The Many Faces of Track Records

The top of a limited partner's ("LPs") funnel is a concept that most general partners ("GPs") find hard to appreciate. The sheer number of investment opportunities from various sources including fund managers themselves, placement agents, re-ups, market mapping, etc. can be extremely disorienting. Analysts have to develop efficient practices for quick passes, polite turndowns, and honest/empathetic feedback. The most used receptacle for removing a candidate from an investment funnel/pipeline is "track record". "Track record" is also the most widely used approach by GPs when seeking an audience with a potential investor – why? – because a track record cuts to the chase, it speaks directly to what we are here for, and it implicitly states that a meeting would not be a waste of time. Leading with some sort of track record has become so mainstream that it is almost an orange flag if an investment manager does otherwise. But what is a "track record"? How should a "track record" be assessed? What is an acceptable or superior "track record"? I will explore the different faces of track records relating to private assets investing, but the tried-and-true overarching caveat "it depends" will explicitly or covertly underpin all verdicts.

Most folks understand a track record to be some sort of measurement of past performance. It shows how investments have performed in the past as well as the current state of any ongoing investments. The track record attempts to assure a prospective investor that the GP is experienced, competent, and has likely learned from past mistakes. Things such as length, relevancy, consistency, and degree of investment performance are usually underscored within the track record description. However, in many cases, the substance contained in those descriptors is fuzzy at best. GPs need to know that among analysts, there is a universal desire for a simple and transparent portrayal of a track record – please just give us a deal-by-deal (line item with relevant dates) page of all investments with the final gross and net results plainly stated. Any shenanigans on this page stick out like a sore thumb.

These days analyzing track records involves a level of mental dexterity usually reserved for the most elite magic trick debunkers or illusion exposurists. There are so many ways to present a track record and there are countless ways to assess what is presented. Regardless of what the SEC and other governing bodies lay out as the proper way to show track records, there are always caveats, footnotes, and other depicted circumstances that leave enough room for interpretation. Track record assessment is often like going down a labyrinthic rabbit hole filled with many follow-worthy leads/passages only to find that the key to getting out of this tunnel lies in the solving of a complex jigsaw puzzle heavily reliant on your own conviction.

Take a simple and logical due diligence question like "Who is responsible for the track record?" If you receive a fund deck from a GP that has its historical track record nicely laid out, isn't it fair to give attribution to the fund? But wait! Most funds are made up of individuals and these individuals usually have different skill sets, so is one individual responsible for the track record, or maybe a specific group of individuals, or should it all be attributed to the entire institution? What if there is one clear rainmaker? Or, what if the fund manager tells you that it is a learning/iterative organization that has institutionalized all processes/actions so no one person makes or breaks the firm? How does one confirm or negate such information? What if the junior staff is responsible for all the investment heavy lifting and senior personnel do all the theorizing/philosophizing around deals? The whole thing can get muddy very quickly. There are also instances where a GP attempts to show variations of a track record with bad deals removed, assumptions projected in models, whole sectors excluded, etc. – these are usually labeled/footnoted, but there is still the potential for distortion.

Here is another iteration of track record analysis worthy of consideration – "Should focus be put on an absolute or relative track record?" With an absolute track record, the prospective investor is confident that the GP has been historically able to hit its (the investor's) internal acceptable/target return threshold – this means had that LP invested with the GP in the past, returns generated would be satisfactory – so why not seriously consider the fund? An absolute track record analysis helps identify fund managers that can meet an investor's minimum requirements but can be hazardous if thoroughness is part of one's due diligence goals. This is where a relative track record assessment comes into play. A relative track record compares the GP's performance with similar funds using criteria (benchmarks) that can range from vintage year, fund size, strategy, geography, sector, etc. On paper, this sounds straightforward enough, but beware of the funhouse of mirrors that invites you in by asking the simple question "Which benchmark should be used?" Benchmarks are a whole other topic that will be tackled at another time, but a quick preview of the headaches they bring includes: What benchmark (creator/provider: Preqin, Pitchbook, Cambridge, etc.) should be used? How big is the benchmark data/universe set? How should the vintage year be determined? Should the performance comparison be localized or global? Would PME (Public Market Equivalent) be useful in assessing the opportunity cost of private versus public investing? The list of questions goes on.

With private assets track records, there is an extra wrinkle thrown into the fold reminiscent of the proverb "a bird in the hand is worth two in the bush". This extra nuance has to do with the evaluation of realized (investments that have been exited) and unrealized (investments yet to be monetized) returns. There are numerous circumstances where a track record contains a large number of unrealized investments – how should these be measured in an asset class that is notorious for ambiguity? Several methods to help gain confidence in the assessment of unrealized returns exist, but the truth remains that seasoned qualitative experience is still necessary to parse through what may seem quantitatively straightforward – if auditors generally have a hard time evaluating valuation methods of a GP and signing appropriate values, investment analysts will also have a formidable task doing so.

Value creation is another way to gauge and compare track records. Since one of the major charms of private investing is its promise of actively adding value to assets without the noise you see in public markets, it makes sense to measure how value is being created. Some quantitative methods/tools help with categorizing where value creation occurred – then a "value creation bridge" chart illustrates the key areas of value creation which include multiple expansion, operational improvement, and leverage. These categories can be sliced and diced in different ways to understand if the value was created through financial engineering, active hands-on alteration of the asset, or just being in a favorable market environment. After getting these results, what can an analyst state as conclusive? Historically, value creation from operational improvement has been the most revered, but should this categorically be the case? What if the fund manager is excellent at financial engineering and has shown this repeatedly? What if the GP is great at picking conducive markets for its strategy? There are many layers to consider here.

"Track records" have many faces so an analyst must be able to look past the various masks and get to the essence of a fund manager. Also, it should not be forgotten that most track records (other than when analyzing unrealized returns) are backward-looking so there is a likelihood of over-indicting or over-glorifying history and losing sight of the future. As I have mentioned in the past, due diligence at its core, is a complicated assembly of a mosaic by gathering disparate pieces of information to create a simplified discernable image. The understanding of a GP's track record is an important piece to the puzzle, but any unequivocal conclusions based on it should be made with caution.

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