THE LIMITED PARTNER PERSPECTIVE

THE OPPORTUNITY IN DIVERSE EMERGING MANAGERS

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We investigate this less analyzed area of the PE industry through two approaches: first, a survey of National Association of Investment Company (NAIC) funds that provides a chronological accounting of the LPs that have been investors in diverse managers; and second, a set of interviews with leading LP practitioners who have deep experiences and knowledge about the opportunities and challenges of investing in what are also known as diverse emerging managers (EMs).

The findings from our analysis result in two sets of data: quantitative and qualitative. We utilized these two sets of data to further our understanding of who and what works when investing with diverse EMs. Given these data, we were able to develop prescriptive recommendations for investors interested in developing a diverse EM program or general interests in investing with diverse EMs.

Who are the limited partner (LP) investors in private equity (PE) funds managed by diverse general partners (GPs)?

Why invest in these funds?

What are their experiences?

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Executive Summary

When attempting to diverge from large private equity (PE) funds, what are the best alternatives available?

Are the experiences with smaller PE firms similar to that of larger firms? How are diverse emerging managers (EMs) different, and is the difference beneficial? Should the experience of the investors in diverse EMs lead other limited partners (LPs) to consider allocating a portion of their portfolio in a similar fashion?

The purpose of this study is to examine the identities, methods, and experiences of LPs in PE firms managed by diverse talent—women, ethnic and racial minorities, and recent immigrants. Little is known about investments in diverse managers. This study attempts to help stem the knowledge gap. Our research is a two-pronged approach. We surveyed the National Association of Investment Companies (NAIC) funds to provide a chronological accounting of LPs who have allocated capital to diverse EMs and conducted a set of interviews with LP investors in diverse EMs. The data on which we rely provide insight as to the identity of the LPs and why those LPs invested in emerging general partners (GPs), and also identifies LPs that should invest in diverse EMs.

Furthermore, we also sought to explore the question of sustainability of this area of PE: What does the future hold? The LPs surveyed expressed positive experiences with these managers. However, the survey data suggest that diverse EMs received committed capital at volatile rates. An increase in the amount of funds invested in this space, combined with an increase in the number of funds managed by diverse EMs, will smooth out capital flow and provide the consistency needed for efficient asset allocation. To be completely fair to the LPs, we are not suggesting that the lack of consistent funding to diverse EMs is a symptom of discrimination. Rather, we are saying that there are flocking

PURPOSE:

The Study
The purpose of this study is to examine the identities, methods, and experiences of LPs in PE firms managed by diverse talent—women, ethnic and racial minorities, and recent immigrants.

The Data
The data on which we rely provide insight as to the identity of the LPs and why those LPs invested in emerging general partners, and also identifies LPs that should invest in diverse EMs.

The Future
We sought to explore the question of sustainability of this area of PE: What does the future hold?

1Throughout this document, we use the term “general partners” to refer to the persons who are active in the day-to-day operations of PE funds. EMs are a subset, a loosely categorized group of GPs who tend to be less identified, either due to their years in the field, their demography, or other factors. The reasons for the ambiguity regarding definitions for the term “emerging manager” is that the phrase is defined differently across the field. In this document, our use of the term “diverse EMs” is meant to indicate funds managed by GPs who are from underrepresented demographic groups (women, ethnic and racial minorities, and recent immigrants) or focused on investments in underserved areas.
Understanding why LPs invest in diverse EMs is central to our exploration.

Naysayers argue against investing in these managers, alleging that formalized EM programs are politically driven and supported by those seeking to foster social change. These charges run counter to the notion that investment decisions rest outside of societal considerations, and that investments encouraged for those reasons are likely to be inherently more risky. An additional consideration is that socially driven pressures may place LPs in the position of having to make decisions about a class of investments for which they may not have the resources to properly conduct due diligence. The LPs we surveyed rebut that presumption. Contrarily, they contend that investing in minority managers is not only an investment in highly educated and talented managers but is also a better way to achieve portfolio diversity and reduce systemic risk.
Our interviews with LPs revealed a central theme in the notion that diversification is fundamental to the Modern Portfolio Theory.

The LPs we interviewed expressed that placing their money with diverse EMs was crucial to attaining true diversification. Further, they explained that investment managers and chief investment officers (CIOs) have a fiduciary obligation to seek return-driving opportunities in the market, and diversification necessitates considering EMs as a part of the overall investment strategy. The LPs articulated that their rationale behind this logic derived from seeing diverse EMs seek opportunities in markets where there is less competition. Thus they rationalized that they were able to avoid the herd mentality that comes with larger firms, which typically compete for similar deals. Specifically, they stated that diversification in portfolio allocation and avoiding groupthink is essential to capturing market uptrends at lower risk levels and protecting against the susceptibility to downturns. As discussed in the study, some LPs asserted that these types of investments helped to avoid total losses in PE portfolios when larger players in the PE sphere experienced down years.

In addition to fund diversification, LPs noted EMs’ talent and training. One of the myths plaguing diverse EMs is that they are not capable of properly investing large amounts of funds and therefore the bar would have to be lowered to evaluate their performance. Additionally, the term “diverse emerging manager” is sometimes thought to mean new or untested. However, during the course of interviewing the LPs, we found that these assertions simply are not true. Many of the managers in EM positions come to the field after training in established, larger PE firms. Having worked at these recognized firms, they then took steps to create their own firms at the middle-market level. LPs espoused that diverse EMs implemented seasoned and well-tested strategies, creating the opportunity to build idiosyncratic value. Not only were these managers trained by the larger firms, they also are similarly situated when one compares experience and education backgrounds. Moreover, LPs, allocating capital between large and emerging funds, asserted that diverse EM funds are evaluated using the same metrics chosen for large PE funds.
EMs provide attractive opportunities, and many LPs have substantiated this claim through follow-on investments.

However, many LPs have experienced difficulty conducting due diligence on EMs as a result of being understaffed. Given the universe of more than 200 diverse and emerging managers, LPs keen on entering the market have outsourced some of the due diligence by using funds of funds (FOFs) to allocate capital. FOFs have been the intermediary step for LPs who are interested in “getting their feet wet” in the EM sector. FOFs often serve as the “first set of eyes” for many LPs initially interested in investing with EMs or looking to find additional EMs. With the increased exploratory use of FOFs, LPs are exposed to vetted, diverse talent and are then able to make larger commitments to GPs. As a result, the EM space is a burgeoning area that is garnering more capital allocation and interest from LPs.
Lessons Learned: What We Prescribe

Consistent LP investments are central to fostering growth of diverse EMs.

The LPs we interviewed stated they were highly optimistic about future opportunities to invest due to past investing experiences, both directly with diverse EMs and via FOFs. However, the authors would be remiss if we did not acknowledge the lack of consistency among LPs. Due to overall market conditions, LPs sometimes fell short of the optimal results when they let market conditions affect the consistency of their allocations with diverse EMs. Nevertheless, according to the interviewees, some diverse EMs, despite the LP inconsistency, met and exceeded the stated returns promised at the outset of investment. Ergo, we posit that EMs may have been able to achieve better returns had the LPs stayed on and continued to invest, as they had with larger funds.

Although increasing the consistency of current LPs is one way to improve the variability of capital commitments to EMs, new LPs, who rarely or have yet to commit capital to diverse EMs, present the opportunity to initiate variance smoothing (consistency in aggregate funding coming into diverse EMs). To identify potential LP investors in the diverse EM investing space, we examined the United States’ demographics and industries, based on LP stakeholder demographics, to assess LPs who may have an interest in diverse managers. Under the demographical approach, we examined state population trends to identify specific areas that could be considered budding diverse markets. Under the industry approach, we identified categories wherein minority households outspend majority households. Taken together, we believe that states along the coasts and corporate pension funds that receive a disproportional amount of minority funds have financial incentives to invest in diverse managers.

