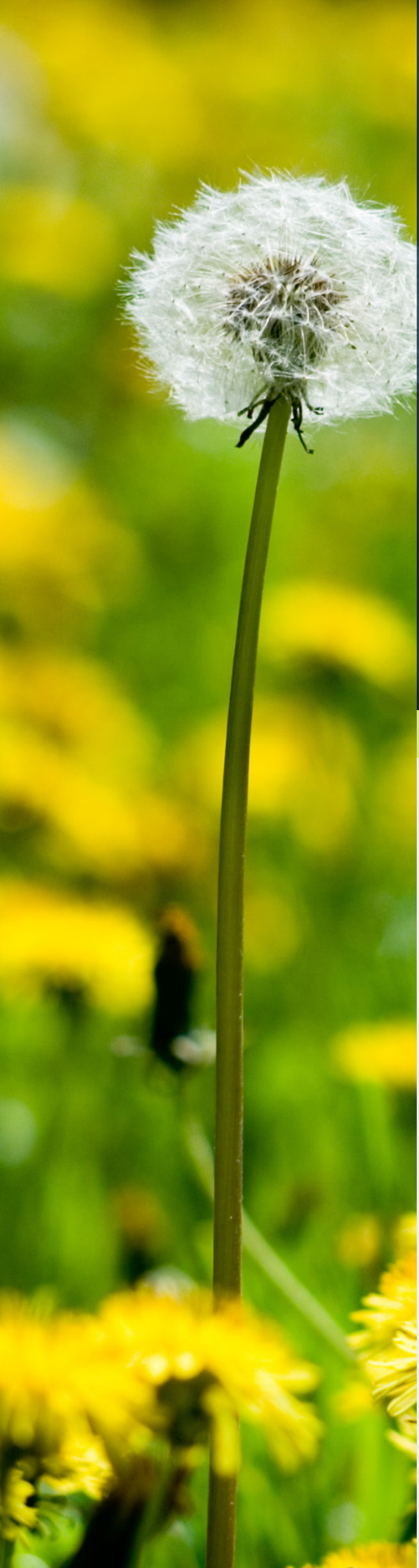


Fight the urge

(to invest in the familiar)

Private equity | MAY 2024

There persists a myth within the investment community that supporting diversity, equity and inclusion must come at the expense of quality.

For investors, this means returns. However, various studies have pointed to outperformance[1,2,3] or, at least, no sacrifice in performance, between diverse- and nondiverse-owned managers.[4] We believe that there are still many limitations to a conclusive study here, including average vintage and sample size. However, despite this, minority-owned firms undoubtedly raise far less capital than non-diverse firms and face a higher bar when raising subsequent funds. This is particularly true of new or emerging managers.

[1] National Association of Investment Companies, 2023. "Examining the Returns 2023: Further Evidence of Diverse-Owned Private Equity Firm Outperformance."
[2] Hammer et al, 2021. "The More the Merrier? Diversity and Private Equity Performance." British Journal of Management, January.
[3] Gompers, Paul and Kovvali, Silpa, 2018. "The Other Diversity Dividend." Harvard Business Review, July.
[4] Bella Private Markets, 2023. "The Case for Diversity, Equity & Inclusion: Stronger than Ever."

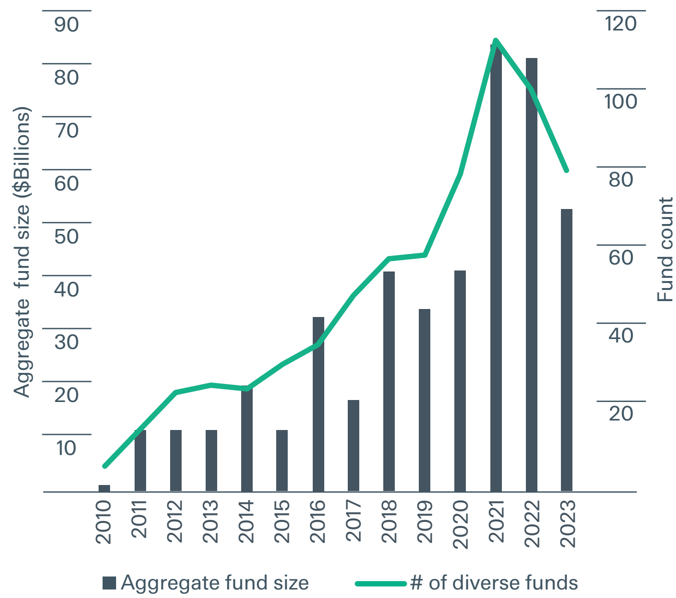
For now, we prefer to reflect on our own activities in backing diverse managers to determine the factors of outperformance and why we believe it is a sustainable and increasingly attractive opportunity.[5]

