Discussion of *"Investing outside the box"* by Lerner, Mao, Schoar, and Zhang

Per Strömberg, SSE & SHoF

ECB Annual Research Conference

September 6, 2019

Potential to become a very important paper in PE literature

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS

- Fantastic and unique data set
  - Difficult data work
- Allows accurate analysis of non-traditional ways of PE investing
  - LP cash flows
  - Good cross-sectional and time-series coverage of LPs and GPs
- Sheds new light on sources of returns in PE investing
  - Heterogeneity in returns and persistence among LPs and GPs
- Starting to see picture emerging
  - But not quite there yet

What do we know about PE returns?

SWEDISH HOUSE OF FINANCE

- Private equity ”outperforms” public equity (KS05)
- Negative correlation between fundraising and returns
  - Both at macro and fund level
- Performance persistence at GP level (KS05)
  - Why are funds leaving money on the table?
  - Weakening over time for buyout funds (but not VC) – Harris et al 2014
- Performance persistence at LP level (LSW07)
  - Although the types of LPs that outperform has changed (SWW14)

PE returns and liquidity premium

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS

- Patterns consistent with PE ”outperformance” being compensation for time-varying liquidity premia
  - Fundraising and returns

- Excess returns to some LPs compensation for providing liquidity
  - Lerner-Schoar (2004): GPs prefer LPs who are likely to commit to next fund
  - Maurin-Robinson-Strömberg (2019): GPs prefer LPs who won’t default on capital calls

- Can explain GP and LP persistence
  - Price discrimination by GPs to cater to liquid LPs
  - Some LPs can provide liquidity by investing more in illiquid periods (secondaries, direct investments, extension funds)

Evolution of PE investing

SWEDISH HOUSE OF FINANCE

- From “endowment model” to “Canadian model”
  - From “fund picking/access” to “cost minimization”
  - Lerner, Schoar, Wongsunwai (2007) vs. Sensoy, Wang, Weisbach (2014)

- Driven by increase in LP AUM and allocations to private capital

- LP econ. of scale: internal teams, bargaining power, liquidity
  - Dyck and Pomorski (2016)

- LP disecon. of scale: need large “tickets” to affect returns
  - Superior access to oversubscribed funds less important
  - Harris et al (2014): return persistence disappearing in buyout, remains in VC

- PE increasingly integrated in overall portfolio management
  - Industry and geographical exposure, different private asset classes, ESG requirements
  - Demand for “bespoke” solutions

This paper helps shed more light on these developments

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS

- Consistent with ”GP price discrimination”, or more generally, LP abilities matter
- LP persistence and heterogeneity in returns even greater than what previous studies suggest.
- Not just because GPs have different skill and LPs different access, but LPs get different ”deals” and invest in different ways in asset class.

Vehicles and LP strategies

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS

- LP direct investment into individual portfolio companies
  - Lower fees but more demand on team
  - Can invest more in illiquid periods (when funds invest less)
  - Different degrees:
    - Co-investment funds
    - ”Plain-vanilla” post-signing co-investments
    - Co-syndicated
    - Co-sponsored / direct

- Secondaries
  - Acquire fund interests from other LPs
  - Ability to capture discounts during time of illiquidity

- Managed accounts – ”special deal” with GPs
  - Lower fees
  - Ability to ”pass” on some investments
    - ESG concerns, etc.
  - Ability to deal with specific regulatory and tax concerns
- Strategic partnerships
  - Invest capital for longer period (e.g. 20 years)
  - Invest across asset classes (BO, VC, Debt, RE, Infra, …)
  - Better deal on fees and carry
- Fund-of-funds
  - Too small / not enough resources to invest directly in funds
  - Pay extra fees
  - Run by FoF manager or GP

Suggestion: separate vehicles more

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS

- Some are likely to cater to large, sophisticated LPs, some are the opposite
  - Coinvestment funds vs ”plain-vanilla” co-investments vs co-sponsored
  - FoF vs strategic partnerships
  - ESG/tax-tailored portfolios vs

- Can use info on cash flows to do this:
  - Few capital calls & distributions vs many
  - Similarity of cash flows to ”main” fund
  - Differences in TVPI for similarly-timed cash flows

Where do performance differences come from?