Diverse EMs present opportunities that LPs should consider as a part of their portfolio-allocation strategy. However, performing due diligence on EMs can be difficult for understaffed LPs. LPs interested in this area should consider using FOFs to facilitate a smooth entry into the sector. Moreover, this sector has the potential to realize growth because large firms continue to dismiss underserved markets and fail to allocate the resources needed to properly vet the unique deals presented. The growth here, as declared by interviewees, is very real, but LPs have to step up both their commitment and consistency. Talented diverse EMs obtained a vast amount of experience at large funds and have the potential to thrive should LPs financially empower them. Therefore, EMs are poised for growth as more LPs allocate capital with steady hands.
How Should Diverse EM Firms Market Themselves?

There has been a considerable amount of conversation regarding the lack of diversity in PE funds.

Diverse EMs should market themselves as the firms leading the diversity conversation and providing opportunities to take advantage of the perspectives that will lead to opportunities diverging from the mainstream. Since PE is largely unregulated and privately held, it is understandably difficult to obtain the number of diverse EMs in the respective funds. Venture capital (VC), recognized by many industry professionals as the earliest stage of PE, has been under considerable scrutiny due to its lack of diversity. Richard Kerby, a vice president at Venrock, surveyed firms and found that there were 32 African-American investors (read, diverse EMs) in VC out of 1,918 investors (1.67%). While his numbers did not take into account the total number of managers within the NAIC, the overall number of African-American investors is likely around 2.63%. The numbers for Asians, Hispanics, and other minorities are not adequate either, according to other reports.

With an abysmal lack of diversity among VC firms, the GPs of the NAIC and those similarly situated have the opportunity to market themselves as the partners with whom more funds should be placed due to diversity concerns and divergence from mainstream thought processes.

VENTURE CAPITAL (VC):

Diversity
Recognized by many industry professionals as the earliest stage of PE, but lacks diversity.

Research
The overall number of African-American investors is likely around 2.63%. The numbers for Asians, Hispanics, and other minorities are not adequate either, according to other reports.

Opportunity
GPs of VC firms have the opportunity to market themselves as the partners with whom more funds should be placed due to diversity concerns and divergence from mainstream thought processes.

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https://docs.google.com/spreadsheets/d/15UQGbkvuOF1UCS_nu5ojH3C79uJIKxeTgGBwOXEb4/edit#gid=0.

Why Study Diverse PE Managers?

Whether it is a high-net-worth individual, a corporation, a university endowment seeking to burnish returns, or a teacher contemplating retirement, the performance of alternative assets has been met with a mixture of awe, curiosity, and occasional doubt.

Indeed, alternative assets have been dubbed the “sports cars” of the investment world—such that pension funds, primary investors in alternative assets and PE funds, have shown increasing interest because of the promise of outsized returns.

The wide interest in alternative assets generally, and PE specifically, is based on the potential for supernormal returns. Alternative assets have been a prime topic of interest for decades. For example, both academics and practitioners alike have examined whether allocations in alternative assets can provide a higher-risk, higher-return counter to the relatively staid holdings in public equities and fixed income.

In addition to the promise of alpha, an additional rationale for the interest in these funds originates in their role as financial intermediaries that fill the breach between capital and innovative, entrepreneurial firms. A core element of the growth of economies derives from the collective action of individuals seeking to “creatively destruct” or disrupt the status quo in markets. These entrepreneurs are seeking ways to make life easier—to improve the quality of goods and services as well as the range of those services, and to reduce the costs necessary to deliver alternative assets to customers. The presence of a sizable and stable PE industry is an advantage to the nations, states, and metropolitan areas concerned about ushering in the next generation of innovation firms that will grow jobs and wealth, or improve the quality of our daily lives. Alternative assets can be used as important public policy tools to spur ideas and innovations that might otherwise go unfunded.
As the PE field has grown over recent decades, so has the sophistication of the actors operating in this field.

A cadre of practitioners rose to respond to demands for better understanding of PE investing—including consultants and our colleagues working in universities. Yet we still lack knowledge and understanding of the PE space. This is, in part, because it remains a relatively unregulated class of financial assets with closely guarded information on operating practices, forms of agreement, and returns. In a sense, a “veil of secrecy” prevents transparency in this area. In essence, the influx of capital in PE is operating ahead of our collective knowledge of investing in this area, and there is a need for careful research to help us navigate this increasingly complicated investment arena. Although there is considerable theorizing on the reasons to invest in alternative assets, we seldom took the step to ask the funds’ LPs why they chose to place their funds with one set of managers over another. This study aims to close that gap by directly surveying and interviewing the LPs of a diverse group of PE funds, and to ask these LP investors about their interests in diverse EM programs.

1 / Lack of knowledge of PE
The PE space remains a relatively unregulated class of financial assets with closely guarded information on operating practices, forms of agreement, and returns.

2 / Asking LPs
This study aims to close that gap by directly surveying and interviewing the LPs of a diverse group of PE funds, and to ask these LP investors about their interests in diverse EM programs.
The Fallacy of Perfect Market Efficiency

One of the prime tenets in the world of investing comes from neoclassical economics:

The clash of collective action among engaged investors in markets will ferret out inefficiencies and close them in short order. Where there are returns to be made in novel or less understood areas, the “invisible hand of the market” will determine what works and does not. In other words, “no one will leave a dollar laying on the ground.”

Yet, we have substantial evidence that market inefficiencies can persist, and irrational behavior can become common among large groups of investors. “Flocking” toward or away from one category of investments has shown that investors tend to “follow the leader” even in large, established markets. For example, in the PE field, there are a number of recognized, established funds with stellar reputations—Bain Capital, the Carlyle Group, Kohlberg Kravis Roberts (KKR), and TPG. And some investors may tend to follow these market leaders without a clear understanding of the reasons and causes for and risks in their outsize returns.
Demographic Diversity: Why Would It Matter in Investing?

Through the arc of the 20th Century, the reasons for demographic diversity and equality of opportunity have become well known and taken for granted. We understand the reasons for the inclusion of women and minorities in the electorate, in our educational and cultural institutions, and in our firms and government agencies. However, the reasons that these same trends would be important to investors aren’t immediately clear.

PE firms managed by diverse EMs—women, ethnic and racial minorities, and recent immigrants—is a less studied but very interesting area of PE wherein a great deal of opportunity is present. This interest comes from a wide range of sources, yet many of these sources share a common insight: by diversifying the base of investors, the range of investments should diversify as well. In this logic, a greater breadth in the diversity of PE managers should guard against flocking tendencies, allow the LPs of diverse GPs to establish better returns, and ensure greater diversification in retirement investments. We know from psychology that people who share similar backgrounds tend to also share perspectives on a number of things, including markets and investments. We also know that humans tend to find comfort in settings that are familiar, and we tend to view the unfamiliar as risky, even dangerous. If these tendencies are inherent in the human condition, one way to guard against them is to alter the composition of the investor class, rather than to attempt to change the way that an investor views familiar and unfamiliar markets.

From a public policy standpoint, investments in diverse EMs also foster opportunities for wealth creation and job growth. This logic moves to counter the tendency toward homogeneity in investing by diversifying the base of GPs in the field. One way that LPs have instituted this discipline is through the creation of formalized diverse EM programs. Although varied in size and scope, diverse EM programs place investment capital outside of the “usual suspects” of iconic PE funds and their managers. Although some LP investors have instituted formalized diverse EM programs, others place capital in diverse management teams through less formal means. However, significant capacity for investment remains. Even recognizing the danger of correlated portfolios and the opportunity in diversification, there is a surprisingly limited base of investments in funds managed by diverse GPs, or information about the investment professionals that lead them.

