Alignment

At its core, investing is the utilization of research, perception, psychology, hard facts, data extrapolation, scenario projection, human behavior, trust, intuition, and goodwill to attempt to sneak a glimpse of the future. The truth is that this dynamic concoction of efforts is not a perfect science or easily discernable art. In fact, it is more akin to a game of high stakes educated gambling. There is clearly some (or a lot of) facetiousness to the prior statements, but there are also glimmers of fact. The unknown future is what keeps most of us from getting too drunk on the egotistic grandeur of our own abilities and/or clairvoyant powers. Acceptance of our psychic deficiencies has led humans to devise several sensible methods to help shield us from, or neutralize the potential damage of unforeseen circumstances – examples include insurance policies of all sorts, clauses in various contracts, private placement memoranda, retail return policies, warranties, etc. During manager due diligence the quantitative and qualitative assessment of "alignment" is a process that tries to lessen the likelihood of unforeseen and undesired outcomes.

In investing (particularly private investing) parlance, the verification of "alignment" generally means determining what existing characteristics unite the interests of the investment manager (GP) with those of the investors (LPs). Most of us are aware of the provocative alignment/commitment anecdote that depicts the plight of a chicken and pig getting into a partnership for a breakfast of eggs and bacon - the narrative for this alliance goes "The chicken is involved, but the pig is COMMITTED!" This extreme example attempts to capture the fidelity of partnering entities in an undertaking (and the potential outcomes of that undertaking). As I have previously mentioned about the many faces of track records, "alignment" can also be measured and/or viewed in several ways - none of these methods is absolute but each helps the analyst with a critical piece of the investment mosaic.

Here is a list of some factors investment analysts assess (or should assess) when determining how aligned or committed a GP is to its investment vehicle, and hence its LPs. A lot of these considerations bleed into and intertwine with each other so it would be foolhardy to overrate one over another or look at each in a vacuum.

1. **GP Commitment**: This is the first thing used to display "skin in the game". The GP commitment is how much of the investment manager's capital is invested alongside LP capital. Average industry GP commitment percentages run between 1% and 3% of total fund size. Usually, the higher the GP commitment, the better, because this shows conviction in a worthy pursuit. However, we should not be overly seduced by the headline GP commitment amount because nuances need to be adequately scrutinized.

   (a) The amount or percentage of GP commitment compared to the overall target fund size is a revealing data point, but an equally telling detail is the GP commitment as a percentage of the GP's net worth. For example, a fund seeking $500 million with an above-average GP commitment of 5% ($25 million) could be viewed on the surface as being highly aligned with LPs, but if members of the GP are substantially wealthy, $25 million does not move their conviction needle as much as a GP with far less wealth. I am not trying to discount the value of any size of GP commitment, because, at the end of the day, money is still money. However, I do want to underscore that in the leagues of private assets investing, seemingly large numbers to the layperson are relatively small when put into context. I have had a few GPs tell me that they are "post-financial", a term I was not familiar with – after further

probing, I found it to simply mean that these folks were operating from heights on Maslow's pyramid so lofty that mere mortals would find it difficult to comprehend. In other words, basic human alignment heuristic tools are ill-equipped to measure what motivates "post-financial" GPs.

(b) The way the GP commitment is paid is also quite important because the amount of GP pain (for lack of a better term) needed to satisfy the LPs' need for alignment, is being anesthetized in some way. This happens in many forms including the use of management fee waivers, the counting of GP affiliates as part of the GP, and the use of capital from the sale of a GP stake. GPs will use all types of justifications to assure LPs that these pain-numbing devices do not affect the sanctity of alignment that the percentage of GP commitment communicates, but it falls on the analyst to "trust, but verify".