SWEDISH HOUSE OF FINANCE

- Fee differences?

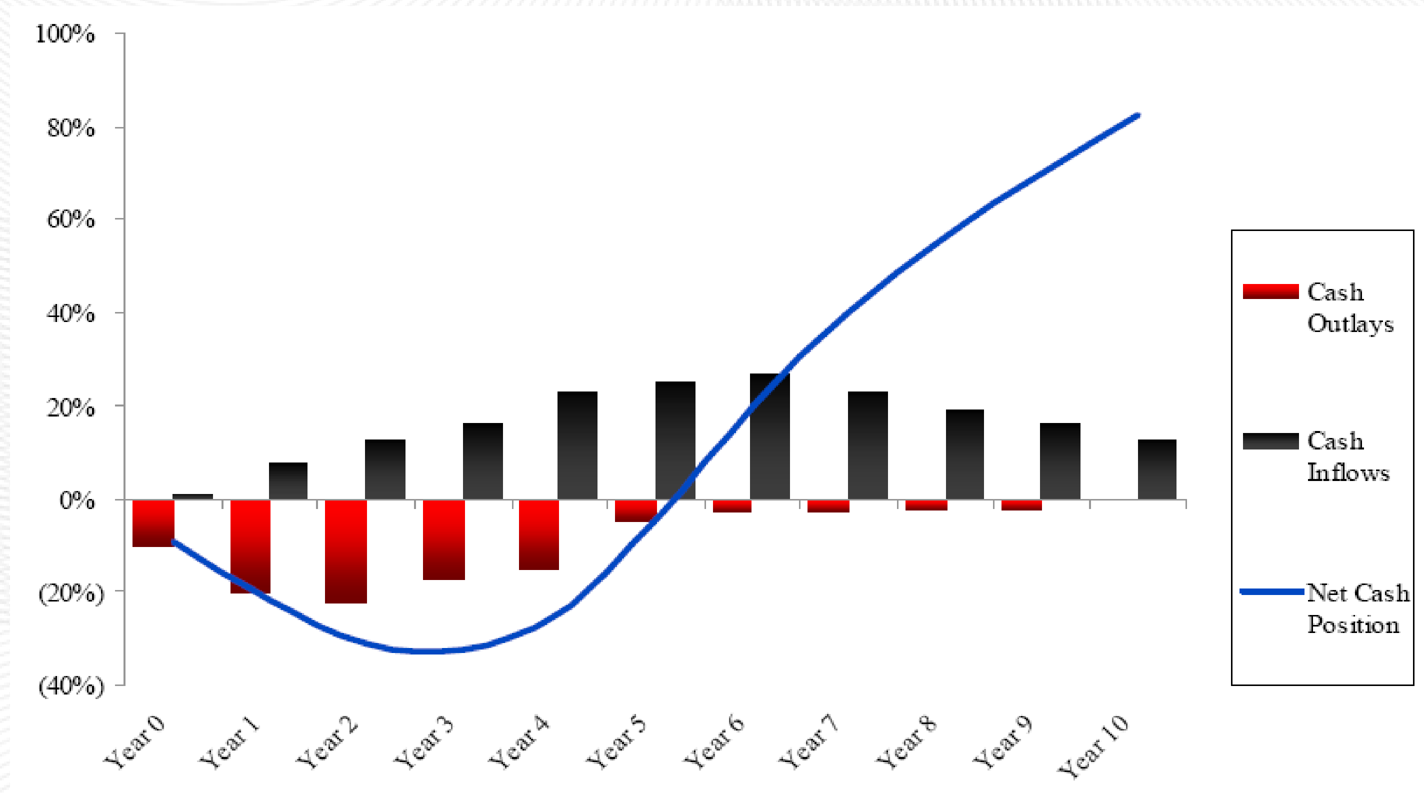
- Different market timing?

- Selection ability?