OPPORTUNITY IN DIVERSE EMs:

Returns
A greater breadth in the diversity of PE managers should guard against flocking tendencies, allow the LPs of diverse GPs to establish better returns, and ensure greater diversification in retirement investments.

Public Benefit
Investments in diverse EMs also foster opportunities for wealth creation and job growth.
Why Do We Know So Little about Diverse EMs?

Why? The rationale for the relative paucity of investments in diverse managers is not readily clear, in part because of the previously mentioned “veil of secrecy” that persists in investing. However, four hypotheses explain the limited base of investments in funds of this type, or knowledge about these investments:

a) a general lack of overall understanding of markets and investments that are unfamiliar or novel;
b) a sense that unfamiliar or novel investments are more risky and that, importantly, the returns are not commensurate with the elevated risks;
c) a desire to protect and shield investment knowledge for competitive advantage (among those who do have investments in diverse EMs); and finally,
d) —the elephant in the room—these investments are driven by political or social pressures.

In addition to the reasons for a limited base of investors, investing in diverse managers is a relatively unstudied field. This study attempts to help stem the knowledge gap in investing with diverse managers through two means: first, through surveying a leading national set of diverse managers to learn a generally closely-held secret—the identity and magnitude of their LP investors; second, through interviewing a set of LP investors who have deep experience with diverse managers to learn more about the challenges, opportunities, and best practices for investors interested in this arena of alternative investments.

This report sets out to answer a number of questions: Who are the LP investors to PE funds managed by diverse GPs? Why invest in these funds? What are their experiences? We acknowledge that this study would not be possible without substantial support from the leadership and members of a leading industry association, the NAIC. In our findings, we provide prescriptive recommendations for those interested in investing in diverse managers and notions about the type of investors who may find this arena promising.

This study was designed to spark discussion, conjecture, and interest in investing with diverse managers. As your questions or thoughts develop, reach out and share with your colleagues, and certainly with the study’s authors. We appreciate your attention.
What You’ll Find:
The Structure of the Report

The remainder of this document is structured as follows: the first section provides the results of our survey of the NAIC membership’s LPs, including the chronology, scope, and source of their investor funds. The next section provides the results of our qualitative findings. This second section is structured into three subsections: (1) the reasons that these LPs have invested in diverse EMs, (2) common misperceptions and questions that have been revealed over time, and (3) suggestions for those interested in potentially starting their own diverse EM program, or in increasing their allocation to diverse managers. The final section of the study provides a review of the study’s findings and makes tentative suggestions for the field.

Who invests in diverse EMs?

One of our first steps in the research process involved learning more about the set of investors in diverse EMs. We made an attempt to better understand: (a) the history of investments in this area, (b) the magnitude of investments to diverse GPs over time; (c) the leading investors in diverse managers, and (d) whether there are important trends that have prevailed or declined over time.

The LP survey: Our methods.

To answer our questions about the base of LP investors that have experience investing with diverse managers, one alternative included surveying a large body of LPs, asking questions about the demography of the GPs in which they invested. However, the sheer magnitude of such an undertaking was not economically or logistically possible. As an alternative, we queried a set of diverse managers about their investors. We partnered with a leading industry association of diverse managers, the NAIC. For nearly 50 years, the NAIC has been the leading industry association for diverse, minority, and women managers. The NAIC has collaborated with researchers in the past, including William Bradford, Timothy Bates, and KPMG.

1 / Reasons
The reasons that these LPs have invested in diverse EMs.

2 / Questions
Common misperceptions and questions that have been revealed over time.

3 / Results
Suggestions for those interested in potentially starting their own diverse EM program, or in increasing their allocation to diverse managers.


We surveyed the NAIC membership and examined the identities of investors over a 12-year period, from 2000 to 2012. Our survey focused on the sources of their funds, the timing and frequency of investments, and the magnitude of those investments. This approach provided a database of the population of LP investors in diverse GPs over the study period. Although this study is not an all-inclusive one, a study focused on NAIC members provides the most effective approach to collect information on a group of diverse managers and those who chose to invest with them.

The NAIC provided a database containing the contact details of their members who are responsible for managing relationships with LPs. These managers were queried using a detailed, year-by-year survey of their investors. In addition to individual fund GPs, we surveyed FOFs that tend to invest with diverse managers. We used an identical research methodology for FOFs.

The surveys were fielded using an online survey tool, which requested that individual PE funds respond. Responses from a substantial proportion of the NAIC members provided a relatively complete accounting of the population of LPs investing in diverse managers. To avoid double counting of investors, each group was separately analyzed. In sum, 18 individual PE funds and 7 FOFs responded.

WHAT DID OUR SURVEY REVEAL?

Detailed results of our survey are in the sections below. To begin, we provide the results of our survey of PE funds. After the PE fund results, we provide the findings for FOFs.

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*All member information was kept confidential*
**LP Investments in Diverse PE Funds**

**Aggregate PE Investment Levels**

**KEY POINTS**

The graph below provides an illustration of the aggregate funding levels to NAIC PE funds over recent years. As the graph illustrates, LP investments in diverse PE funds were very high in 2000 (nearly $1.4B), and dropped off precipitously in 2001 during what became known retrospectively as the “technology bubble.” After 2001, they rose steadily, peaking in 2007 (at approximately $1.7B). Concurrent with the recession of 2008, funding levels again fell to a low of $186M (representing a nearly 90% decline since 2007). Funds rose again in 2011, reaching a study-period high of $2.9B.
**LP Investments in Diverse PE Funds**

**Sources of Funds**

**Categories**

**KEY POINTS**

The pie chart below shares the portion of aggregate funding from various categories of funding during the study period (2000–2012). Of the total funding in the period, public pension funds represented over 41% of the total, followed by investment firms (33%), and high-net-worth individuals (21%).
LP Investments in Diverse PE Funds
Sources of Funds

Municipalities

KEY POINTS

The second pie chart shares the portion of aggregate funding from various metropolitan areas. New York (30%) and California (20%) represented half of all funding. These states also tended to have high incidence of PE funds, are demographically diverse, and have long-standing, recognized diverse EM programs. These are followed by Illinois (7%), New Jersey (7%), Connecticut (5%), and Massachusetts (5%). These few states made up nearly three-quarters (74%) of all funding to NAIC PE managers during the study period.
Top Providers of Capital to Diverse PE funds

KEY POINTS

Our data allow us to capture the leading providers of capital to NAIC PE Funds across funds. The table below provides information about the top five providers, and the bar graph below shows the contributions of the top six over time. High-net-worth individuals represented one-fifth of all funds (21%). New York City and New York Common represented 11%, followed by SAC Capital Advisors and Credit Suisse.

<table>
<thead>
<tr>
<th>Limited Partner</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>HNW Individuals, Families, Small Offices</td>
<td>21%</td>
</tr>
<tr>
<td>New York City</td>
<td>6%</td>
</tr>
<tr>
<td>New York Common Retirement Fund</td>
<td>5%</td>
</tr>
<tr>
<td>S. A. C. Capital Advisors&lt;sup&gt;4&lt;/sup&gt;</td>
<td>5%</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>3%</td>
</tr>
</tbody>
</table>

<sup>4</sup>SAC Capital Advisors made an unprecedented investment in 2011.
LP Investments in Diverse FOFs

Aggregate FOF Investing Levels

KEY POINTS

The graph below provides an illustration of the aggregate funding levels to NAIC FOFs that invested with NAIC members over recent years. As this graph illustrates, LP investments in diverse FOFs showed the same peak years of 2007 (at approximately $0.92B) and 2011 ($1.1B). Investments in FOFs didn't show the level of variability found in the investments in PE Funds.
LP Investments in Diverse FOFs
Sources of Funds

Categories

KEY POINTS

The pie chart below provides the portion of aggregate funding from various categories of funding during the study period (2000–2012). In comparison to investments in diverse PE funds, pensions overwhelmingly invested in FOFs. Public pension funds represented 82% of the total, and another 10% from other pension funds. Clearly, pension fund investors are the key source for FOFs that invest with diverse managers.
The pie chart below provides the portion of aggregate FOF investments from various metropolitan areas during the study period. These results show an even greater degree of concentration than the categories (chart above). New York (39%), Connecticut (26%), and California (20%) contribute 84% of capital to FOFs, which in turn provide capital to NAIC PE funds.
Top Providers of Capital to Diverse FOFs

KEY POINTS

As with PE funds, our survey allowed us to provide the leading providers of capital to FOFs that invest with NAIC PE funds. The table below provides information about the top five providers in aggregate over the study period, and the bar graph below shows the contributions of those same providers over time. These five represent more than 50% of all investments to these FOFs.

