
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

- 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?

- 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)

- 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)

- 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

- 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.

- 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

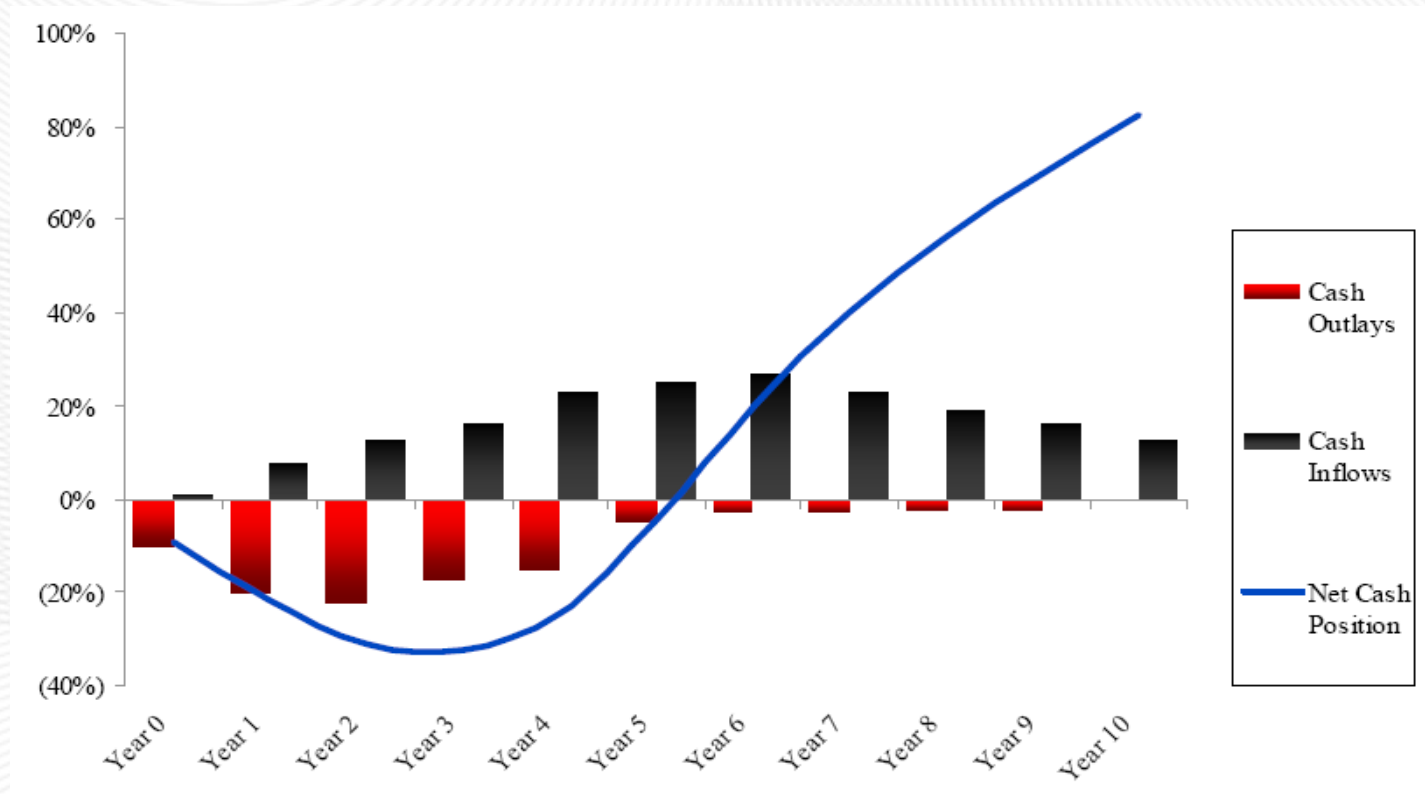
Suggestion: separate vehicles more

- 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?