- Can do better in distinguishing these when account for differences in types of vehicles

Performance benchmarking

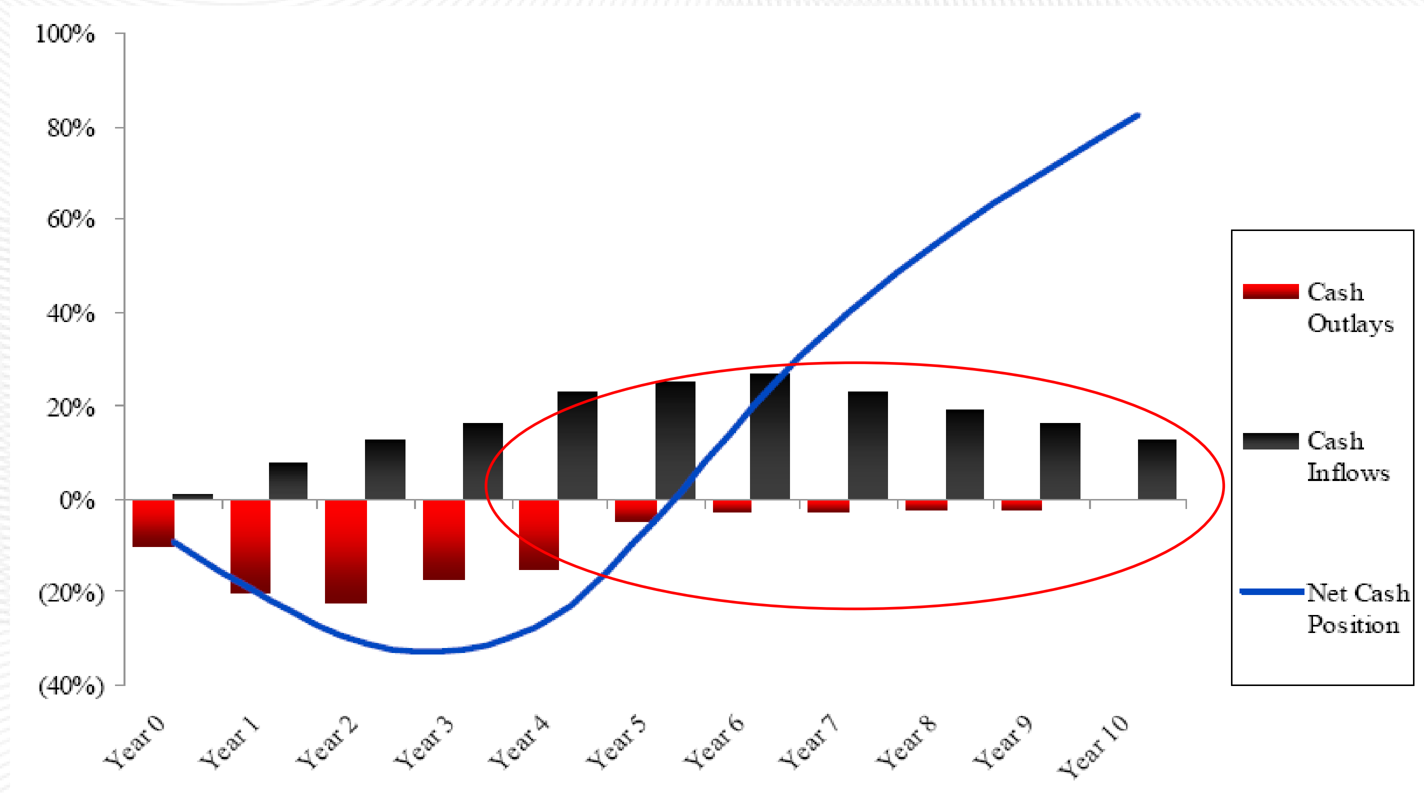
SWEDISH HOUSE OF FINANCE



Main fund

Performance benchmarking

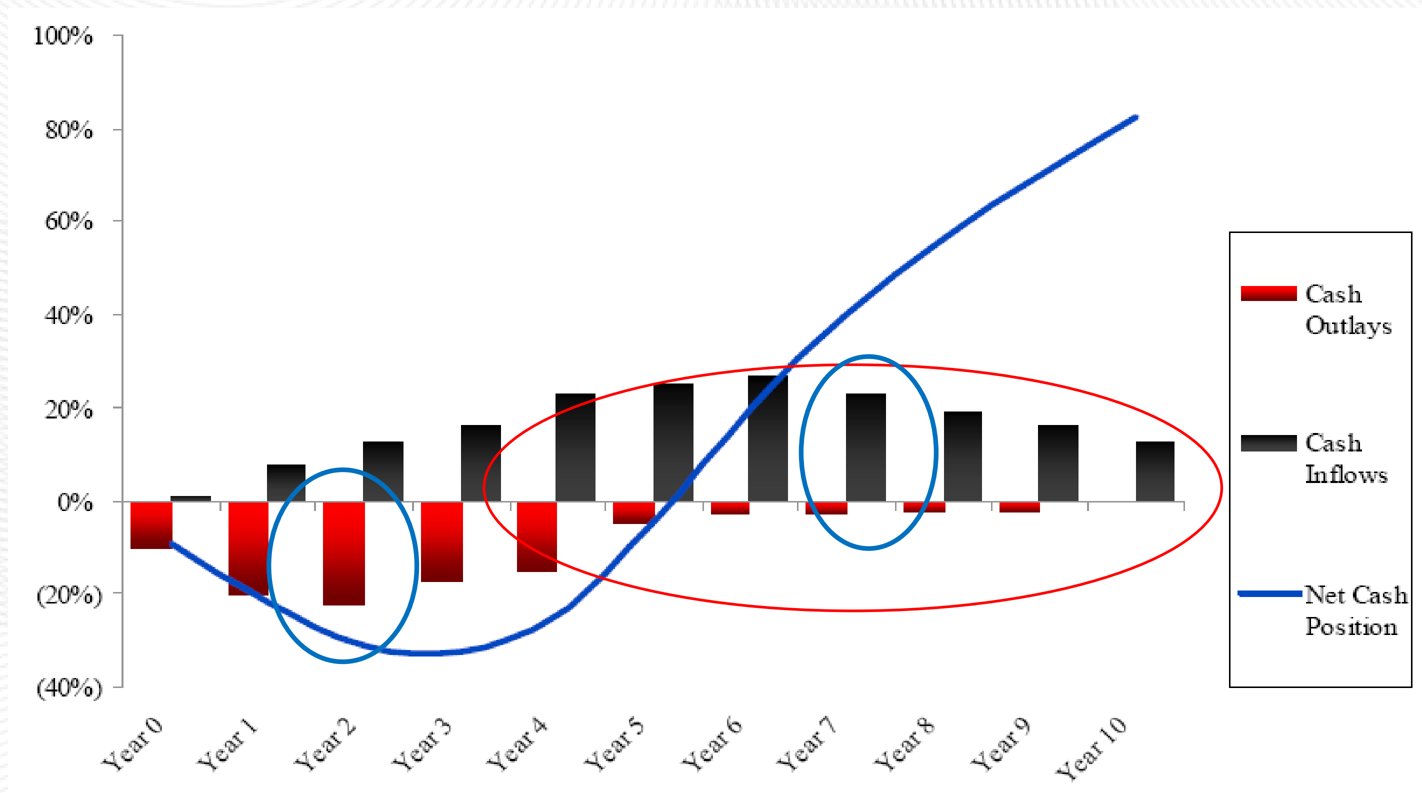
SWEDISH HOUSE OF FINANCE



Main fund

Secondary

Performance benchmarking



Main fund
Secondary
Co-investment

Performance benchmarking

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS

- Adjusted PME tries to alleviate this, but still problematic
  - Co-investment PME T+2 not well benchmarked with main-fund PME year T+2
  - Same with secondaries

- Would like to estimate PME at capital call level, year by year

More on LP heterogeneity

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS

- Currently show broad categories, not in regressions
- Look at size (Dyck-Pomorski)
- Look at liquidity provision
- What did PE portfolio return have looked like with vs without co-investment/managed account/secondary etc.
  - Not exactly done in paper

Other

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS

- Private debt - different. Take out of main analysis. Separate paper?
  - Risk different. Maturity / cash flow timing different. Vintages different.
  - Liquidity provision.
  - Discretionary vehicles during crisis?
  - How many main funds? Timing?

- Selection of LPs: who uses State Street?

- Regressions where some categories have very few observations