<table>
<thead>
<tr>
<th>Limited Partner</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut Retirement Plans &amp; Trust Funds</td>
<td>15%</td>
</tr>
<tr>
<td>New York State Common Retirement Fund</td>
<td>15%</td>
</tr>
<tr>
<td>CalPERS</td>
<td>12%</td>
</tr>
<tr>
<td>Florida State Board of Administration</td>
<td>5%</td>
</tr>
<tr>
<td>New York City</td>
<td>5%</td>
</tr>
</tbody>
</table>

The Limited Partner Perspective:
The Opportunity in Diverse Emerging Managers
The survey provides insight into a less studied arena in the field of finance: the pool of investors who provide capital to diverse managers. These results are helpful in acknowledging the substantial support the industry has received from a relatively small base of investors. After conducting the quantitative research, we found it imperative, in order to gain a holistic perspective, to ascertain qualitative information such as why these investors have chosen diverse managers, what they have learned from their experience, and what advice they would give those interested in investing with diverse managers.

Prior to sharing the results of our interviews, we can make a few tentative observations based on the survey responses.

**High concentration among investors.**

LPs who have invested with diverse managers comprise a relatively small, core group of investors. We know from sociological research that tightly knit groups are characterized by loyalty and close-confiding relationships. However, the risks of such a high level of concentration also creates what statisticians call “a small-numbers problem”—the behavior of a relatively small group can skew the results in dramatic ways. This is a likely reason for the wide swings in the aggregate funds coming into these funds over the study period. Such a high level of concentration and concomitant variability puts the sustainability of this set of diverse funds at risk.

**Potential investors.**

The categorical and municipal analyses appeared to reveal a conspicuous absence of investor types. Given the tendency of diverse managers to invest with women and minority entrepreneurs and markets, it is likely that there is a potential zone of mutual interest with a number of investors that, until now, have had a limited presence. For example, corporations that operate in diverse markets and serve diverse consumer markets might find common interests with these funds. Many of these corporations are well aware of the potential of minority-led firms through their established supplier-diversity programs. Further, corporations who typically engage diverse suppliers tend to do so because meaningful portions of the customers come from these diverse groups. Ergo, with increased investment in diverse EMs, they are in the position to create jobs and possibly increase their customer base.
Companies Operating in Diverse Markets

KEY POINTS

In examining industries where minority households outspend majority households, it is worth noting that there are changes from year to year. However, according to The Buying Power of Black America, 2014, categories such as food and apparel have long shown that minority consumers annually outspend majority consumers.8

Foundation endowments that are mission driven to build jobs and employment in diverse markets might find interest in diverse EMs. Many of these foundations have program-related investments (PRIs), which are investments that match the foundations’ charitable aims.

Many states and metropolitan areas, which are rapidly moving toward plurality in their demographic makeup (these states are largely those on the two coasts), could be considered a third group of potential investors. Although states like California, New York, Florida, and Texas have long been recognized as near-pluralities, some of the fastest-growing states for minorities and immigrants are in the mid-Atlantic (Maryland, North Carolina, Pennsylvania, Virginia) and the Midwest (Ohio, Minnesota, Missouri).

<table>
<thead>
<tr>
<th>Category</th>
<th>Companies</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cars/Trucks</td>
<td>Toyota, GM, Ford, Daimler AG</td>
<td>102</td>
</tr>
<tr>
<td>Footwear</td>
<td>Nike, Adidas, Under Armour</td>
<td>668</td>
</tr>
<tr>
<td>Electronic Video Games</td>
<td>Microsoft, Disney, Sony, Nintendo, EA Sports</td>
<td>264</td>
</tr>
<tr>
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<td>Boys/Girls Uniforms</td>
<td>Dennis Uniforms, Dickies, Classroom School Uniforms</td>
<td>2055 (Boys) 975 (Girls)</td>
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</table>

Source: The 100 Plus Index (2014)7

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The Limited Partner Perspective:
The Opportunity in Diverse Emerging Managers

# State Demographics

## KEY POINTS

The chart below highlights states that have population demographics at or shifting to majority minorities. Based on the U.S. Census Bureau’s 2013 population data by state, we define plurality states as those states lacking a single race that represents greater than 50% of the state population.

**Source:** U.S. Census Bureau

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U.S. Demographics

KEY POINTS

States wherein a single race represents more than two-thirds of the state's population make up 39% of the U.S. population. On the other hand, plurality states, and states wherein less than 60% of its population is represented by a single race, make up almost 48% of the U.S. population.

Source: U.S. Census Bureau

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Population Demographics (2013)

KEY POINTS

As noted below, states that have population demographics approaching plurality tend to be along the coasts.

POPULATION DEMOGRAPHICS (2013)

Source: U.S. Census Bureau

What We Learned: Perspectives of Investors in Diverse EMs

QUANTITATIVE AND QUALITATIVE DATA

The quantitative data does not give us the complete picture of the LP perspective. Further understanding the qualitative side helped us to fully comprehend the LP experience and decide if it was a determining factor in an LP’s decision to allocate funds to diverse EMs. Lastly, the quantitative data was inadequate in helping us to understand factors that numbers simply cannot communicate, such as: motives for investing, diversification needs, the appeal of EM strategies, diverse EMs talent, and the sustainability of this PE space.
Why Invest in EMs?

The staffs of PE firms, as with those in many industries, tend toward homogeneity. All things being equal, managers tend to replicate themselves when hiring, and these patterns are illustrated in the demography of firms. Firms founded and led by men tend toward male hires, firms run by women toward female hires, etc. In the PE field, the pattern is evidenced in an overwhelmingly white and male field, especially at the GP level. Unless there is an explicit effort to address this tendency, where can investors create incentives in their GPs to branch out and look at different types of managers who represent diverse backgrounds and perspectives?

1. Diversification

Diversification is often called “the only free lunch in investing.” Typically investors must endure a tradeoff between risk and return, where higher returns are necessarily accompanied by higher risk exposure. But modern portfolio theory (MPT) stipulates that effective diversification allows investors to reduce risk by spreading their bets while still maintaining higher levels of return. Of course, the key to diversification is betting on relatively uncorrelated assets, a challenge in the interrelated web of networks in the PE industry. The biggest PE funds often share similar LPs, investment bankers, talent, and ideas. These PE funds also compete for many of the same buyout opportunities, given the vast assets under the control of these funds. However, diversification at the pension fund or LP level can only be found by looking at the world with a different perspective.

“What was the first rule from business school? Diversification. What makes you think diversification does not apply to investment personnel? You need a diverse set of ideas. You need people that come from different walks of life.” – Solange Brooks, California State Teachers’ Retirement System (CalSTRS)

MPT classifies risk into two types: idiosyncratic risk and systemic risk. Idiosyncratic risk is the risk that comes with owning a single asset that may decline on its own, like a company, a stock, or a fund. This risk is diversifiable. The pension fund managers we surveyed consistently claimed that their diverse EM programs improved diversification because the diverse EMs were less correlated to the general PE universe than the larger funds.

