

MAKENA INSIGHTS

Emerging Manager Alpha

JULY 2019

Competition for generating excess returns continues to grow given meager long-term capital market returns. The 20-year return on global equities (the MSCI ACWI) was a mere 4.5% through the end of 2018. In our search for managers who can exploit inefficiencies to produce alpha, emerging managers have become a growing area of focus for our investment team. First-time funds and new managers are often perceived as riskier and structurally disadvantaged compared to their established peers. In this letter, we address issues regarding emerging managers and discuss how we evaluate these investments. In short, we believe that investing in emerging managers using a disciplined framework can yield strong, risk-adjusted returns.

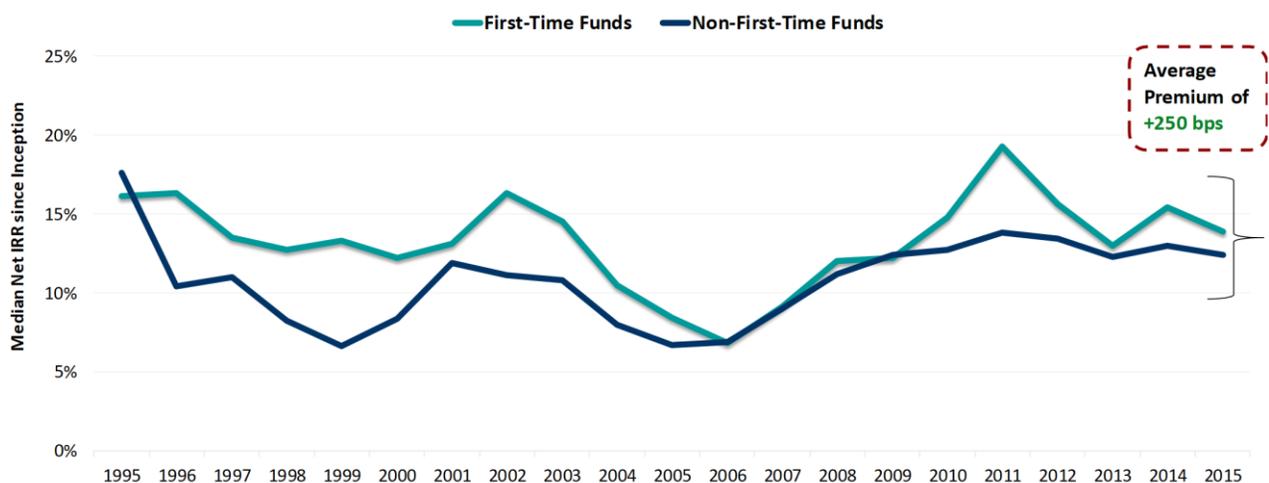
What is an Emerging Manager?

There is not a widely-accepted definition of “emerging managers.” Some investors define emerging managers as brand-new launches, while others focus on small assets under management (AUM). At Makena Capital, we broadly view emerging managers as experienced investors who begin operating under a new organizational umbrella. Our precise definition varies depending upon the asset class. Within private asset classes we define an emerging manager as having two or fewer fund offerings. For liquid assets, we view an emerging manager as a firm that is less than three years old, or one with an AUM of \$500 million or less. Emerging managers don’t always look alike and can vary across multiple dimensions, including strategy, fund size, and the extent of their General Partners’ experience. For example, emerging managers in venture capital tend to raise smaller funds than do those in the buyout and growth equity asset classes, which makes the speed of due diligence crucial given limited capacity.

Emerging Managers: Quantifying their Edge

Industry data show why first-time funds deserve close attention. Our analysis of 1,100 private funds, across the private equity, real estate, venture capital, and natural resource asset classes, finds that first-time funds offer an average premium of 250 basis points over non-first-time funds (see chart below).

First-Time Funds vs. Non First-Time Funds: Median Net IRRs by Vintage Year



Average number of first-time funds, per year, from 1995–2015 = 52

Average number of non-first-time funds, per year, from 1995–2015 = 272

Aggregation of private fund data across multiple sources: Burgiss Private iQ, PitchBook, Makena analysis

Importantly, the dispersion of returns is larger for first-time funds than for more established funds, highlighting the importance of sound manager selection. This emerging manager “premium” is also evident among hedge funds. Separate research shows that younger hedge funds tend to outperform their more seasoned peers by 200–300 basis points over long periods of time.¹ Age and success often lead to AUM growth, which is typically the enemy of returns. Unsurprisingly, the same research shows that smaller hedge funds generate 150–250 basis points of outperformance compared to larger funds.

Why Emerging Managers? What is the Value Proposition?

The rationale for investing in emerging managers might seem obvious, but our long history of sourcing and sponsoring these funds has reinforced our conviction in why these managers offer attractive risk-adjusted returns. Why do these managers produce better returns?

