a missed opportunity to potentially achieve outsized returns. Many emerging managers have identified and invested in smaller businesses that often are overlooked by the mainstream market. The managers have been able to drive attractive operating results using strategies executed by small, dynamic teams. Additionally, emerging managers have the benefit of not being distracted by legacy portfolios that demand attention in an inflationary environment, which may be preceding a recession. Instead, they can focus on sourcing and executing new deals for their current funds.

Figure 4: Quartile Performance Distribution by Fund Number



Source: Barings and Pitchbook. As of March 1, 2023. Data set includes primary funds (i) employing buyout, growth, diversified private equity and turnaround/distressed strategies; (ii) with vintages between 2004 and 2019; and (iii) domiciled in the United States. Funds must have performance data and fund size to be considered. Sample set includes 1,047 funds.

In fact, while emerging managers historically may have been considered riskier due to their tendency to over-index to the first and fourth quartiles, recent performance suggests that emerging managers actually over-index to the first and second quartiles. **Figure 4** shows 31.1% of emerging managers generated top-quartile returns. Further, 36.1% of first-time funds are top-quartile performers and 60.2% performed above the median. We believe emerging managers are typically hungry for success and tend to be more entrepreneurial and motivated than their more established counterparts, often seeking to create something new and innovative with the potential to generate higher returns for investors.

4. ASSUMPTION

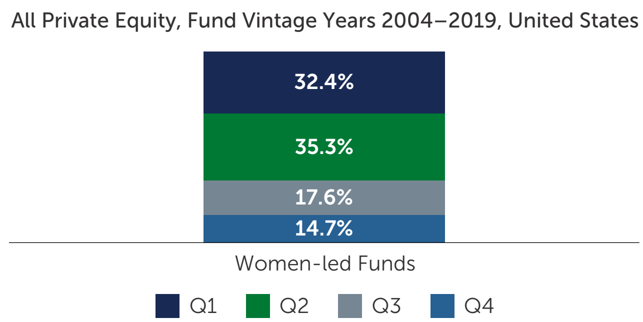
Investing in diverse managers compromises returns.

REALITY

Embedded in many investor assumptions is a belief that investing in emerging-, diverse- or women-led managers imposes a cost. In reality, there is a subset of women-led firms in the emerging manager universe that have been demonstrating very strong return potential.

Research indicates that 32.4% of women-led funds are top quartile performers and 67.7% performed above the median **(Figure 5)**. While those statistics would almost certainly be considered impressive by most investors, we also want to highlight how few women-led firms there are and the glaring gap in the market. According to a study by the Knight Foundation, just 7.2% of U.S.-based private equity firms are women-owned but women-owned firms manage only around 1.6% of the U.S.-based private equity AUM, despite representing 51% of the U.S. population.[6] That said, we believe that by overlooking women-led managers, investors may well be forgoing an opportunity to achieve outsized returns.

Figure 5: Quartile Performance Distribution by Ownership



Source: Barings and Pitchbook. As of March 1, 2023. Data set includes primary funds (i) employing buyout, growth, diversified private equity and turnaround/distressed strategies; (ii) with vintages between 2004 and 2019; and (iii) domiciled in the United States. Funds must have performance data and fund size to be considered.

Time to Consider Emerging Managers

By seeking what they perceive to be the safety of large managers in uncertain times, investors actually may be increasing their risk of underperformance. While returns by large managers have been trending to the median, many emerging managers—whose principals typically have large-firm experience—have often outperformed historically. We believe that it may be time for another look.

6. Source: Knight Foundation, Knight Diversity of Asset Manager Research Series: Industry. As of December 7, 2021.

Barings is a $362+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, Baring Asset Management Korea Limited, and Barings Singapore Pte. Ltd. each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

LEARN MORE AT BARINGS.COM

**As of March 31, 2023*

23-2906588