Polynomial Ventures

Fund Manager Experience: Less is More

By Steve Valentor

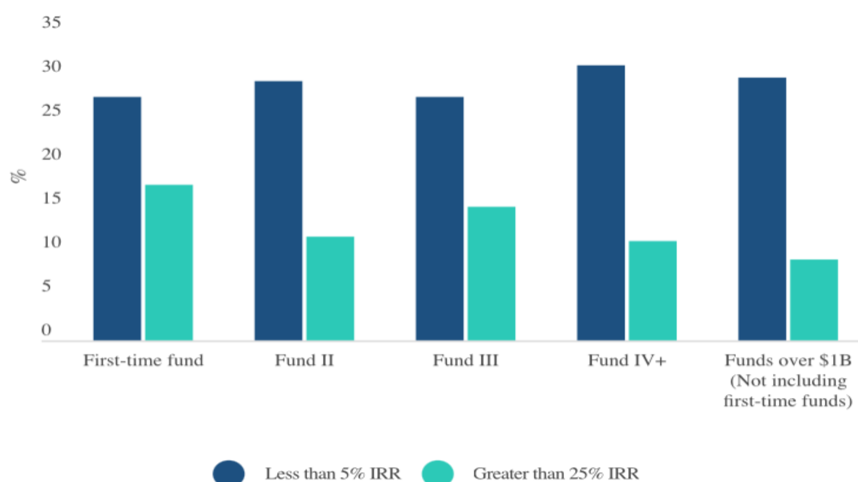
Professional and Institutional investors have a tough job. They must take full responsibility for enormous sums of money and shepherd it through time and complex conditions to ensure that it will not only arrive intact but also with suitable growth. As portfolios grow, constant rebalancing and reallocation is necessary.

To accomplish this, these investors seek exposure to various asset classes. They distribute their investments to include fixed income securities, bonds, real assets, precious commodities, stocks, private equity, hedge funds, venture capital (VC) and more exotic alternatives such as art and cryptocurrencies.

Publicly traded securities are easy to access and there are plenty of analysts researching these investments and providing excellent advice. The alternatives or alts are another matter. These are rare, and expertise is even more rare.

There are 10,000 hedge funds, 3500 private equity firms, and fewer than 1000 VC firms.

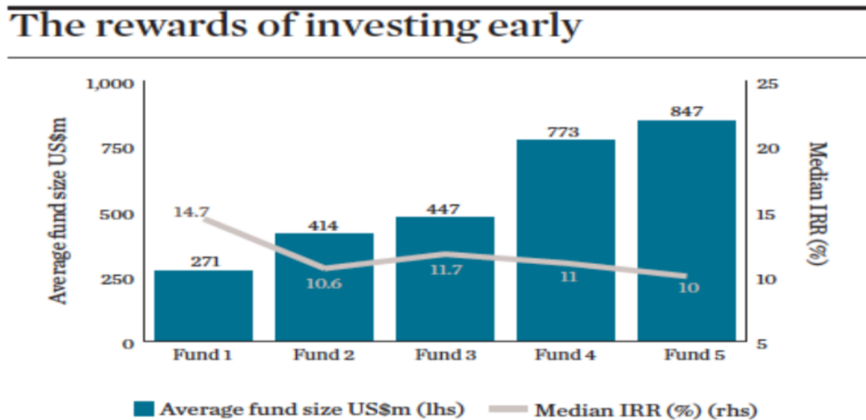
There is a strange phenomenon in the relationship between experience and performance. Published data confirms that new managers, often called Emerging Managers, outperform established managers. This is such an important trend that many institutional investors maintain special programs to attract emerging managers. Led by California, Texas, New York and Illinois, state and local government retirement systems sponsor such programs. University endowments also recognize the value of emerging managers and many sponsor programs to attract them.



Source: PitchBook

The graph above shows that fewer first-time funds return less than 5% IRR, and more importantly, the highest percentage of returns greater than 25%. Both of these important statistics trend worse in later vintages. The lowest returns are generated by funds exceeding $1 billion.

The following graph, from a different independent source shows a similar steady decline in internal rate of return (IRR) as fund managers offer subsequent funds.



Source: Preqin

And finally, over an 18-year period, we see that overall, emerging managers outperform established managers, with a few exceptions. It is also worth noting that the emerging managers lowest performance returns are always higher than the lowest return by established managers.

Source: Preqin

There are theories as to why emerging managers do so well. Their firms are startups which are nimble, flexible and adaptive. They are started by dynamic entrepreneurs who are willing to work harder to prove their value. Many bring a new theory or value assessment technique to the industry.

Regardless of the actual reason, emerging managers consistently perform better. Their challenge is to build an environment to ensure that they don't lose their advantage.

Steve Valentor is a 30-year technology industry veteran who has worked in computer engineering, semiconductor R&D and software development for companies ranging from startups to the Fortune 200. He has held positions from entry level engineer to senior technical management, CEO and board chair. Currently the managing partner of Polynomial Ventures and an adjunct professor at DePaul University, Valentor holds an M.B.A. in finance and a bachelor's degree in math, both from the University of Illinois at Chicago.

Polynomial Ventures invests in early stage technology companies outside of Silicon Valley and Boston. The Chicago-based firm is an emerging, registered investment adviser (RIA) operating an evergreen fund.