- For primary buyout, growth equity and venture capital funds, diverse managers' net TVM of 1.7x outperforms the benchmark median of 1.4x over the same vintages.[6]
- Outperformance has been concentrated in the lower end of the market, where diverse managers raising less than $2 billion have generated a net TVM of 1.8x.

Don't tell us there aren't enough diverse managers

The diverse manager opportunity set is vast and has experienced meaningful growth over the past several years. Within SPI by StepStone, our proprietary private markets library, we track more than 530 GPs and 1,000 funds that count as diverse. The number of investable funds has grown at a 21% CAGR since 2010. Today diverse funds make up over ~8% of the total PE fund universe by fund count, up from mid-single-digits for most of the past decade. In 2023, StepStone estimates there were 80 diverse funds in market seeking to raise ~$57 billion in capital commitments.

FIGURE 2: DIVERSE FUNDRAISING TRENDS (2010–2023)



Sources: SPI by StepStone & Preqin, December 2023. SPI by StepStone and Preqin data are continually updated; historical values are subject to change.
Note: Includes North America-focused buyout, growth equity and venture capital funds.

FIGURE 1: STEPSTONE DIVERSE MANAGER TRACK RECORD

Fund size category	# of investments	Commitment	Net IRR	Net TVM	Gross IRR	Gross TVM
< = $2B	256	$9,460.15M	21.1%	1.8X	22.6%	1.9X
> $2B	28	$10,718.89M	17.0%	1.4X	17.6%	1.4X
Grand total	**284**	**$20,179.04M**	**19.6%**	**1.6X**	**20.8%**	**1.7X**

Source: StepStone Group, September 30, 2023.
Note: Track record includes primary investments in diverse private equity managers. Limited to North American buyout, growth equity and venture capital funds.

[5] In our view, to be diverse, funds must pass at least one of the following tests: one-third of ownership counts as diverse; one-third of carry goes to diverse individuals; or one-third of individuals covered by a fund's key-person clause are diverse.
[6] SPI by StepStone, September 30, 2023.

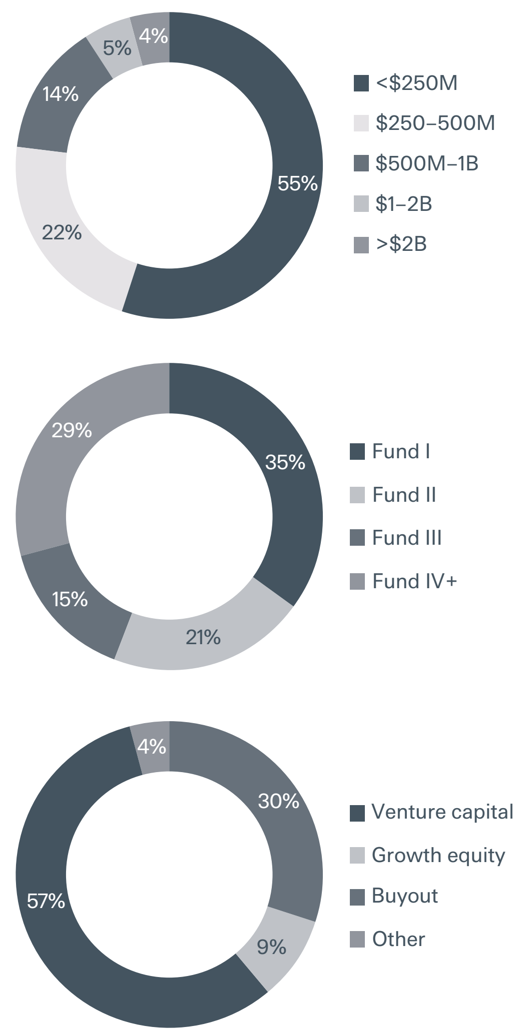
Although a handful of established large-cap GPs account for most of the capital raised, the diverse-manager universe by fund count skews smaller and younger. Nearly three-quarters of diverse-managed private equity funds are new or emerging, and over 90% are less than $1 billion.[7]

