Generalists vs. Industry Specialists – What you see and what you don’t! Or The Perfect Investment Solution in the Perfect World...

Posing the Hypothesis

If there were a perfect investment world, all investors would have complete and accurate knowledge. They then would be able to allocate among asset classes, to appropriately weight among sectors within each asset class at the right time, and to select the best single investment within each sector. With thanks from all of us making livelihoods in the investment sector, perfect knowledge does not exist or perhaps perfect judgment and analysis to interpret the knowledge is not yet proven. So instead, investors at all levels - those investing among every asset class available down to those of us selecting only within the relatively small private equity universe - struggle with the quandary of whether to asset allocate ourselves and select specialists in each sector, or to abdicate both decisions to a manager who will presumable be relatively capable at both.

The quandary arises from two premises that have existed across all the sectors of the investable universe, but, due to the greater volatility and dispersion of returns across time and among managers, are even more important to private equity investors.

- The first is that industry sectors do not move in tandem, and therefore the performance of private equity investments among these sectors has a similarly divergent pattern.
- The second is that excess return is available in private equity investing by capitalizing on market inefficiencies and by adding value to individual private companies in which investments have been made. That is, private equity investors can produce incremental gains by investing on informational advantage and creating value through post-investment action.

Assuming the perfect investment world has not yet arrived, in order to determine whether it is better to invest with a manager who will cover a reasonable percent of the investable industry sectors or to invest with a series of industry specialists, one must assess the impact on returns from the industry sectors and from individual company selection. Further, one needs to assess the potential for capturing both segments of the equity return.
Relative Equity Performance among Industry Sectors

In order to assess whether performance of private equity investments among industries moves in tandem – or presumably not – we have used the public equities returns as a reasonable proxy for the comparable private equity industry groups. While the volatility is greater and the associated dispersion of returns would be logically wider in private equity, there is enough correlation among public and private equity returns to give credence to the proxy. The schematic in Exhibit 1 is based on the last 50 years over 10 economic cycles and makes the timing of industry sector returns a simple and clearly investable pattern! Were it so simple, equity investors, private equity included, would follow this roadmap, hiring a series of industry specialists at exactly the right time.

However, the actual annual returns from the last 15 years, as displayed in Exhibit 2 (next page), indicate a more complex pattern so chaotic that one might not want to take on sector allocation at all.

Given that one invests in private equity over multiple years, examination of rolling multiple year patterns is warranted, again using the public equity markets as a private equity return proxy. The three-year return analysis makes the industry sector selection potential more manageable and at the same time indicates sufficient persistence. Thereafter, the sector selecting investor, if timing correctly, still has an advantage over the broad market generalist.

In sum, the data shown indicates that, while all equities perform together on an extremely macro scale, industry sectors have been proven to perform differently throughout the business cycle. The dispersion among some industries is
sufficiently large that investors would create outsized gains if they were able to invest in those industries at certain times — and exit at points of time as well.

Therefore, one could pose a slightly different hypothesis — that investing in or at least attempting to over- and under-weight certain sectors is a valuable exercise. Reviewing Exhibit 3, one may select IT in the late 90s and energy in the current environment as good “sector” bets. Moving to the consideration of private equity investing within sectors, one must ask is the universe large and active enough without too much competition to warrant a sector specialized effort?
Investing on informational advantage and creating value by post-investment action

The basic premise of all private equity investing is that due to the inefficiency of information flow and post-investment value-added, there is opportunity for excess returns above the public markets indices. The question the investor must answer is whether an industry specialist private equity manager has an enhanced opportunity through industry expertise to have better information and deeper expertise than generalists investing in the same industry.

First, it is important to assess whether an industry sector is large enough and active enough in terms of activity to warrant focus, and therefore specialization. While the analysis can be performed for all industry sectors, one example indicates the kind of industry opportunity warranting a specialist manager-Media & Communications, as shown in Exhibit 4.

The sector is large – approximating 12% of GDP; the merger and acquisition activity is substantial, representing nearly 25% of all US M&A activity of the last twenty years; and the percent of all buyout activity in this sector has hovered around 10% – more than enough activity for a diversified portfolio in a sector fund, in a universe with sufficiently ebullient activity that the private equity manager can remain very selective. Such a scenario is not enough to prove our hypothesis a priority, but bolsters the case sufficiently to go on!
Unique Information—Determining which firms – generalists or specialists – have more unique information is not possible to gauge quantitatively in any practical way; however, again relying on proxies, one might determine relative information access based on the number of deals reviewed by the firms over the course of the same period. Deal flow can measure the actual number of opportunities to invest, drawing the conclusion that the larger the universe the higher the likelihood that a subset of better opportunities will arise from the larger universe of deal flow. This presumes that deal flow measured among firms is of comparable general quality and reviewed in some relatively consistent manner. Even if a deal does not end up as in investment, one should be able to make an assumption that substantive review of that deal provided some incremental knowledge of either a fundamental aspect of the industry sector, some pricing knowledge regarding current multiples within the sector, or both.