“When building a diverse portfolio of PE funds, you need exposure to all of the areas within PE. This means looking at the smaller companies and funds, not just those focused on the large buyouts.” – Chris Wagner, Los Angeles County Employees Retirement Association (LACERA)
Why Invest in EMs?

During market crashes, like the Great Recession of 2008 and 2009, risk is considered systemic or non-diversifiable, according to MPT. It has become axiomatic to say, "All correlations go to one in times of stress." But even during this period, over almost complete devaluation, some diverse EMs stood out because of different approaches to the market. Solange Brooks of CalSTRS explained that during the Great Recession, "A couple of larger funds lost their entire portfolios in one fell swoop. But the diverse EMs did not have everything overleveraged. Diverse EMs add value the old fashioned way. It takes time. It is not over leveraged. There are some companies that are not going to do well. But it is a different way of looking at the market. They kept their value because it was real value."

Brooks also highlighted the example of a smaller fund in the CalSTRS portfolio, one which is managed by African-American investors. For the first few years, it seemed the managers were overly deliberate in deploying the assets. But when the Great Recession occurred, the managers stuck to their discipline and bought assets at attractive values. Brooks explained, "At first their discipline was so incredibly slow. But with 2008 and 2009, these people captured what they should be investing in and their returns have been terrific. They are head and shoulders above a lot of other funds."

2. Incentives aligned

One of the reasons often given for EMs' performance is structural. That is, the investors running the GP have more "skin in the game" than their larger peers. Ergo, EMs' interests are better aligned with that of their LPs, who are concerned primarily with capital protection and performance. With personal reputation and the majority of their wealth on the line, EMs are often more relentless in their pursuit of market-beating investment strategies. Aligning incentives is so important at LACERA that it is built into their definition of the asset class. LACERA's Chris Wagner said that to be considered an EM, "The GP must own the firm and the economics of the fund. They should not be sponsored by some other large buyout fund or some wealthy businessperson for the purpose of helping that person make money. We want to make sure that the people orchestrating the investments are going to be rewarded like any other GP who owns and runs their own firm."

The LPs we interviewed pointed out that the hypothetical successful senior investors raising their eighth large fund are more likely to become complacent. Grosvenor Capital
Why Invest in EMs?

Management’s (Grosvenor’s) Derek Jones explained: “The numbers somewhat show that as you get into additional funds and more capital, you can make the argument that you can be in the fee game and still do pretty well economically regardless of the performance of the fund because of the fees that get collected and how they get paid out. For these small GPs and EMs, everything is on the line. It has to work. Their reputation and more of their personal net worth is tied to the fund’s performance. So the alignment of interests is stronger.”

Interviewees also suggested that EMs’ smaller size was another advantage—that they were more likely to better manage risk through exhaustive due diligence or less aggressive leverage.

LACERA’s Wagner said, “When you are out there on your own doing it yourself, the last thing you want to do is fail. That alone gets people, I believe, to put in a lot more sweat equity. Not that they are not putting in a lot at these other firms, but when it is your own name and you are the leader, you know that if you fail you will probably not last long in this business. I think that the possibility of failure accounts for a lot in the desire of these people to be successful and make sure they think through their investments and they understand the risks.” The alignment of incentives is no guarantee of performance, of course. It is impossible to even prove causation versus correlation when it comes to EMs’ returns and managers’ motivations. However, the LPs we interviewed gained great comfort knowing that EMs’ incentives were aligned.

3. EMs possess more inefficiencies to exploit

Another reason to invest in EMs relates to the nature and size of the corporate targets such funds are buying. There was a prominent notion that EM programs were better positioned to exploit market inefficiencies and informational asymmetries because of the very nature of their opportunity space. One could definitely arrive at the conclusion that public companies are generally run more efficiently than middle-market companies. The continuity in management is likely to make a difference. This is in stark contrast to middle-market and family businesses, which tend to undergo generational changes.

It is therefore not difficult to comprehend why inefficiencies exist and why operational improvements are more likely in large firms that staff numerous managers who have deep experience. People who previously worked at larger firms are able to engage the middle market using skills that they acquired from working at larger funds, optimizing the enterprise.
Why Invest in EMs?

Some of the biggest gains in PE come not from financial engineering but from the investors adding hands-on managerial help, strategic vision, and operational expertise to its targets. The LPs we interviewed were excited by the outsized impact EMs can have on the companies they own. Grosvenor’s Derek Jones said, “We think in the market [EMs] play, the middle market, the vast majority of companies have operational inefficiencies and the opportunity to move the needle with these companies is far greater.”

While negotiating a lower entry price is more likely for smaller funds approaching less competitive markets, there are additional ways to ultimately monetize an investment in a diverse EM. LACERA’s Chris Wagner said, “If you put money with a small fund, they have a lot more ways to sell that asset. That brings up the ‘greater fool’ theory. You can sell it to another PE fund. You can sell it to a strategic buyer. You can merge it with a couple of companies and then sell it to another company or a strategic buyer. There are just so many more options to create value.” Inefficiencies in the middle markets translate into better entry prices, a greater possibility for diverse EMs to provide a value-add, and a better chance to profit from the investment. Given the structural and operational inefficiencies found in these markets, EMs provide an attractive option.

4. EMs are nimble

The LPs we interviewed also appreciated EMs’ ability to move quickly. Whether in taking advantage of a market dislocation or during opportunistic acquisitions, EMs receive high marks for their decisiveness. Traditional PE funds hunting big game often require more time for due diligence and financing considerations in order to put together complex, multiparty deals. EMs and their targets rely less on leverage and the debt capital markets, which can save time and investment banking fees. Stuart Bernstein of the Teacher Retirement System of Texas (TRS) explained that, “Because these managers are more nimble, they can move faster. They see opportunities that the bigger managers just could not do.”

“If you put money with a small fund, they have a lot more ways to sell that asset. That brings up the ‘greater fool’ theory. You can sell it to another PE fund. You can sell it to a strategic buyer. You can merge it with a couple of companies and then sell it to another company or a strategic buyer. There are just so many more options to create value.”
—Chris Wagner, LACERA
5. Demographics and growth markets

The LPs we interviewed consistently spoke about the demographic shift driving market opportunities. According to a 2014 Pew Research Center study, "Our population is becoming majority nonwhite at the same time a record share is going gray." Immigration and population growth rates are influencing the composition of the United States. More than 40 million immigrants have arrived in the U.S. since 1965, and more than half of them have been Hispanic. The PEW report summarizes, "In 1960, the population of the United States was 85% white; by 2060, it will be only 43% white." Over the same time period, Hispanic and Black Americans will grow to 45% of the 2060 population.

The investors we spoke to are laser focused on this trend. As Solange Brooks of CalSTRS said, "It is a big wave and there is some money in that wave."

To take advantage of the demographic shift, our interviewees believe minority-led EMs are optimally positioned to capitalize not only on promising population trends, but also increases in the income and educational attainment of minority groups. According to CalSTRS’s Solange Brooks:

“We believe you may have an advantage playing the Hispanic market. And you may have a further advantage if you are a Hispanic playing the Hispanic market because the loyalty to brands is different. The purchasing is different. The behavior is different. Managers who understand the behaviors and understand the trends, along with demographic trends, like aging in America, can have an advantage in terms of how they see risk and how they ride trends.”

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DEMOGRAPHIC SHIFT:

Future Shift

The PEW report summarizes, "In 1960, the population of the United States was 85% white; by 2060, it will be only 43% white." Over the same time period, Hispanic and Black Americans will grow to 45% of the 2060 population.

Opportunity

Our interviewees believe minority-led EMs are optimally positioned to capitalize not only on promising population trends, but also increases in the income and educational attainment of minority groups.
Why Invest in EMs?

