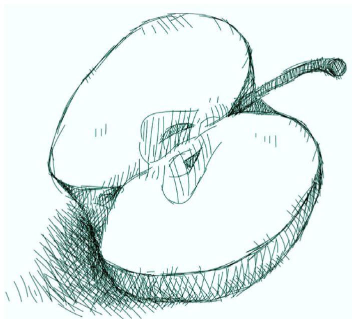
Like Them Apples? Check Twice Before Sipping the Cider.

The phrase "How do you like them apples" emerged, we're told, from World War I trenches where the British artillery corps lobbed mortars the shape of toffee apples toward enemy lines. It almost certainly gained modern currency when Matt Damon's character in the 1997 film *Good Will Hunting* famously posed the same question to an uppity grad student. The scene took place just a few blocks from TIFF's Cambridge office, and as we walk past that corner we sometimes think to ourselves, "What if that grad student in *Good Will Hunting* didn't like apples?"



When money managers offer us a piece of fruit – i.e., when they present their investment performance – our first instinct is to take a bite and chew carefully. It's the best way to know for sure that the fruit on offer is an apple to be compared with other apples and not – as the cliché tells us – some sort of bad fruit salad featuring oranges, too. But this essay isn't about fruit salad. It's about knowing how critical it is to assess private investment performance with sufficient care and to make appropriate comparisons.

In our business, we are constantly assessing the track records not only of the private investment managers to whom we allocate capital but also those being monitored for future allocations. We expect our members to focus the same kind of scrutiny on us. Reporting past investment performance is not a strictly mechanical task, and reviewing it shouldn't be either. While certain private investment measurements have become nearly universal – internal rate of return (IRR), total value to paid-in multiple (TVPI), etc. – there is enough flexibility in the way those measurements can be portrayed that investors must be ready to dig beneath the surface. Only then can an astute investor understand the full impact of fees and expenses, for example, and see clearly the effectiveness of one manager over another.

Before we get to some examples of the subtleties we look for, a very brief summary of the relevant law governing performance reporting may be worthwhile. First of all, the relevant securities laws define the term "advertisement" very broadly; basically anything other than a one-on-one presentation could be considered an act of advertising. In the world of registered investment companies, i.e., mutual funds, there are some very precise rules about how performance results in "advertisements" must be portrayed. Even with the expansion of regulations governing privately offered investment funds, however, performance reporting is still largely governed less by precise rules and more by broad standards. Section 206 of the Investment Advisers Act of 1940 states:

> *It shall be unlawful for any investment adviser ... to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.*

Rule 206(4)-1 promulgated under the Advisers Act clarifies that requirement slightly and, some would say, obviously:

> *It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act for any investment adviser registered or required to be registered under section 203 of the Act, directly or indirectly, to publish, circulate, or distribute any advertisement ... [w]hich contains any untrue statement of a material fact, or which is otherwise false or misleading.*

In the new regulatory regime in which nearly all investment advisers are required to register with the Securities and Exchange Commission (SEC), all performance reporting is subject to the following common sense standard: Don't be false or misleading. But what is misleading? The SEC has in some areas clarified its view on certain finite issues, but to a large extent investment advisers are left to use their judgment. We are hesitant to say that any investment adviser presents data in a manner that is intentionally misleading, but because presentation is not strictly prescribed – nor should it be, in our view – there is potential for confusion.

There is a good chance the important process of cold-

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eyed data sifting by investors is about to become even more critical. Legislation signed into law earlier this year, the Jumpstart Our Business Startups Act (or JOBS Act, for short), may result in many more public solicitations for private equity vehicles. The relevant portion of the act won't be fully effective until the SEC writes the specific rules. As we craft this essay, the process is delayed but nearing completion (the SEC issued proposed amendments in August 2012). Until the JOBS Act, "general solicitations" by private equity fund managers were prohibited. The policy argument was that complex private funds could not be sufficiently understood by the average investor. It is this restriction on "general solicitations" that has required us to limit the mailing list for our PI fund offering materials and caused us to park our PI quarterly reports on the password-protected portion of our website. Among other things, the JOBS Act aims to remove the restrictions on "general solicitations."

Does the IRR shown for that home run deal include the management fee and carried interest? It isn't always clear.

