BARINGS VIEWPOINTS | January 2019

DON'T JUDGE A PRIVATE EQUITY FUND BY ITS NUMBER

ASSUMPTION vs REALITY

AT BARINGS, WE BELIEVE THAT IDENTIFYING HIGH-QUALITY PRIVATE EQUITY MANAGERS EARLY IN THEIR FIRM LIFECYCLE CAN DELIVER ATTRACTIVE RISK-ADJUSTED RETURNS.

As private markets mature, new firms continue to enter the private equity asset class. The fundraising landscape has grown increasingly competitive, with more general partners (GPs) in the market and more funds seeing record amounts of capital.[1] Emerging managers (broadly defined as GPs raising institutional funds I, II or III) are facing challenges as limited partners (LPs) decrease the number of GP relationships and commit larger amounts to fewer funds. Emerging managers also face the need to differentiate themselves from their peers as the market continues to grow.

Notwithstanding the ever-present fundraising challenges, data shows ***emerging managers typically deliver better returns to investors***, with first-time funds having delivered higher median net IRRs than non-first-time funds across 10 of the 15 vintage years since 2000 ***and*** one-third of first-time funds having achieved top-quartile performance (all vintage years combined).

Despite this, emerging managers are often avoided or overlooked by investors.

1. 2017 saw 2,296 funds in the market raising $744 billion. Source: February 2018 Private Equity and Venture Capital Spotlight.

Challenging common assumptions

Almost half of all investors have chosen not to invest in first-time funds, many also avoiding Funds II or III, due to some common misconceptions around emerging managers, including the belief that all such managers are unproven investors with no track record, far too risky and vastly under-resourced.

ASSUMPTION: *Larger funds are positioned to generate higher returns.*

REALITY: As PE funds in general grow larger and more established, the likelihood of a "home run" or a "strikeout" that makes or breaks the overall performance of the fund decreases. Performance tends to gravitate toward the mean versus the upper or even the bottom quartile.

Investors who assume that investing in the biggest funds will deliver the best returns may well be disappointed. In actuality, the performance of those funds is more likely to be middling or mediocre, often landing in the 2nd or 3rd quartile.[2]

This sobering truth has been exacerbated by a trend of steadily declining median PE returns over the past 15–20 years.[3] Competition in the space has intensified and as a consequence, on an absolute basis, a 2nd- or 3rd-quartile performance ranking is meaningfully lower today than it was a decade ago and may fall short of meeting many investors' return objectives. That is precisely why it is more necessary than ever for investors to pursue 1st- or at least 2nd-quartile performance potential.

"Investors who assume that investing in the biggest funds will deliver the best returns may well be disappointed."

ASSUMPTION: *An established brand name manager is typically a safer pair of hands.*

REALITY: Performance for more mature fund managers has been trending toward the median. As managers mature and as subsequent larger funds are raised, fund performance has historically declined relative to previous performance.[4] For the largest and most mature funds (Funds IV-XIII), performance often declines over time, resulting in the relative performance of these funds increasingly falling into the middle quartiles. This trend is often due to a shift in focus by the GP. Previously focused on fewer companies, spending 100% of their time on that portfolio, the GP now has multiple funds in various stages of the lifecycle (fundraising, investing, portfolio management and exiting) that demand their focus. With partners moving up and teams moving on, the original track record associated with a brand name is often no longer attributed to the remaining management executives.

We believe investors' widespread avoidance of emerging managers is a missed opportunity. Many such managers have identified and invested in smaller businesses that are often overlooked by the mainstream market. They have been able to drive attractive operational results utilizing differentiated strategies that could only be executed by small, dynamic and nimble teams.

In our view, emerging managers are typically hungry for success. As a group, we believe they tend to be more entrepreneurial and motivated than their more established counterparts, often seeking to create something new and innovative with the potential to generate higher returns for investors.

2. Source: 2018 Preqin Global Private Equity and Venture Capital Report.
3. PitchBook 2017 PE & VC Fundraising Report. As of August 1, 2017.
4. PitchBook 2017 PE & VC Fundraising Report. As of August 1, 2017.

