Breaking a Culture of Echo Chamber Investing

In my almost 20 years of private assets investing, the thing that has caused me the most disconcertion in the industry is the conspicuous, but intellectually masked, lack of individuality when choosing where to invest. The dearth of independent thought is the openly hidden backbone of the investment world. This groupthink frame of mind is understandably born from the way incentive systems are structured, the fear of being wrong and alone, the knowledge that critical mass can create safety, and confirmation bias masquerading as due diligence thoroughness.

This is not a holier than thou attack on investment institutions and/or professionals, but rather a critical look at how almost all industry participants, the majority of whom vehemently proclaim intellectual rigor, seem to perennially end up in/with the same ideas, names, strategies, and approaches. Of course there are subsectors such as credit, fund of funds, mega-cap funds and secondaries within private assets that are less susceptible to the pitfalls of crowding, but most of the rest are prime participants.

A logical response to the herd mentality allegation within private assets is to point to performance and argue that if everyone is doing the same thing, why isn't everyone getting the same results? In other words, benchmarks and investors' varying positions within quartiles are shown as proof of differentiation. The answer lies simply in one of the core ways in which funds and advisors try to lure investors in – "the large gap between top and bottom quartile performance (i.e. dispersion)". In McKinsey and Company's March 2023, Private Market's Review, private equity (buyout, venture and growth), private debt, real estate, natural resources and infrastructure showed dispersions of 18.4%, 5.6%, 11.4%, 13.9% and 10.3% respectively. These relatively large performance gaps in asset classes where most managers preach uniqueness are worthy of further exploration - I argue that the gaps are part of a chain reaction that starts with the type of research and due diligence conducted on managers, and then dominoes into the eventual performance of these funds. Meaning, if LPs are asking the same questions, running the same analyses, speaking to each other, and then coming to the same conclusions, clustering in the same names should be an expected outcome. This clustering consequently leads to the ordained managers raising larger funds, typically becoming more diversified in holdings, getting richer quicker (from management fees and not necessarily carried interest), creating distractive brother/sister products, etc. – all classic ingredients for average or under performance.

I would like to quickly play out a scenario of how investment decisions are made in most organizations. Specific processes may differ here and there, but the gist is always something like this:

- An investment idea comes in through a network, market mapping, placement agent, re-up opportunity, etc.
- The people in charge of due diligence have to get a sense of investment viability so they turn to their network, historical familiarity, pattern recognition, etc. All this while, the household investment mantra stating that "past performance is no guarantee of future results" annoyingly lurks in the background of their psyches.
- However, the lion's share of information being reviewed occurred in the past. But credence has to be given to the past because the future has not happened yet, and the present is too ambiguous.

- Additionally, most information available in data-rooms, regardless of how vast, is somewhat curated. Even if due diligence information provided is relatively transparent, rest assured that bad news is buried deeply alongside a plethora of good news and carefully crafted excuses backed by economic and market data.
- It should be abundantly clear that no matter the will of the research analyst, information available during due diligence is persistently asymmetric.
- But the analyst is determined to show thoroughness, so all the right qualitative questions are asked, all the quantitative assessment/modeling is executed, and multiple scenarios are weighed. Also, the process takes a decent amount of time, which is corporate parlance means "a deep dive is occurring".
- The analyst is getting close to what he/she believes is a high confidence "YES" decision level. But let's not forget about the psychology haunting the decision - How against the grain (organizationally) is this decision? What is the cost (reputation, compensation, career, etc.) of getting it wrong? How quickly will he/she be proven right/smart and rewarded? How long will it take to be proven wrong? Does this investment align with the current economic trajectory, meaning does this decision gel well with the headlines of what is the next big thing (past and present good alignment categories would be SaaS, cost curtailment in healthcare, energy transition, AI, Gen Z spending habits, etc.)? Who else is investing?
- FYI, the last question above is a doozy.
- It is time to do reference calls and speak to past (and potential future) investors, portfolio companies, service providers, etc. Reference calls are useful, but I am yet to come across stern unambiguous rules (other than allegations of fraud) governing how reference calls' results are utilized.
- Of course some off-list references are thrown in for good and "thorough" measure, and of course you will sometimes hear some negative feedback from on-list references, but "confirmation bias" stands as a stronger, more formidable opponent than all of the other things. This is because the decision has tilted positive based on some other stronger forces.
- Past performance, organizational acceptance, and validation from respected peers, tends to outweigh any attempts of true individual thought.
- The idea is eventually presented to an investment committee of some sort. Most of the time, this idea has been pre-socialized or somehow telegraphed to IC members, and these individuals have likely reached out to their own personal echo chambers for validation, so the final decision to invest is usually preordained.
- Sometimes, there are skirmishes of hard questions at the IC meetings. Sometimes, analysts are sent back to review certain points or clarify a few things. However, the overarching conclusion usually bends towards what most other investors have already concluded on.

The above scenario gives a sense of why it is so difficult to make fully independent decisions. The industry, like the broader world, likes to label things. Labeling provides a sense of comfort. There are labels such as "emerging manager", "unrealized returns", "unseasoned", "structured", etc. that all have logical meanings, but are also subliminally meant to exculpate, assure and/or protect risk takers from the full brunt of what time will reveal.

Another reason why echo chamber investing in the private assets industry has not been overly detrimental is that median returns have historically been acceptable and have tended to outperform public markets. So, if you can stay within the pack, not make any waves, keep your job, and still outperform public markets, then you are golden with median or subpar returns. However, the point I want to accentuate is that if you are investing in something that is termed ”non-traditional”, is “illiquid”, and claims to be “active”, why settle for middling returns?

Although, psychology will always play some part in manager selection, I have found that the best way to avoid “group think” and “confirmation bias” is to try your darndest to tilt due diligence to the future. Easier said than done, I know. But when questions, assessments, and analyses tilt more heavily to the future, the work trajectory and general mindset changes. There are several methods that have been effective for me when looking forward rather than backwards – assessing alignment, hunger, incentive sharing, pipeline of potential exits, etc. are some of the most effective.

There is no denying that the past (mistakes, lessons, successes, etc.) affects future actions, but overweighting the past can lead to myopic conclusions, because with managers that pass one’s due diligence hurdle, we consciously or subconsciously tend to equate their past with positivity (describing it with words such as “seasoned”, “cycle tested”, “experienced”, “tenured”, “lessons learned”, etc.). The goal is to be one’s own devil’s advocate in an exercise that is fraught with psychological and organizational conflicts of interest. The lengthy nature of private assets funds throws many wrenches into decision making. This is because answers to questions are always in flux since - the investment periods are about five years on average, it takes time for value to be created, current valuations tend to be tenuous at best, many datapoints are subjective, etc. All these aspects make it difficult to apply traditional asset class decision making criteria. However, an honest reality-based approach to how you as an analyst came to a conclusion will always reign supreme over a self-protective aggregation of crowd approved validation.

Self-doubt during due diligence is something even the most experienced of investors cannot escape. However, harnessing some of the angst that self-doubt brings, along with conviction that due diligence is an ongoing refinement process with constantly changing variables, allows one to continually improve research methods.

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