

Emerging Manager Strategy

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Conventional wisdom is that [emerging managers \(EMs\) outperform](#), and increased volatility is a worthy trade-off for a potentially higher return profile. But what does that outperformance mean? Beating 'average performance' means very little, especially in comparison to sophisticated core manager strategies.

From a purely performance-driven point of view, it's a difficult case to make. A few questions remain:

- Can index coverage reduce volatility and preserve the performance edge?
- Can an EM strategy contribute to the success of a core manager strategy?
- Given the challenge of EM selection, where do you even begin?

To reduce this to one question: how can an EM strategy meaningfully increase exposure to the few generationally important companies?

Why this is interesting today

VC strategies must survive across all markets and support consistent allocation; adjusting investment pace or scale to the market rarely makes sense. However, significant and sustained evolution of the venture strategy should spur evolution from LPs.

Today, there's a much-discussed bifurcation of venture into 'asset gatherers' and 'traditional managers', with some [hollowing-out of the middle](#). This evolution is the result of about 13 years of low interest rates, but is now a fixture of the venture market.

For EM's, who raise the smallest funds, this bifurcation puts a spotlight on performance (specifically, time to meaningful DPI) in a way that hasn't been common since the post-dotcom/pre-GFC period. Practices are adapting, liquidity strategies are becoming more sophisticated, and there's growing awareness of pitfalls like overcapitalisation or overconcentration — essentially, how the 'traditional VC' strategy must diverge from the 'asset gatherers'.

It seems likely that these conditions (combined with a potential operational edge from AI) ought to produce a generation of exceptional EMs, as well as greater levels of churn in the top quartile of established GPs. However, selection remains a challenge.

Index

There are three reasons to allocate to emerging managers:

- 1) Contributing to the overall health of the VC ecosystem
- 2) An option on future breakout firms
- 3) Casting the widest possible net for top 1% outcomes

If we agree that 2) is essentially luck due to the inherent lack of track record and no obvious parallel experience, then for 3) we must look through the GPs themselves to their intended portfolio.

From the pool of qualified prospects (more below), the sourcing, thesis, geography and network of each should be examined to build broad-based and diversified coverage of underlying companies.

The lack of data on EM strategy and performance makes determining an ideal structure challenging. However, research suggests that [40-45 fund investments](#) may be the ideal size for an LP pursuing a venture capital strategy where selection is challenging (i.e. in contrast to a core manager strategy). [Gredil et al. \(2024\)](#) suggests that 50 funds would represent a 'fully diversified' strategy without diminishing returns, which would be suitable for an index strategy given the [U-shaped relationship](#) of diversification and performance.

Example Fund of Funds Structure:

Component	Description	Allocation (\$)	Percentage (%)
Fund Investments	Anchor checks in 50 emerging manager funds (\$6.3M each, avg. 15% of \$41.7M fund size)	\$315,000,000	~89.9%
Management Fees	Standard FoF fees (blended ~0.75% annually over 15 years)	\$35,500,000	~10.1%
Total Fund Size		\$350,500,000	100%

Eliminate

While selecting good EMs is a challenge, as described above, it is possible to screen managers based on three research-backed criteria. Are they...

- **Educated**
- **Motivated**
- **Differentiated**

Educated

How well do they understand the systems that underpin venture capital? At least the fundamentals of finance and economics. Exit markets and liquidity. Running businesses, developing technology, hiring and scaling. Not to be confused with generic MBA-type experience.

"Fund management teams with more task-specific human capital, as measured by more managers having past experience as venture capitalists and by more managers having past experience as executives at start-up companies, manage funds with greater fractions of portfolio company exits. I also find that fund management teams with more industry-specific human capital in strategy and management consulting and, to a lesser extent, engineering and non-venture finance manage funds with greater fractions of portfolio company exits."

[The Role of Top Management Team Human Capital in Venture Capital Markets: Evidence from First-Time Funds](#)

"The results do indicate a positive relationship between the proportion of investors with a degree in science/engineering or law and the probability of a successful exit. In the context of the venture capital model, investors with a degree in science/engineering might be better able to deal with technological risk. A law degree might be beneficial in contracting, for example when creating term sheets."