Therefore, one might gauge private equity funds’ access to deals as a proxy for informational advantage. The schematic in Exhibit 5 demonstrates the natural advantage that a specialist private equity firm may have in media/communications, relative to a generalist firm with media/communications as one of four areas of interest.

With exposure to four times as many deals in the sector, the specialist has a better investable universe and greater opportunity to gather information that should make them better investors in their sector. Actual selection of a specialist firm would require satisfaction that the multiple of deals seen is sufficient to provide this information edge. Questions to gauge the depth of deal flow in the industry are:

- What percent of all deals in your industry do you see?
- Do you track after the fact all industry deals that you do not see?
- Why did you not see them?
- What characteristics do they have?
- Is there a consistent pattern about them?
- What percent of deals not seen, based on information available, would you have done?
Post-Investment Value Added—The next major opportunity to create excess returns is through value-added portfolio company activity, whether it be strategic advice, operational assistance, financial transactions, or management improvements. Assessing the potential for value-added post investment activities, like informational advantage, does not lend itself to empirical testing. Nevertheless, an examination of the industry-specific levers that a private equity fund may have should provide some gauge of its ability to provide post-investment assistance of the nature and quality to create material value. The complexity of the industry will also determine if the potential for value-add through a sector specialized manager is material. Investors should ask:

- How technologically complex is the industry?
- Is it subject to extensive and changing regulatory issues?
- Is it the potential beneficiary of high growth and/or rapid technological change? If so, a specialist may be better able to capitalize on the opportunities available through advanced knowledge and expertise, either in-house or through their industry contacts.

Once the specialized approach is selected, the investor must assess the quality of the specialized firms value-add, other than through firm-specific due diligence. How many years of industry-specific operational experience are there among the partners? How many years of industry-specific investment banking, research analysis or other relevant experience are resident among the partners? Do they belong to industry associations? Do they have access to strategic co-investors? Do they have a (legitimate) industry Advisory Board, and, if so, how is it used? It is likely, in the measurement of industry-specific post-investment tools, a generalist firm investing in four or more sectors will have a very difficult time comparing favorably to the industry specialist firm of comparable quality.

What then is the best choice: generalist or specialist?

In the perfect world, one would find one firm that has the unique ability to over- and under-weight industry sectors, or at least the ones with the outsized volatility and risk/return characteristics, while at the same time having each of the sector groups be the top sector investors in the private equity industry, rivaling their specialist brethren through every cycle. We propose that firm does not exist. So the investor must compromise, working within an Adjusted Perfect World Hypothesis, combining the beneficial characteristics of a generalist firm, who will invest in the sectors with lower relative volatility overall, with the information advantaged specialists where the incremental advantage is most outsized. So the best decision is a combination of generalist and industry specialists.

What can go wrong with the Adjusted Perfect World Hypothesis?

The looming risk is to get the timing wrong, either on the part of the investor or on the part of the private equity manager. Selecting the very best firm in an industry sector worthy of focus should be an institutional investor’s goal. However several timing problems can occur.

The investor could have selected the specialist at exactly the wrong time—telecom before the bubble burst provided dismal returns, or immediately after the bubble burst may have resulted in uninvested capital while paying healthy management fees. However, the investor should be able to rely on the sector specialist to judge when to invest at a more or less rapid pace in its own sector-exercising market timing within the sector fund, if you will. The appropriate balance of management...
fees and carried interest should motivate the sector specialist to this wise endeavor.

Despite reliance on the specialist private equity firm to get the timing right, human nature is a powerful deterrent to perfect market timing. Picture the phenomenon where the private equity firm can easily raise a sector fund in a late bull market for that sector, and then wisely sit on the capital for some period of time waiting for the more opportune time to invest in that sector. This sector strategy requires a tremendous amount of discipline on the part of the private equity manager, and a comparable amount of respect and patience on the part of the investor. Examples of sector funds that lacked sufficient market timing discipline litter the landscape of lowest quartile vintage year returns. However, sectors that have some less correlated sub-sectors can lend themselves to opportunity to exercise the discipline described.

Last, a generalist private equity firm can also make the wrong timing decision, over- or under-weighting one of their sectors at the wrong time. More than one generalist firm over-stayed telecommunications, perhaps because they didn’t have the unique industry insight a specialist firm would have had. Other generalist firms gave up on healthcare, virtually eliminating the area as one of their sectors, just in time for it to re-emerge as an investment-worthy industry.

Summary

What is clear is that there is significant demonstrated opportunity for outsized investment returns by making the correct sector timing decisions. It is also highly likely that informational advantage, combined with the judgment to analyze and act on the information, should create additional investment returns. There are timing and selection risks accompanying implementation of each premise. However, the balanced use of generalist and industry specialist private equity managers may prove the Adjusted Perfect World Hypothesis to be correct.

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