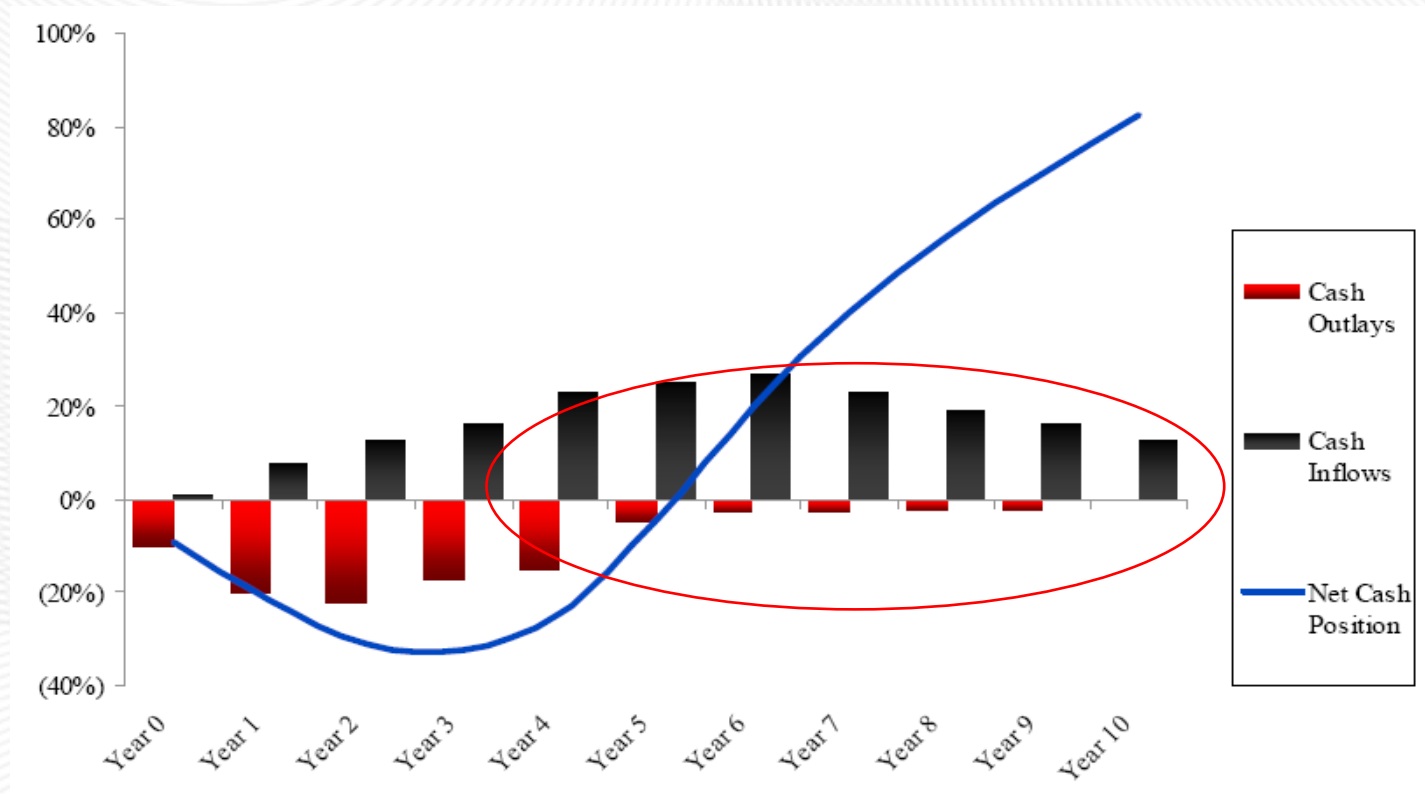
- Fee differences?
- Different market timing?
- Selection ability?
- Can do better in distinguishing these when account for differences in types of vehicles