[Investor Human Capital in Venture Capital Firms: The Effect of Experience and Education on Investment Risk and Investment Performance](#)

Motivated

Are they raising a fund because they want to find the most important companies of each generation? Or are they looking to chase a hot market, exploit relationships, or further a particular cause?

"The market for follow-on capital discourages risk taking by venture capital fund managers. The amount of follow-on capital raised by venture capitalists is concave with respect to current fund performance. In addition, managers with less consistent performance are slower, and less likely, to raise a follow-on fund. Venture capitalists adjust their investment strategy to balance fundraising incentives against the incentive to pursue risk provided by carried interest."

[Venture capital and career concerns](#)

"I have shown evidence that indicates investors are systematically underperforming and systematically over-relying on certain signals of quality. The findings are consistent with misprediction and attentional biases and that is my preferred interpretation. However, other mechanisms could be at play and that would make it inappropriate to label these choices mistakes. For example, the incentive structure may not be well-aligned between principal and investor, and/or investors could have a rich set of preferences that includes reasons to tradeoff financial returns in favor of say interpersonal relationships, administrative ease, or simple effort reduction."

[Predictably Bad Investments: Evidence from venture capitalists](#)

Differentiated

Do they have a perspective which is aligned with identifying true outliers? Or are they looking to simply emulate renowned managers, build relationships, pattern match, and follow outdated industry wisdom?

"Our results suggest that herd behavior in the venture capital market are driven by positive signals of essential information and a higher degree of information uncertainty. However, we find no evidence of the influence of feedback trading signals on herding among venture capitalists. Further analysis suggests that a better external information environment would help weaken the herding among venture capitalists, while their reputation concerns might amplify the

herding effect. Finally, we examine the economic consequence of the herding and find that the herd behavior of venture capitalists would have an adverse effect on their exit performance."

[Herd Behavior in Venture Capital Market: Evidence from China](#)

"We find that higher levels of past coinvestment activity leads to fewer, not more new coinvestments. Moreover, higher levels of past coinvestment lead to lower exit performance, a result that continues to hold after controlling for endogeneity. The empirical analysis suggests that the negative performance effect of deeper relationships comes first, followed by a somewhat slower retrenchment from deeper relationships."

[Getting Tired of Your Friends: The Dynamics of Venture Capital Relationships](#)

Thus, there should be an appropriate level of due diligence to remove predictably bad managers – not trying to select good ones – introducing minimal selection bias and remaining fundamentally open-minded in order to catch '[outlier GPs](#)'.

Co-invest (?)

Optionally, a fourth reason to invest in an index of emerging managers is where an LP wishes to pursue a co-investment strategy and have a large number of opportunities to select from. Co-investing increases workload and capital requirement (risk), but enables greater 'process alpha' from an otherwise heavily diversified strategy, and utility for the portfolio GPs. However, this requires its own deliberate strategy:

"For VC the results suggest that larger portfolios, of 20 or more, deals are required, and that significant out-performance (relative to fund investing) is only achieved if the GPs do not charge fees and carried interest on the co-investments."

[Adverse Selection and the Performance of Private Equity Co-Investments](#)

Example Fund of Funds with Co-investments:

Component	Description	Allocation (\$)	Percentage (%)
Fund Investments	Anchor checks in 50 emerging manager funds (\$6.25M each, avg. 15% of <u>\$41.7M</u> fund size)	\$312,500,000	~70.2%
Co-investments	Direct investments in 25 top-performing underlying companies (~\$3.5M each)	\$87,500,000	~19.7%

Management Fees	Standard FoF fees: 1.25% annually (years 1–5), 0.5% annually (years 6–15) totaling \$45M	\$45,000,000	~10.1%
Total Fund Size		\$445,000,000	100%

Conclusion

The objective is an EM strategy which offers a consistent improvement on existing aggregate returns through greater diversification and a different profile for liquidity that offers [greater stability over hot and cold markets](#).

The ultimate distribution of capital would be much wider, reaching darker corners —a broader range of geographies and sectors — increasing the odds of exposure to the most important companies.

For the most successful EMs who develop into top-performing established managers, this also provides an on-ramp into a core manager strategy.

Finally, the data gathered from broad exposure to early-stage managers adds further value to market intelligence.