The pension fund managers we spoke to note that the changing demographics were already reflected in their investors. "When you look underneath these pension plans and the demographics within the pension contributor base, it is largely made up of women and minorities," said Derek Jones of Grosvenor. “Somewhere between 2% and 5% of the demographic gets to manage that pension money. We think there is an opportunity for it to be much bigger than that, based on the talent we see in the marketplace.”

Nowhere has the change in demographics been clearer than in California, where the Latino population surpassed whites this year to become the single largest “race or ethnic group,” according to Governor Jerry Brown’s 2014–2015 budget proposal. CalSTRS’s Solange Brooks said, “Teachers were the first ones to see the changing demographics in California. Not because of their own ethnicity or race or gender—because if you look at California teachers, about 70% of them are white females. But what they saw was the changing demographics in their classrooms, where the diversity was just exploding. And they understand that we have to capture those new ideas that come with a change in demographics because that is good for our system. So if we capture the smaller EMs, we are capturing those new ideas emanating from diverse groups because that is the way the world is going.” As the demographic shift unfolds, EMs may be better positioned to capture an outsized portion of future PE returns.

6. Leveraging underserved markets requires different skill sets

EMs are not only a way to adjust to the demographic shift or approach minority markets; EMs might be the best way. CalSTRS’s Solange Brooks related a mistake she and colleagues made when assessing a traditional fund that was attempting to play in an underserved urban trend, “They were focusing on the inner city or places where there was infrastructure that was not being utilized. So we selected early on a group of terrific investors. They were all seasoned. They all came from great schools. They all had good backgrounds. Good returns in other funds. And these folks went into the inner city, the underserved space, and these folks did absolutely lousy. They were not from the inner city. They did not understand a lot of things that went on. They did not understand the underserved space. They applied their techniques and know-how to an area they were not really knowledgeable about.”
Why Invest in EMs?

Despite some hard lessons, the investors we spoke to sense an opportunity in these demographic shifts, and are determined to invest in managers who understand the minority communities and buying patterns. In a relatively stagnant and uncertain U.S. economy, EMs are a place to find growth. Grosvenor’s Derek Jones explained, “If you are the leadership team at Wal-Mart [stores], if you are any retailer, the only way to grow beyond an anemic growth is to find a way to serve the minority community because that is where the growth is located. And they have to figure it out. We think managers who understand the community, come from the community, and can source deals from the community in the same way that the majority community has done for a number of years in their communities have a leg up.” According to the LPs we surveyed, the EM space is replete with these types of managers.

7. Build future capacity for allocating capital

Although EMs may require extra effort to build and develop, the reward of finding a strong manager is not restricted to the returns in the first fund raised. Investing early builds the necessary rapport to entrust larger sums of capital to the EM. Chris Wagner explained LACERA’s thinking, “If you look at EMs, many of them have very differentiated strategies than the Blackstones, the Carlyles, the GTCRs, and the other large funds that are out there. So we thought we would find managers that conducted strategies or operated in areas that were not in our portfolio and it gave us a chance to find newer managers that we could grow with, and hopefully someday commit more capital to those funds.” —Chris Wagner, LACERA
Misperceptions Blocking the View

Although the LPs we interviewed had overwhelmingly positive things to say about investing with diverse EMs, many investment professionals neglect to enter this area of PE due to misguided perceptions of the aforementioned GPs. Misperceptions about around the LP circles include such thoughts as, “Investing with diverse EMs is just a social agenda”; “The standards on returns must be lowered for diverse EMs”; “Investing with diverse EMs is definitely riskier than investing with large PE funds”; “Making these types of investments may limit career advancement”; and “The resources simply aren’t available to enter the diverse EM space.” We found these claims generally lacked standing when compared to LP interview responses.

1. “It’s just a social program”

EM programs frequently must manage the common stereotype that they are started primarily for political reasons. “The biggest hurdle we still come across, especially with the diverse EM, is a very subtle ‘we are fiduciaries and we are not running a social program,’” said Derek Jones of Grosvenor. “There is some presumption that they are being asked to accept higher risk and sacrifice returns and therefore they are not fulfilling their fiduciary obligations.” Some may ask, “Why choose to invest with a diverse EM when I can place money with a more established, larger-level PE firm?” The implication is that investments are being placed with diverse EMs who aren’t held to the same standard as their general market counterparts. Although perhaps an unstated belief, there isn’t actual evidence to support this hypothesis. Our fieldwork indicates that in practice, diverse and general-market EMs are being compared side by side, using identical criteria. Therefore, the core choice for an investor is where she wants to place her money. It would be a mistake to assume that diverse EMs have a “finger on the scale” or “extra points for showing up.” The reality simply is that some investors are looking at the options and saying, “Why not choose managers who provide additional perspectives?”

The role of politics in the formation of EM programs is not always well defined, which can cause problems. When an outside influence such as a legislator, city council, or regulatory body imposes a directive on a pension fund to invest in EMs; some are bound to think it is just politics. Many write off investments with these groups as being purely political, and we concede that may be a small portion of the reasoning behind some LP investments. However, these LPs are still driven to focus on funds that promise great returns and to uphold their fiduciary duty to do so. Therefore, one could properly conclude that the potential negative responses of political stakeholders is a minor piece of the primarily return driven decision to invest with...
Misperceptions Blocking the View

a diverse EM. LPs are not focused on elections, endorsements, or appeasing groups (or Chief Investment Officers, for that matter) when deciding how to ascertain possible returns and allocate portions of their portfolios.

Even if an LP has board-level or political backing to pursue EM investing, the portfolio managers are not always receptive to external tampering with their investment process. Stuart Bernstein of TRS offers this hypothetical gripe by a portfolio manager pressured to invest in diverse EMs, "These little managers are not fun, they are not exciting, and that's compounded by the fact that they appear political to me. I cannot put my finger on it, but now I have a fear factor because I think this is politically motivated and nonsensical. I do not know how to judge it." Bernstein has heard this complaint from some of his peers. "Unfortunately, this an outrageous way to think, and I encourage CIOs not to staff their EM programs with individuals that operate out of fear and misconception." Still, when pressed about the politics of EMs, every LP we interviewed was careful to highlight their commitment to honoring fiduciary duty above all else.

"The presumption often is that you are sacrificing return for a mission. To the contrary, we only run return-driven programs. So managers, whether they are black, white, or green, all go through the same screen and rigorous process conducted by the same investment committee. It is the same standards." —Derek Jones, Grosvenor

While EM programs have made great strides in terms of acceptance and perception, the belief remains in some quarters that "it's just a social program.

2. Have to lower bar to accept unqualified funds—"Can't find anyone"

Women and minorities have long been passed over for opportunities based on the argument that the employer or organization "can't find anyone" qualified. In PE, where a gold-plated education, buyout experience, and deep relationships are a necessity to raise capital, the "can't find anyone" argument may have held some water in the distant past, but no longer. Grosvenor’s Derek Jones explained, "As far as women and minorities are concerned, there are over 200 firms that we follow, and most people are surprised by that. They would think that there are 30 or 40."

Although the term “emerging managers” suggests that the investors are new or untested, CalSTRS’s Solange Brooks disagrees. Brooks said, “EMs are not new managers. We do not invest in new managers. We invest in experienced managers who are raising their
first fund. The average EM has something like 14 to 15 years in the industry, so they are not newbies.” But are they qualified? Do they have what it takes to perform? “These people did not get to where they got to be because they are not intelligent. They are smart people,” LACERA’s Chris Wagner said. “They will do what they have to do to be successful, and they will typically do a good job. If you look at first-time funds that we have committed to, they have all been pretty successful.”