Performance benchmarking



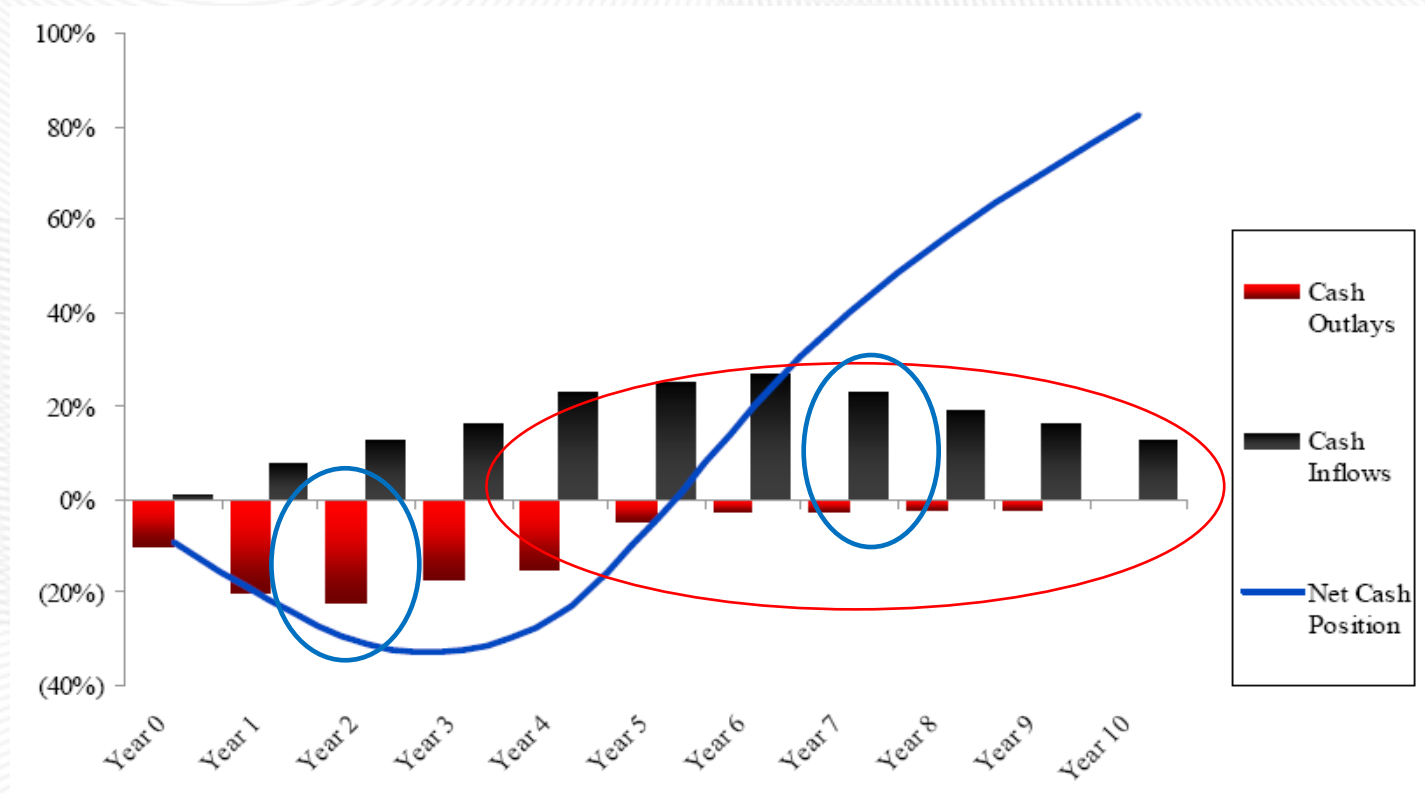
Main fund

Performance benchmarking



Main fund
Secondary

Performance benchmarking



Main fund

Secondary

Co-investment

- 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

- 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

- 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