The funding gap

The private markets have made progress on the diversity front, but that progress is tenuous, and a significant funding gap persists. Research suggests that minority managers are less likely to meet first-time fundraising goals for first-time funds, raising about 40% less capital. Additionally, when raising follow-on funds, fundraising success for minority managers is three times more sensitive to past performance (i.e., the bar is higher). There are many reasons for this including:

1. Diverse managers have diverse networks, but not always access to the conventional funding channels that nondiverse managers have access to.
2. Diverse managers do not always come from traditional backgrounds (e.g., investment banks or private equity firms), and it may be less clear to institutions how nontraditional backgrounds can translate to investment acumen.
3. Diverse managers may be subject to implicit bias, which is very hard to identify or shake.

FIGURE 3: DISTRIBUTION OF DIVERSE PRIVATE EQUITY FUNDS BY FUND SIZE, AGE AND STRATEGY



Source: SPI by StepStone, December 2023.

[7] We define new managers as those raising a Fund I; emerging manager as those raising Funds II-III.

Structure is our biggest impediment

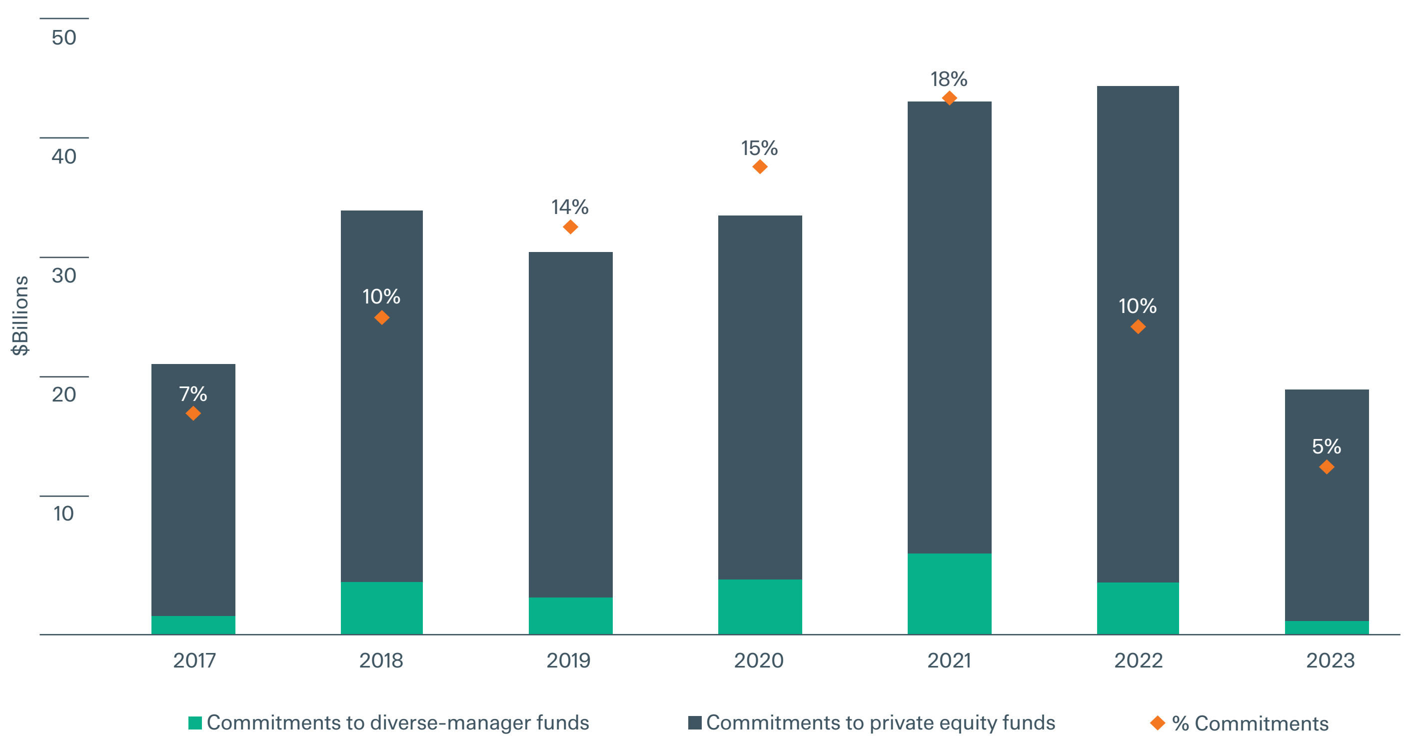
Structural disadvantages make it hard for LPs to access diverse managers (and vice versa). For LPs implementing institutional investment programs at scale, this goes from hard to harder. Resources, time and experience are prerequisites for any successful investment program. And building a diverse portfolio is no exception. It requires a large team to track and a broad network to diligence. And that's after you've decided to be intentional with your capital.

