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Top Managers Tend to Repeat Their Success

Two world-renowned researchers recently concluded that top-performing, established VC and LBO managers have a strong tendency for their subsequent funds to outperform the funds of their peers.[1] The researchers analyzed returns of 1,000 VC and LBO funds over two decades. They found that if a manager's previous fund ranked in the upper-third in terms of performance when compared to its peers, there was a 55% probability that the fund manager's subsequent fund would again rank in the upper-third. Conversely, there was only an 11% chance that such manager's next fund would rank in the lower-third. If we could assume that returns in the middle-third ranking are fairly evenly distributed, we would postulate that there is roughly a 72% probability that such manager's subsequent fund will perform better than the median return in its peer group.[2] Since median (and average) private equity returns often approximate S&P 500 returns, this study stands to encourage investors weighing new commitments to VC and LBO funds vs. public equities because it says that there are statistical guidelines they can use to pick VC and LBO managers who, on a probabilistic basis, should beat the S&P 500.[3]

	Probability of Next Fund Performance		
Previous Fund Performance	**Lower-Third**	**Middle-Third**	**Upper-Third**
Upper-Third	11%	34%	55%
Middle-Third	24%	34%	42%
Lower-Third	44%	37%	19%

The study also found a positive but concave relationship between performance and fund size, which means that strong past performance indicates strong future performance so long as the subsequent fund doesn't get too big. This makes sense. Firms with strong performance are typically rewarded by increased investor demand for subsequent funds but those firms only have a limited capacity to efficiently put capital to work (i.e., partners have a finite number of deals they can review each year and number of boards upon which they can proficiently serve). Firms that over-extend themselves in subsequent funds tend to see their performance suffer. We believe this is intuitive for most private equity firms, and we have witnessed rational behavior in the top ranks of the private equity community—most obviously in the VC community where firms like Kleiner Perkins and VantagePoint have decided to raise smaller funds than they previously did. LBO firms generally have headed in the opposite direction lately.

Conclusion

In summary, this is an intricate and exciting study that supports what we have been saying all along: that **high-performing, established managers have a strong tendency to outperform other private equity firms in subsequent funds**. But there are other considerations for investors than purely past performance, including fund size, consistency of strategy, length of time the partners have been investing together, quantity and quality of deal flow and industry expertise. Further, this is not to say that emerging managers should be ignored altogether, in part because real world options don't always neatly align with academic theories and suggested actions. Since our inception we have sought to commit to well-established firms with strong track records, while also seeking a select group of emerging managers who have the hallmarks of tomorrow's top firms.

If you would like more information on this study, please see the August 2005 edition of the Journal of Finance.

1 The Journal of Finance, "Private Equity Performance: Returns, Persistence and Capital Flows," Steve Kaplan of the University of Chicago and Antoinette Schoar of MIT, August 2005.

2 Calculated based on 55% probability of upper-third performance plus half of the 34% probability for middle-third performance.

3 The study found that average venture returns, net of fees, slightly outperformed the S&P 500 and that average LBO returns, net of fees, slightly underperformed the S&P 500.

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Private Equity Partners

Investment Professionals

Dan Donoghue
312 920-2132
daniel.j.donoghue@pjc.com

Scott Barrington
612 303-1110
scott.l.barrington@pjc.com

Jonathan Seltzer
612 303-0410
jonathan.c.seltzer@pjc.com

Seth Trier
612 303-6674
seth.r.trier@pjc.com

Fund Administration

Gretchen Postula
Investor Relations
612 303-6331
gretchen.s.postula@pjc.com

Susan Swift
CFO
312 920-2153
susan.e.swift@pjc.com

Amber Preston
612 303-6588
amber.d.preston@pjc.com

Private Capital Group

800 Nicollet Mall
MS: J09N03
Minneapolis, MN 55402

Hyatt Center, 24th Floor
71 South Wacker Drive
Chicago, IL 60606-4616

Find us on the web at
piperjaffray.com/fundoffunds