Although not all firms are created equal, today there are more qualified EM candidates than ever before. The diverse PE labor pool is evolving. Many of the recently founded and historical funds are attracting individuals that have a broader array of experience than previously seen in these funds. In addition to talent, many of the individuals raising funds are coming in with larger networks than previous years as well. The common path of going from investment banking to raising a PE fund has been all but disrupted. It appears that in today’s landscape, someone from the investment bank would have a reduced chance of successfully raising a fund. Grosvenor’s Derek Jones scoffed at the notion that investing in an EM meant lowering the bar in any way, “The managers we are backing are coming from the same schools, and they have traditional PE training. We do not sacrifice; we get the best of the best.”

3. More risky

A common gripe by traditional PE investors is that EMs are more risky. Notwithstanding the possibility of higher returns, does the added risk justify investing? The most common risk mentioned during our survey was whether the diverse EMs could manage the growth of their firms. “Not only do you have the risk of PE and all that goes into investing in new companies, but these managers had to also learn to run a business,” LACERA’s Chris Wagner said. “They probably came from a fund that had a whole back office, which did all kinds of things. Now they were on their own. They had to run a PE firm and not just find deals. They had to actually run a business.” Stuart Bernstein of TRS sees more than just business risk: “I have to make determinations: Has this team of individuals worked together before? Have they seen their investments all the way through to profits? The other thing I have to be sensitive to is, can they raise dollars and have a relevant final close? Do we want to be with a group that can only raise a third of what they should and will that be a diversified portfolio? I’m not worried if Blackstone can raise a fund when I am looking at them. I know they will. You have to dive deeper when executing due diligence on EMs.”

Greater risk is also inherent in the smaller companies in which the
diverse EMs tend to invest. “The risk is that one thing goes wrong with a small company and that company could be toast,” said LACERA’s Chris Wagner. “Something happens with their accounting function or they blow out their IT and that company misses revenue targets. They could lose their place in that industry. So there is risk there. If you pick the right managers at the smaller end of the spectrum, whether emerging or not, you will find that you are going to see greater value returned to you as an investor.” In order to mitigate risks, the investors we spoke to mentioned extensive due diligence. Chris Wagner said EMs “are high risk, but I think through the diligence process you can lower the risk and get more comfortable that they are not going to lose our money.” He continued that you have to understand “how they attract deal flow. How are they looked upon in the community? Are they respected? Will people call them? Have they done the right things for their companies?”

There was not universal agreement that EMs represent more risk. Among some LPs, there is a belief that the risk involved in EMs is different, not greater in magnitude. The distinction is an important one, since our understanding from psychological research is that individuals tend to evaluate concepts that are unfamiliar or novel as exotic or even dangerous. If this is the case, the key task is to determine how to proceed in new arenas and determine whether to make an investment. Building idiosyncratic value can be a very good thing at different points within the overall market’s cycle.

4. Career risk/reward

Portfolio managers are experts in calculating risk and expected return, not only on investment choices, but related to their own career as well. Our LP interviewees speculated that many traditional PE investors were hesitant to invest in EMs because of their own personal risk/reward calculations.

“This is what normally happens to a staffer in my position. You get a call from a fund like ‘a Blackstone’ and they say, ‘Look, you are in our fund eight, it is top quartile. We are now raising fund nine. It is the same team, same strategy. Would you like to invest?’ The person in my seat says, ‘Well yeah, I guess so. Why not?’ The consulting universe is glad to sign off on ‘a Blackstone’ because they are doing it for their other clients too. They have the materials already written. If something were to go wrong, there is a herd mentality scenario because everybody in the planet is invested in Blackstone, so no one is to blame if something happens.” —Stuart Bernstein, TRS.
Misperceptions Blocking the View

One way of looking at what can be called “the herd-mentality scenario” is that this type of behavior among LPs is a significant impediment that is holding back the growth of EM programs in the pension universe. Our guess is that in the absence of an explicit EM program, investment managers simply are not instructed to look for EMs. Conversely, there are incentives to “follow the leader.” We doubt many managers have been fired for hiring big, powerful PE firm X, even after poor performance. If the investment in large firm X underperforms, a substantial portion of the industry will likely show similar results. Put differently, “So you made a bad choice, but it is a bad choice everyone is going to make with you.” For most investment managers, this would be a much safer professional place to be than to be the person making the bets on newer managers of whom the large community has probably not heard. PE investors, like pension funds, have always appreciated company in their investments, which can offer confidence in their investment thesis, and a second set of eyes. But taken to an extreme, “club” investing can be lulled into groupthink, resulting in below-average returns and heightened risk.

Stuart Bernstein of TRS also believes the glamour factor inherent in the biggest leveraged buyout (LBO) funds appeals to some investors in his seat. He explains the dilemma in the hypothetical example where “I, the head of PE, love doing the big Blackstone deals. These deals are really exciting. These individuals go to the annual meeting. They see all of the different people. They are doing the deal that goes on the front page of the Wall Street Journal and they can tell their family that they have just invested in Sea World or whatever it is. There is a massive novelty factor—they get to meet Steve Schwarzman at the annual meeting. However, I would rather be around entrepreneurs in the early stages of their business and watch them grow.”

But can something so seemingly trivial really be holding back investment in EMs? Perhaps. Or maybe it is the very public nature of decisions made by the portfolio manager of a large pension fund that tends to drive investment into the bigger, brand-name funds. “One of the risks we look at is—we do not want to be in headlines, so we always have to be careful that, if we commit money to any manager, they are not going to embarrass the county or the investors in some way or somehow,” said LACERA’s Chris Wagner.

HOW THE HERD MENTALITY HOLDS BACK GROWTH OF EM PROGRAMS:

Incentives of the Herd Mentality
“So you made a bad choice, but it is a bad choice everyone is going to make with you.” For most investment managers, this would be a much safer professional place to be than to be the person making the bets on newer managers of whom the large community has probably not heard.

Novelty Factor
Stuart Bernstein of TRS also believes the glamour factor inherent in the biggest leveraged buyout (LBO) funds appeals to some investors in his seat.

Public Perception
“One of the risks we look at is—we do not want to be in headlines, so we always have to be careful that, if we commit money to any manager, they are not going to embarrass the county or the investors in some way or somehow.”—Chris Wagner, LACERA.

17A colloquial term indicating a desire of some investors to have an explanation for negative performance that does not result in the blame for that performance resting on the decisions of the investment manager.
Misperceptions Blocking the View

5. Takes too much effort/understaffed

Perhaps the biggest obstacle to EM investing is that it is just too much additional effort for the LPs. “The biggest complaint you will hear from any large LP is limited staff. They will say, ‘We do not have enough staff to do this or that,’” said Stuart Bernstein of TRS. Understaffing is a refrain we heard consistently from our LP interviewees. This assertion makes sense when we consider the following scenario. An LP could do the same due diligence that they would perform on a deal and write a $25-million check to an diverse EM or a $500-million check to a large PE manager. It is also important to consider that lots of LPs are understaffed and very much under resourced, and the same effort has to be done on each deal. Ergo, looking at the aforementioned example, a manager can write one $500-million check or 20 $25-million checks. Additionally, there is the cushion of comfort that if the investment doesn’t go well, the manager or investment officer can say that “its Large Fund X that lost everyone’s money, and everyone shrugs”. LACERA’s Chris Wagner argued that the due diligence is easier on a smaller firm, but still ended up defaulting to hiring an FOF to manage the process. “We just did not have the manpower to look at all the managers that were out there trying to raise money,” said Wagner.

But aren’t fund managers paid extremely well to actually do the work? CalSTRS’s Solange Brooks thinks so. “You are not fulfilling your responsibilities by only going to the same well all the time. Alpha is going to come from various people with various outlooks in various industries. Fund managers have to go ahead and do the work. Is it more work? It is a different kind of work,” said Brooks.

