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CalPERS Private Equity Emerging Manager Program Review

Anita Ng
Managing Director, Cambridge Associates

CAMBRIDGE ASSOCIATES LLC

Project Scope and Process

Objective	Identify lessons learned and adopt any additional best practices for investing in emerging private equity managers
Methodology	Detailed review of 10 direct emerging managers and 3 funds of funds
Panel discussions	Panel of CalPERS' senior staff, consultants and 9 external industry experts 3 day-long workshop sessions

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Challenges of Investing in Emerging Managers

- Investing in private equity in general is challenging for even the most sophisticated LPs
- The private equity industry is mature and increasingly competitive
  - Only a small portion of emerging managers will ultimately be successful at raising subsequent funds
- Investing with emerging managers requires a higher degree of subjectivity and judgment
- Less information available to prospective LPs

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Challenges of Investing in Emerging Managers

Continued

- Higher potential of lower returns, as emerging managers have exhibited wider dispersion of returns
- Greater inherent uncertainty as newer teams learn how to work together and execute their strategy, manage a portfolio, face unexpected developments, and build their organization
- Less proven strategies
- Potential distractions arising from fundraising difficulty

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Goals for Investing in Emerging Managers

- Given their unique challenges, why does CalPERS invest in emerging managers?

> **Access the comprehensive landscape of investment opportunities**

> **Develop relationships with the next generation of core investment managers**

> **Generate appropriate risk-adjusted returns**

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Summary of Panel Conclusions

- Emerging managers should be held to the same standards as established managers
  - CalPERS' proprietary Manager Assessment Tool provides a fair and consistent process through which to evaluate the full manager landscape
- CalPERS generally should not invest in emerging venture capital managers
- Selectively invest directly when appropriate, but continue to use funds of funds to gain emerging manager exposure

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Summary of Panel Conclusions

Continued

- Maintain delegated authority to make investments with CalPERS' investment staff
- No "secret sauce" alone can explain the success or failure of emerging managers
- The study suggested a number of factors that are particularly important, keeping in mind:
  - Sample size not statistically significant and selection relied upon some degree of subjectivity
  - Some factors are more important than others, and factors that matter most will vary by situation
  - Some factors are correlated and there is interplay between the factors

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Best Practices for Evaluating Emerging Managers

Most Important Factors

Attractive investment thesis	• Strategies of scale, and repeatable • Sustainable and growing addressable market opportunities • Strategy differentiation or deep sector expertise • Edge in sourcing and relevant industry networks
Prior relevant investing experience	• Relevant investing experience as principal investors • Prior fund management experience
Team dynamics	• Previous experience working together • Avoid groups with unchallenged single dominant partners able to make unilateral investment decisions • Intense cultural focus on introspection and striving for continual improvement

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Best Practices for Evaluating Emerging Managers

Most Important Factors, Continued

Clearly articulated strategy	• A clear identity recognized and understood by all team members • Explicit and consistent decision-making structures and processes in place
Strategy adherence	• Adherence to strategy that was defined at the onset of each fund
GP/LP Alignment	• Meaningful "skin in the game" • Fair economics sharing to properly motivate team • Transparency and integrity

Other Factors To Consider

- Ensure "critical mass"
- Ability to attract and retain additional talent around key founders
- Early professional turnover can signify deeper problems
- Sponsorship/endorsement/commitment from previous employer(s) or knowledgeable LPs can offer some level of validation

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Best Practices for Evaluating Emerging Managers

Other Factors To Consider, Continued

- Historical performance evaluation
- “Hungry” team. Understand the rationale for the founders wanting to start a new firm
- Funds sponsored by larger, more established organizations may result in reduced alignment of interests of an investment team with LPs
- Though not observed in our sample, the panel believes that unconstrained fund size growth is a negative