In our view, this feature of the JOBS Act has some real value. Supreme Court Justice Louis Brandeis said it best when he famously wrote that "sunlight is the best disinfectant." The more private fund advertisements can be disclosed publicly, the better investors can be informed. We are tempering our enthusiasm for this potential new transparency, however. Eliminating the "general solicitation" requirement will open a fire hose of private fund advertisements on us, on our members, and on the market generally.

So what should investors look out for as they sip from that fire hose? A good place to start is fees and expenses. Here, it's not only important to look for the words "gross" and "net" but what those terms mean specifically. Many private equity managers present their track records not only by providing the overall performance of past funds but also by showing the performance of each individual deal. But do the returns shown for that home run deal include the management fee and carried interest we paid? It isn't always clear. A venture capital manager with premium fee terms (let's say a 2.5% management fee plus 30% of all profits) might generate a 10x return on an investment, gross of fees. If it took them 10 years to achieve that result, the actual cash returned to investors, net of fees, is closer to 7x. That's nothing to complain about, to be sure, but a deal that generates a 9x return, gross of fees, by a manager who charges the more typical 2% management fee plus 20% of profits delivers a slightly higher net return to its investors.

Funds of funds, like TIFF's private equity funds, present further complexity for investors, because there are two levels of fees and expenses. Investors pay the manager of a fund of funds fees to conduct research aimed at selecting superior underlying managers and monitoring the work of those managers. The underlying managers also charge fees for their investment work steering their portfolio companies toward (one hopes) successful exits. Different managers use different terms to indicate what is included or excluded in their performance data. At TIFF, we prefer the simplicity of "net" (all levels of fees included) and "gross" (only the underlying manager's fees and carried interest).

Beyond fees, another feature of fund advertisements that should draw close investor scrutiny is the case study, or what might be termed investment highlights. Here, managers can arguably engage in another exercise involving fruit – "cherry-picking," or presenting results that may not give a full picture of the manager's performance track record. Recall that the Advisers Act makes it unlawful for an investment adviser to distribute advertisements that are misleading. When it comes to presenting selected examples of past investments, the SEC has provided some direct guidance of what it might consider misleading but has not prohibited the practice completely. The term "cherry-picking" has developed negative connotations, and for good reason. Any investment adviser could present an outstanding track record if the adviser presented only successes.

In some situations, however, examining a subset of a manager's past results is appropriate. For example,

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imagine that a global buyout fund manager decides to form an Asia-focused fund. In evaluating a potential investment in that fund, we would want to focus on the team that has led past Asia deals and how those deals performed relative to other comparable Asia-focused funds. Comparing the manager's full, global track record to Asia-focused alternatives would be comparing apples to oranges. (Note that we'd also want to be clear whether or not the performance presented for those selected Asian deals is net of the manager's fees!).

Those of you who have seen the Offering Memoranda for TIFF's recent private equity funds may note that we engage in a form of selection in the addendum listing "Representative Private Equity Managers." Essentially, the list shows our active manager relationships in the private equity arena to provide a sense of those managers that may be selected for the TIFF fund on offer. Each year, we revisit this list and ask ourselves, "Will we continue funding this manager?" If a manager is unlikely to form another fund, or if we have made a decision not to invest in the manager's most recent fund, we remove the name from the list. That often means we're cutting managers whose performance has lagged, but it also means we're eliminating certain brand name managers. The latter group may have served our funds well but fails to make the cut on our assessment of factors unrelated to performance.

Reporting the numerical past performance of only those managers appearing in our "representative" list, however, could be misleading. It could create the impression that future TIFF private equity funds will experience similar performance, and that's certainly not a promise we can or wish to make. Some managers may not be able to replicate past successes (and some might exceed them). We might discover new managers who don't live up to lofty expectations. A member would be right to be skeptical of such a selective performance number. Similarly, we look critically at case studies or subsets of a manager's track record when we research potential managers for TIFF funds. What does such a track record really show? What is being left out? Is it repeatable? Is it representative of the investment we're being offered?

The lessons of evaluating an investment adviser's performance cannot be reduced to a simple formula. Sometimes, an apples-to-apples comparison is essential. At other times, seeing the entire fruit salad can be useful, so long as you know the real ingredients. Even picking just the cherries out of the bowl is fine if it's relevant to the specific research at hand and placed in a proper context. We do, however, have a simple protocol for responding to the question "How do you like them apples?" We never ask ourselves how we like them before we've confirmed what they really are. ■

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