Still, the perception that EM investing takes too much effort persists. We conclude that as long as understaffed and under resourced pensions continue to be the norm, efforts to engage with diverse EMs will continue to be inconsistent.
Five Things You Absolutely Need to Do if You are Considering an Investment Program in EMs

1. Ask questions

It sounds simple enough as a starting point, but the EM fund managers we spoke to consistently urged others interested in the space to begin by raising their hand to ask a few questions. Grosvenor’s Derek Jones said that regardless of whether one wanted to launch an internal program or hire a fund-of-funds, “I would start with talking to those who have made a business out of it and they can share with them results, dos and our don’ts, learning experiences and encouragement to interact and meet with some of the managers so they can get a feel for the talent, experiences, and strategies that we are seeing.”

One of the best ways to diligence the EM opportunity is to visit an industry event. “Attend some of the conferences, get a feeling for some of the discussions, pros and negatives, who is in the space, other LPs, and what their experience has been,” said Derek Jones of Grosvenor. “It’s similar to retail: you have to go out and see the merchandise.” If after a visit to a conference and meetings with some managers you are still not convinced, perhaps you should meet with LACERA’s Chris Wagner. His pitch would be simple, “The easiest thing to do would be to point to the successes.” Nothing sells like success, and the LPs we interviewed have had plenty.

2. Clarify the mission

Any corporate goal should start with a clear mission, but it is particularly important when launching an EM strategy. If the mission is unclear, the goals of elected regulators might clash with those of the investing organization, causing chaos and frustration. Stuart Bernstein of TRS explained, “Boards and elected officials (legislators or city council, whatever it is) that set up these programs or that come up with some sort of legislation or policy that forces the investment staff to have it give no thoughtfulness or construct to how it should happen. They just say ‘CIO A, we are going to require you to start doing EMs or minority- and women-only firms.’” If the EM program is externally force-fed with limited internal buy-in, problems soon follow. In such a case, a CIO (or staffer delegated to the issue) is forced to invest in an EM asset class, “(1) they probably did not want to do, (2) they do not know that much about, and (3) they say ‘I have a limited staff and this is a burden. This is not productive.’” according to Bernstein of TRS.

When elected officials are involved, communication is mission one. Problems can arise when legislation is thoughtlessly handed down,
requiring a pension fund to invest in EMs without further mission clarity. Stuart Bernstein of TRS explained, “They are not at all forced or encouraged to have a formal program... What happens is you have a manager in PE... who calls the head of PE. The head of PE does not even want to deal with it because for starters the CIO did not even want to deal with it so there is no enthusiasm internally as an organization.” A formal program is needed both to assert internal enthusiasm as well as to promote clear communication. Bernstein thinks most problems stem from the construct of the legislation. They often foster a miscommunication that means, “Everybody is frustrated, things are getting worse, and it is all because the elected official or board members did not clearly define the program, set up its parameters, and make sure it is a program of access.” EM programs need a strong point person or a well-defined mission, which should include clear access for the EMs to gain feedback along with a cohesive and transparent communication structure with elected officials.

3. **Educate everyone within the organization**

Even with a clear mission, internal resistance can still hamstring EM programs if not enough people in the organization believe in the benefits of investing in EMs. The answer, according to many LPs, is for the internal EM advocate to educate board members, investment managers, and even junior staffers on the merits of an EM program. If not, you might run into the problem Stuart Bernstein of TRS explained in the voice of a hypothetical CIO, “Maybe there are 100 firms on the planet we have the capacity to examine. When we make the decision to examine EMs, there are 500 or so. I do not have a big enough staff to deal with the 100, much less a brand-new 500 in a smaller subset of the marketplace that I do not know but have to learn. So I just do not want to deal with this. So I am going to ask the junior person on the team, the analyst or the associate or something, to go ahead and take this on. So now, I have the most junior person on my staff dealing with the most sensitive and potentially the most public thing that we do. There are PE managers that cannot get a returned e-mail or phone call. When they finally get a meeting, it is with Johnny or Suzie junior person. So they are not asking the best questions. They are not doing the most thorough analysis because they are the junior person. They are
also kind of hesitant because they sense there is something political going on or something to be leery of.” Without proper organizational buy-in, the results of an EM program can be frustrating at best or disastrous at worst.

Of course, not all LP management structures are the same. An EM program advocate at a pension fund might be slowed by their firm’s strategic mandate to invest in assets determined by an investment committee made up of board members. “Maybe the direction they get from their board is different than we get,” said CalSTRS’s Solange Brooks. “We get a very general direction and our CIO has latitude for setting the direction. If you do not have that, then I would say start educating your board members.” Of course, not every investment firm lacks wisdom or vision in the same places. “Education is the key,” Brooks continued. “I think that board members have to be educated, but perhaps the CIO has to be educated.”

One thing is clear. Institutional buy-in is key to ensuring that the EM program extends past the term of the leader who first suggested EM investing. If the EM asset class is new to your organization, prepare to evangelize the benefits to members throughout the firm. Only then can real institutional buy-in occur, which will outlive the EM advocate’s term and bring the sustained benefits inherent in EM investing.

## 4. Consider hiring an FOF

LPs we spoke to believe that pension fund managers interested in EMs should consider investing first in an FOF, despite the added layer of fees. “You should probably hire a fund of funds, and pay the premium, to have an organization that will take the phone calls, have a process, give clarity to the process,” said Stuart Bernstein of TRS. “By hiring them, you should have a defined dollar amount or a range of dollars on an annual basis to employ. At the least, you will have an organization representing you because you are not set up to do it yourself. Perhaps you may alleviate the paranoia created by all of the political stuff and you can outsource that fear to a third party.”

—Stuart Bernstein, TRS

### Diversification

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—Solange Brooks, CalSTRS

## HIRING AN FOF:

### Benefits

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Engaging an FOF also allows a pension fund to make a smaller initial commitment while still enjoying the benefits of diversification. CalSTRS’s Solange Brooks advised new EM investors to, “Select an FOF that is forward thinking, that is aware of the EM space, and have them do a couple of investments in this space to see how your portfolio performs. What you are doing is rounding out your portfolio.” You can also piggyback off of the FOF’s work in the event that an investment stands out. Brooks explained that, “Every quarter [the FOF] comes to me and says, ‘we looked at this many funds, we invested in these few funds, out of those funds that we invested in, we think that fund X is institutional quality and they are ready to be your partner.’ Then we conduct an independent due diligence to determine if we want to start our process... At the end of that process, we might decide to invest in them side by side.” In this way, FOFs may be used to gain diversification, learn the EM market, and screen for PE funds that might be worthy of a bigger LP bet.

5. Be patient

Both the LPs and the governmental body that legislated the program need to have patience when it comes to diverse EM investing. Why? Finding the right managers is not easy. “It is not as simple as saying, ‘Okay, we want to have women and minorities as our partners, so we want to go with fund X because they have three African-Americans, two Latinos, and an Asian woman. It is not like that at all,” said CalSTRS’s Solange Brooks. “EM investing takes work, real work, and resources too. But perhaps most importantly, it takes time.” Brooks continued, “The problem is that most investors not in PE want immediate results. You have to be patient in PE. However, patience and governmental agencies do not seem to coexist.”

GPs need patience too, naturally. If you are trying to raise your first fund, keep your expectations in check. Raising a fund is a process. As LACERA’s Chris Wagner said, “It may be ‘no’ now, but be patient... It is vitally important that you have successes that you can point to that will give people comfort [needed] to invest in your fund.” With the proper approach to EM investing and the patience to see it through, the results can be extraordinary. As CalSTRS’s Solange Brooks put it, “It’s a very good space for institutional investors. It’s long term, it’s great results.”

“EM investing takes work, real work, and resources too. But perhaps most importantly, it takes time. The problem is that most investors not in PE want immediate results. You have to be patient in PE. However, patience and governmental agencies do not seem to coexist.”
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