1. *Motivated talent that is hungry and focused on improvement.* Emerging managers are especially motivated to perform; and, when building their own firms, newer managers are determined to learn from prior experiences and incorporate lessons-learned into their processes. This entrepreneurial spirit and drive for excellence is highest early in a firm’s existence—and such organizations tend to attract like-minded talent.
2. *Strong alignment of interests.* Because first-time funds are generally smaller than their established peers, the General Partner (GP) tends to be more aligned with their Limited Partners (LPs). More specifically, the smaller fund size means that emerging managers can’t profit handsomely from management fees; instead, the lion’s share of their economics derive from earned incentive fees, benefitting both LPs and GPs.
3. *Deeper relationships.* Partnering with emerging managers leads to deeper relationships with GPs, generating multiple benefits. First, we are often one of the first calls for proprietary co-investments, advice on governance issues, potential new ideas, and market intelligence. This has a compounding network effect, which further solidifies our role and reputation as an LP of choice. Makena often serves as an informal advisor, partnering with our emerging managers to share industry best practices on everything from communications to portfolio construction. Second, deeper relationships increase transparency into our partners’ portfolios and organizations, allowing us to conduct better up-front and ongoing due diligence.
4. *Favorable terms.* Being an early investor comes with advantages, such as the opportunity to negotiate preferred terms or access to co-investments, especially if an LP has the brand recognition and expertise to help an emerging manager jump-start the business. We have a long track record of working with emerging funds, positioning us favorably to be founding LPs with best-in-class first-time managers.
5. *Runway to grow capacity.* Partnering with emerging managers early in their life-cycle generates goodwill with the GP and typically results in guaranteed rights to increase capacity with the manager as they become more successful and sought after by other LPs. This is especially relevant for capacity constrained strategies.
6. *Small size performance advantage.* The larger a fund gets, the harder it can be for a manager to generate alpha. Emerging managers tend to keep their fund sizes more reasonable. Backing these managers early in their life-cycle enables us to scale into meaningful exposure across multiple vehicles despite their small fund sizes.
7. *Targeted strategies.* Our research shows that managers with highly focused strategies tend to perform best. Often, the emerging managers we support launch their own funds after demonstrating a core competency—sector, asset, or otherwise—at a prior firm.

¹ eVestment Emerging Managers Report, 2015.

Emerging Managers: Makena Capital's Experience

To capitalize on these seven value propositions, Makena has actively sourced and invested in emerging managers since its inception. It is important to note that we do not have an explicit target to emerging managers. Rather, our process of identifying these funds is exclusively bottom-up. Decisions to add emerging managers to the portfolio are made in direct competition with non-emerging managers. We will never invest with a manager simply on the basis of its “emerging” status. While we believe in the promise of emerging managers, we only invest with those having a differentiated, demonstrated, and repeatable investment process. Across strategies and vintages, the Makena team has backed many successful first-time funds, many of which continue to be high-conviction managers in which we are material investors across multiple funds.

As we reflect on our experience, we have found two conditions that improve our odds of success when investing with emerging managers. The first situation is when we were an investor with the GP at his or her prior firm. Information (e.g., track records) on first-time fund managers is more difficult to find and corroborate. Having pre-existing relationships with such investors provides us with an enormous edge in understanding their capabilities and contributions made at their prior firms. This positions us one step ahead of our competition when such managers decide to spin out. More than a third of our total emerging manager commitments have been with fund managers with whom we were a prior investor. Knowing and working closely with such GPs lets us understand their strengths, as well as areas where they may benefit from our counsel.

The second condition that has improved our success with emerging managers is when the new manager is a team carve-out. Teams that have worked together before launching a new fund face less organizational risk than ones without a strong history of collaboration. The new organization's investment philosophy and process can be quickly integrated and understood by all members of the team, allowing them to quickly “hit the ground running.” Team carve-outs also reflect a positive signal as the new fund is leaving with the support of his or her prior organization and top lieutenants. More than half of the emerging managers we have supported have been team carve-outs. Investing in team carve-outs has also improved returns. Finally, combining both conditions is the most attractive of all. Investing in emerging managers in which we were invested in their prior funds and that were team carve-outs has added 530 basis points of performance compared to other emerging managers.

Emerging Manager Takeaways

While the allure of emerging managers is clear—strong alignment of interests; deeper relationships; demonstrated performance premium; the potential advantages of smaller, more targeted funds — they are not without risk. Evaluating emerging managers requires expertise and experience. Since 2006, Makena has developed and refined our bottom-up approach to investing in emerging managers, building meaningful relationships with nearly 100 emerging managers and identifying success signals and critical lessons along the way. Although we will continue to evaluate and invest in emerging managers, it is crucial that we maintain our long-term investments with premiere established managers as well. These established managers will provide us with the best opportunity set for future emerging manager talent.

Sincerely,

The Partners of Makena Capital Management

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