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# Access versus Selection: What Drives Limited Partners' Private Equity Returns?

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# Background

- What determines limited partners' private equity returns?
  - Access or Selection?
- Previous studies (e.g., Lerner et al., JoF, 2007) suggest that selection could explain observed differences between LPs' returns even when access is controlled for
  - But GP performance is persistent (e.g., Kaplan et al., JoF, 2005) which has to be taken into account
- Our research controls for both LPs' access and GPs' prior returns
  - Unlike the previous studies, our approach is able to isolate the effect of selections from that of access

# Data

- Reinvestment decisions made by more than 150 of the largest European pension funds and insurance companies
    - 1,485 reinvestment decisions, out of which:
      - 501 in which investment took place
      - 946 where the LP decided not to invest
    - Information on the GPs' previous (and some cases also 2nd previous) fund's returns
    - Provided by Preqin database
  - Sample chosen to minimize unobserved heterogeneity due to locations, legislations, fund types, etc.
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# Methods

- Multilevel mixed effects regression model controlling LP/GP
  - Dependent variable: fund return (IRR/multiple)
  - Explanatory variables: prior fund returns (+2nd prev. fund returns), LP reinvested, prior LP investments, prior GP funds, prior LP-GP investments
  - Control variables: fund size, type, location (+vintage)
  - Heckman-like correction for selection bias
- Each LP also analyzed individually
  - Shows that results are not due to aggregation but exist also on LP-level

# Results

	Dependent variable				
	IRR		Multiple		
	Model 1	Model 2	Model 3	Model 4	Model 5
<b>Fixed Effects</b>					
LP selection not significant	0.019 <sup>†</sup> (0.011)	0.017 (0.014)	0.004 (0.011)	-0.007 (0.011)	0.002 (0.012)
Prior fund returns (IRR)	-	0.046 (0.038)	-	-	-
Prior fund return (multiple)	-	-	-	-0.011 (0.024)	-0.022 (0.039)
2nd previous fund's returns (multiple)	-	-	-	-	0.149*** (0.030)
LP experience	0.000 (0.000)	0.000 (0.001)	0.000 (0.001)	0.000 (0.001)	0.009 <sup>†</sup> (0.005)
LP-GP relationship	-0.007 <sup>†</sup> (0.003)	-0.005 (0.005)	-0.002 (0.003)	0.006 (0.004)	0.000 (0.001)
GP experience	-0.002 (0.001)	0.000 (0.002)	0.000 (0.002)	-0.001 (0.002)	0.005 (0.004)
Fund size	0.012* (0.005)	0.006 (0.007)	0.015** (0.006)	-0.003 (0.007)	-0.069*** (0.010)
Fund location: US	-0.093 (0.088)	-0.182* (0.086)	-0.019 (0.112)	-0.042 (0.122)	0.127 (0.149)
Fund location: Europe	-0.075 (0.088)	-0.157 <sup>†</sup> (0.085)	-0.012 (0.111)	-0.026 (0.121)	0.091 (0.150)
Fund type: Buyout	0.110*** (0.026)	0.071* (0.035)	0.079*** (0.025)	0.102** (0.035)	0.157* (0.064)
Fund type: Mezzanine	-0.006 (0.028)	-0.049 (0.039)	-0.147*** (0.028)	-0.174*** (0.035)	-0.224*** (0.067)
Fund type: Fund-of-funds	0.040 (0.036)	0.006 (0.046)	-0.052 (0.033)	0.007 (0.046)	-0.156 <sup>†</sup> (0.086)
Fund type: Venture capital	-0.036 (0.049)	-0.014 (0.059)	-0.039 (0.047)	-0.058 (0.052)	-0.030 (0.071)
<b>Random Effects</b>					
LP	0.001 (0.005)	0.000 (0.028)	0.004 (0.004)	0.003 -	0.001 (0.005)
GP	0.096 (0.010)	0.070 (0.011)	0.136 (0.011)	0.146 -	0.177 (0.019)
Residual	0.129 (0.003)	0.123 (0.005)	0.164 (0.003)	0.152 -	0.131 (0.004)
N	902	420	1485	1075	703

*Our results provide support for the hypothesis that when access and prior returns are controlled for, LPs are not able to select funds that have higher returns.*

# Discussion

- Previously, the question has been whether access or selection could explain differences between limited partners private equity returns?
    - Our research shows that when controlling for access and prior returns, LPs are not able to reinvest in better funds
      - Therefore, observed differences between LPs' returns are not explainable by selection but by access
      - These results are in contrast to prior knowledge (which does not take into account prior returns)
  - Our findings should be taken into account whenever:
    - Comparing returns between limited partners,
    - Attributing LP's returns to actions made by that LP, or
    - Considering why LPs invest in funds without proven track records
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