> *"Where investors have been quick to invest, Barings has maintained a highly disciplined investment approach."*

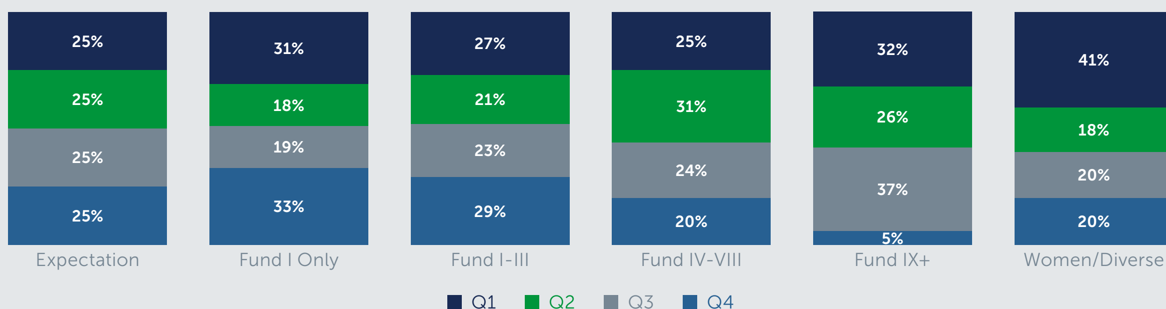
WHAT ABOUT DIVERSE MANAGERS?

ASSUMPTION: *Investing in diverse managers compromises returns.*

REALITY: Embedded in many investor assumptions is a belief that there is a performance cost to investing in emerging or diverse managers. Within the emerging manager universe, there is a subset of diverse or women-led firms that have been demonstrating even stronger return potential.

According to research led by Harvard Business School, only 1.9% of private equity firms are women-owned, and they manage approximately 1.5% of total industry assets.[5] Minority-owned firms represent 3.7% of all private equity firms and manage 3.4% of industry assets. However, our research shows 37.5% of women-owned funds and 41% of minority-owned funds are top-quartile performers.[6] While those statistics would almost certainly be considered impressive by most investors, we also want to highlight the extremely small sample size of women and diverse managers within our total data set. Only 8 women-owned funds and 37 minority-owned funds highlight the extremely low penetration of these groups within the partner ranks and highlights a glaring gap in the market. That said, we believe that by overlooking diverse managers, investors may well be foregoing an opportunity to achieve outsized returns (FIGURE 1).

FIGURE 1: QUARTILE PERFORMANCE DISTRIBUTION BY FUND CATEGORY (BUYOUTS, FUND VINTAGE YEARS 2004–2014, UNITED STATES & CANADA)*



*SOURCE: *PITCHBOOK 2017 PE & VC FUNDRAISING REPORT. AS OF AUGUST 1, 2017.*

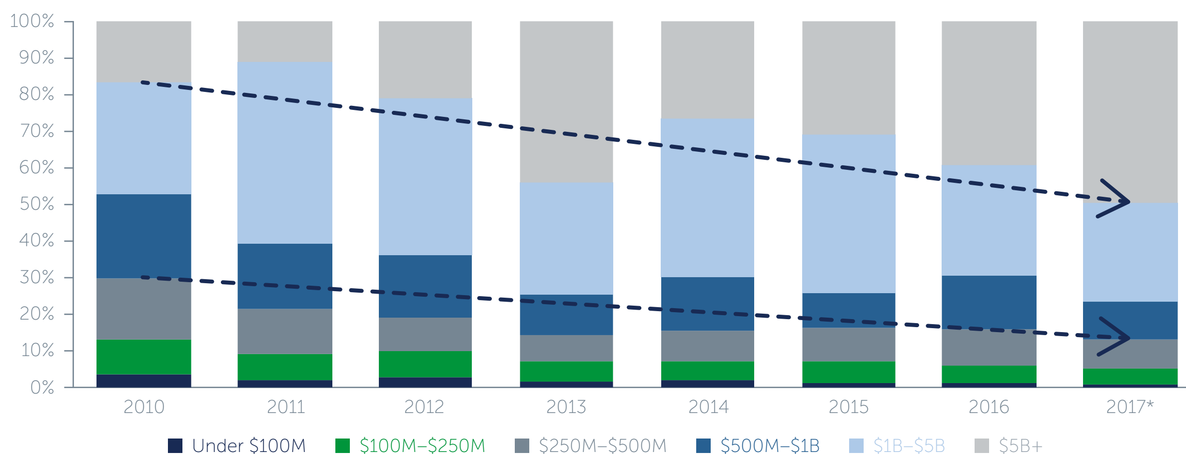
5. Source: https://bellaprivatemarkets.com/diversity-report.pdf.
6. Source: Pitchbook. Includes mature vintages (2004–2014) across North America Buyouts where performance information is available. Quartiles determined based on reported Internal Rate of Return (IRR). Women or diverse managers defined as having at least 33% woman or diverse partners. Total sample size includes 602 funds.

ASSUMPTION: *The PE markets are flush with cash and overheated.*[7]

REALITY: In absolute terms, capital flows into private equity have increased substantially in recent years. However, as LPs reduce the number of relationships and with dry powder at a record high, large/mega funds tend to garner higher allocations of the capital committed, while lower-market funds[8] tend to receive smaller allocations. Private equity funds with assets of $1 billion or more accounted for approximately 75% of all capital committed to private equity in 2017 (FIGURE 2).