LPs must frequently contend with resource constraints when faced with the large universe of diverse managers. They must also navigate the due diligence challenges that emerging GPs present. The lack of resources and perceived risks often result in LPs prioritizing large-cap and established funds, while the long tail of compelling small-cap diverse funds remain under-allocated to.

This dynamic could become even more pervasive in the face of economic headwinds that have exacerbated the overall funding gap for diverse managers. Over the past 24 months, commitments to diverse funds have declined by 85%, resulting in a 71% decrease in the percentage of total commitments going to diverse managers.

The recent drop highlights our concern that challenging economic conditions affect small, diverse and emerging managers disproportionately. And yet, as LPs flock to larger, more familiar managers at the upper end of the market, the opportunity to generate alpha at the lower end is even greater.

FIGURE 4: DIVERSE PRIVATE EQUITY FUND COMMITMENT TRENDS



Source: SPI by StepStone, as of December 31, 2023.
Note: Reflects 6,776 private equity funds tracked in SPI Reporting, StepStone's monitoring and reporting database.

	Direct	Separately managed account	Fund of funds
Description	LP takes full responsibility for manager selection, GP access, due diligence, legal negotiation and relationship management	LP commits capital to a "fund of one" in partnership with a capital allocator with customized portfolio construction, exposure goals or other target profiles set by the LP	LP commits capital to a commingled fund product in order to receive diversified exposure
LP influence	Full discretion	Customized up front; LPs retain influence GP referrals considered for SMA	No discretion; LP is one of many GP referrals may be considered
Strategy exposure	Diversified; LP portfolios typically skew large market	Customized; access to small & mid-market	Diversified; access to small & mid-market
Internal time & resources	High	Low	None
Additional fees	None	~50–100bps, on average	~50–100bps, on average
Commitment size (minimum)	~$10M	~$100M	~$5M
No. of commitments	Multiple	Single	Single

Accessing diversity at scale

Overlooking one's exposure to diverse managers when building a private equity portfolio is a significant missed opportunity. While the structural challenges that many institutional LPs face are not easily addressed, there are several options available to investors:

- Partner with a private markets specialist to serve as an extension of your investment team to find and vet diverse funds;
- Invest in a fund of funds with a diverse investment mandate; and/or
- Set up a bespoke separately managed account targeting diverse funds.

Bottom line

The diverse-manager market has never been larger, and we believe it has never been more attractive. The body of research supporting and level of interest in the investment opportunity are perhaps at an all-time high. However, despite progress to date, diverse managers remain significantly overlooked and under-allocated to. To make progress, LPs must be intentional about putting actual dollars to work.

1. Educate yourself on the opportunity set.
2. Evaluate the options available to you to increase exposure.
3. Set achievable long-term goals.

Whether you're launching a new effort or expanding a current program, we have found investing in diverse managers to be well worth the effort. So we encourage you to "Fight the Urge." Don't let the denominator effect, allocation cutbacks or economic uncertainty affect the most impactful part of your portfolio. Not only do we risk losing years of momentum it took to see an improvement in the number of diverse funds raised, but we also risk depriving ourselves of the potential diversification and performance benefits associated with investing in diverse funds.

All data is as of May 2024 unless otherwise noted.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. ACTUAL PERFORMANCE MAY VARY.

We are global private markets specialists delivering tailored investment solutions, advisory services, and impactful, data-driven insights to the world's investors. Leveraging the power of our platform and our peerless intelligence across sectors, strategies, and geographies, we help identify the advantages and the answers our clients need to succeed.

For more information regarding StepStone's research, please contact us at research@stepstonegroup.com.

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