(c) A relatively high GP commitment, although generally preferable, has been known to prompt some adverse effects. The GP in some circumstances becomes risk-averse when a large amount of its own capital is at stake. This means that some GPs with high GP commitments do not take the requisite risk for the investment strategy to fulfill its return promise. Sometimes the opposite is also true when a GP (mostly the renegade ones) starts to take excessive amounts of risk to gain bigger paydays quickly. I have been privy to both circumstances and have found that getting to intimately know what drives a GP is the most prudent way to assess the adequate amount of GP commitment that will keep a manager engaged in a manner that is beneficial for all parties.

(d) Understanding the source of GP commitment capital is also fertile ground for alignment assessment. If the GP comprises several individuals, but the lion's share is coming from one person, there is more digging to do. Also, if the GP commitment is coming from an internal mechanism where some individuals can borrow (or are fronted) capital at a cheap rate, it can be argued that alignment pain is not coequal.

2. **Preferred Return Hurdle**: This is the minimum return LPs must receive before a GP can receive carried interest ("carry"). The typical preferred return hurdle is somewhere between 7% – 10%, although some strategies like venture capital typically have no preferred return hurdle because the risk level of investments inhibits them from projecting minimum returns. The compounding periods and the method of calculating elapsed time must be analyzed before determining how aligned a GP is with its LPs. Additionally, the waterfall (method of capital/returns distribution) should be examined when assessing alignment because an American waterfall (where carry is received by the GP on a deal basis before LPs are made whole on a fund level) generally provides less GP alignment than with European waterfalls (where the GP receives carry after LPs have been made whole on a fund level).

3. **Depth of Carry**: Sharing is caring. Understanding how far carry goes down the manager's hierarchy is another way to ascertain organizational alignment. Carry that is shared fairly (in proportion to value contribution), broadly, and deeply is usually a sign that the organization is conscious of the power of incentives.

4. **GP's Focus**: With some GPs, it is challenging to pin down a clear sense of their alignment. This is not because the GP commitment percentage is below the industry standard or the preferred return is suboptimal, it is usually because it is hard to determine the manager's focus. Some GPs have so many

activities such as multiple investment vehicles, other business interests, constant media appearances, numerous committee seats, various charitable obligations, etc., at play that it is difficult to measure their dedication to the LPs of a particular vehicle. I am always inclined to cease due diligence when presented with such a situation.

5. **Operating Partners' incentives**: Operating partners or individuals attributed to the hands-on creation of value in portfolio companies are the darlings of the private investing ecosystem because these people unlock the targeted/marketed returns. Verifying that these folks are adequately incentivized to stay with the manager and keep generating strong active returns is a critical part of alignment assessment.

6. **Age of GP**: This sounds terrible to say/write and I know I could be persecuted by the "ageism" police, but the age of a GP plays a significant role in assessing alignment. The alignment dynamics of a GP in their early forties are very different from those in their mid-sixties – this is of course in the private investment context where investment vehicles generally have a 10-year-plus term. It is just one of those truths in life that we all have to face. A GP early in their career with a lot still to prove is generally a lot more aligned with LPs than one in the sunset phase of their professional life.

7. **GP's Aspiration/Motivation/Legacy/Reputation**: Related to almost all the above points, learning a GP's aspirations goes a long way in determining the degree of alignment between the GP and LPs. "Fortune", "fame", "winning", and "legacy building", are a few goals that solely, or in some combination, motivate GPs to do what they do. Each of these ambitions comes with different variations of alignment. For example, a GP concerned about "legacy" will be a lot more likely to share carry and have an organized succession plan than one primarily concerned with celebrity. Also, some GPs have exhibited a history of restlessness and quick boredom by jumping from personal project to project and having a plethora of hobbies. Others have demonstrated clearheaded steadfastness in strategy/process (with prudent ongoing refinements) along with thoughtful fund sizes and transparent growth objectives. Alignment in each scenario will be unmistakably different – an analyst needs to be relentless in uncovering what makes a GP tick.

In my many years as a research analyst, I have found that there is no silver bullet that assures alignment. However, I have also gathered that following the breadcrumbs purposely, subconsciously, or inadvertently dropped by GPs lands you in close enough proximity to the truth.

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