Although these large funds have dominated the market in terms of sheer dollars raised, the market is highly saturated and competitive. Lower-market funds represented approximately 15% of capital commitments raised in 2017. Astute investors recognize the need to access lower-market funds and are well positioned to identify promising fund managers with the potential to generate strong performance in the future. Investors would also be wise to dig into the investment strategy of their larger, more mature and lower-middle market managers. As fund sizes increase, it may be time for investors to consider a smaller, emerging lower-middle market manager.

FIGURE 2: PRIVATE EQUITY FUNDRAISING BY FUND SIZE (JANUARY 2010–AUGUST 2017*)



*SOURCE: *PITCHBOOK 2017 PE & VC FUNDRAISING REPORT. AS OF AUGUST 1, 2017.*

The Barings Advantage

With increasing numbers of emerging managers entering the market, an investor is faced with the challenge of being able to track and select which managers to partner with.

With over 25 years of experience investing in emerging managers, Barings has a successful track record of selecting the top-performing managers. Through our deep network and proprietary market knowledge, we have the ability to:

- Be the first call for new teams coming together
- Confirm and evaluate a manager's performance track record
- Validate the market opportunity and strategy
- Accurately assess the nuances of team dynamics
- Evaluate operational capabilities
- Act as a preferred partner, sharing value-add capabilities and best practice knowledge

Where investors have been quick to invest, Barings has maintained a highly disciplined investment approach. We only select the managers that we believe have taken steps to help mitigate many of the common risks associated with emerging managers. Barings believes that by fostering and investing in emerging managers, attractive returns can be achieved over time.

7. PitchBook 2017 PE & VC Fundraising Report. As of August 1, 2017.
8. Barings defines the lower-middle market as companies with an enterprise value of between $100 million and $250 million.

BARINGS ALTERNATIVE INVESTMENTS

EMERGING MANAGER CAPABILITIES*

28-YEAR	330+	300+
TRACK RECORD *of investing in* EMERGING MANAGERS	EMERGING MANAGER COMMITMENTS	EMERGING MANAGERS IN CURRENT PIPELINE

Information as of December 2018

Mina Pacheco Nazemi

Managing Director

Mina Pacheco Nazemi is a member of Barings Alternative Investments, a global real estate, private equity and real assets platform. Mina is part of the Funds & Co-Investments team and is responsible for overseeing all co-investments. She is also responsible for originating, underwriting and monitoring primary fund, co-investment, and secondary fund opportunities for private equity and real assets. Mina has worked in the industry since 1998 with experience as a General Partner and Limited Partner investor in private equity and focused on underwriting direct/co-investment opportunities. Prior to joining the firm in 2017, Mina held several leadership and investment positions including Co-Founder and Partner at Aldea Capital Partners and Partner and Investment Committee Member at GCM Grosvenor Customized Fund Investment Group (formerly Credit Suisse CFIG). Mina holds a Bachelor of Arts with honors in Economics and Political Science from Stanford University and her Master of Business Administration from Harvard Business School. She is an alumna of Sponsors for Education Opportunity (SEO) and Robert Toigo Foundation. She also is a board member of the Pan American Development Fund and on the alumni board of Harvard Business School.

Richard Spencer, CFA

Head of Funds & Co-Investments

Richard Spencer is a member of Barings Alternative Investments, a global real estate, private equity and real assets platform. Rick is the Head of the Funds & Co-Investments platform and a member of the leadership team. Rick has worked in the industry since 1986 and his experience has encompassed a number of positions at the firm including Head of Fixed Income Restructuring Practice, Co-Head of Private Placements and Co-Head of Mezzanine and Private Equity. He served as Vice President of Babson Capital Corporate Investors and Babson Capital Participation Investors, two public closed-end funds, and from 2000–2016, Rick served as a voting member on the investment committee for a group of absolute return funds co-managed with Tennenbaum Capital Partners. Richard holds a B.A. in Economics and History from Bucknell University, an M.B.A. from the State University of New York at Buffalo and is a member of the CFA Institute.

Barings is a $303+ billion global financial services firm dedicated to meeting the evolving investment and capital needs of our clients and customers. Through active asset management and direct origination, we provide innovative solutions and access to differentiated opportunities across public and private capital markets. A subsidiary of MassMutual, Barings maintains a strong global presence with business and investment professionals located across North America, Europe and Asia Pacific.*

IMPORTANT INFORMATION

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

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Barings Real Estate Advisers Europe Finance LLP, BREAE AIFM LLP, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate").

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

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

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

Copyright in this document is owned by Barings. Information in this document may be used for your own personal use, but may not be altered, reproduced or distributed without Barings' consent.

LEARN MORE AT BARINGS.COM

**As of December 31, 2018*

For investment professionals only

18-683943