What GPs Don't Know About LP Risk Tolerance

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Private equity comes with a level of risk that's inherently higher than other, more liquid investment options. And when GPs are perceived to be underplaying risk or managing it poorly, it can negatively impact their reputation and their ability to attract investors.

But when a panel of GPs and LPs explored the issue at the 2017 SuperReturn CFO / COO forum, they discovered that GPs may be fundamentally misunderstanding LPs' attitudes and expectations around investment risk. Here are some of the key insights:

LPs are not afraid of risk

GPs may assume that their investors are risk-averse and expect the fund manager to find ways to eliminate risk. In fact, LPs have more tolerance for risk and a more realistic perspective on risk than many fund managers give them credit for.

LPs recognise that the element of risk is what enables them to see attractive returns, but they want to know what the fund manager is doing to identify risk, what risks they have identified, and what they are doing to manage those risks. If the fund manager can provide a list of potential risks and a clear plan for managing them, they will have gone some way to addressing the LP's concerns, increased their comfort, and built trust.

Tolerance levels vary widely

Different types of LPs—a pension fund versus a sovereign wealth fund, for example—will have different tolerances for risk. Generally, an LP's tolerance towards investment risk will mirror their tolerance for risk internally within their firm.

Regional differences can also affect risk tolerance, and some GPs have started to create products with lower risk profiles in order to appeal to investors in more risk-averse regions, such as Germany.

ESG is important

GPs often don't understand why LPs are asking for an ESG framework, but this information is an important part of the investment's overall risk profile. LPs are increasingly using ESG factors to evaluate the potential resilience and performance of an investment, and they want to know that their fund manager is managing the risks from an environmental, social, and governance perspective. LPs may also have a responsibility to their investors to ensure that they are not investing their money irresponsibly.

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Centralise the data

For most GPs, risk-related data is collected by the deal team, the finance team, and other business functions. Each group holds a piece of the puzzle, but being able to consolidate that data on a centralised platform helps to build up a more complete and in-depth picture of the overall risk. Many LPs are looking for the centralisation of risk data and the risk management function because it indicates that the GP is taking investment risk seriously and investing in supporting processes.

Operations are a factor

Increasingly, LPs are factoring the GP's operations into the overall risk profile of the investment. Many are now performing a complete operational review and evaluating deals based not only on the strength of the investment thesis, but on the strength of the GP's back office function, including process efficiency, data integrity, and cybersecurity. Investors are recognising that a firm's ability to manage its own business is related to its ability to manage its portfolio companies. If they don't see secure and efficient operations, they will be concerned and ultimately may walk away.

Ongoing monitoring is key

LPs want to know about the investment's risk profile during the due diligence process, but their interest in risk doesn't end when the deal closes. They want to know that the GP is continually revisiting and revising the risk profile and the risk management strategy as the portfolio develops. Have new risk factors been introduced? Has the political, currency, or market risk changed over time? These changes need to be communicated to LPs as they happen, along with the new plan for responding to emerging risks.

While LPs have more tolerance for risk and a more realistic perspective on risk than many fund managers give them credit for, they do want to see that the GP has the appropriate risk-management strategies in place. They may not be more risk-averse, but they are definitely more risk-aware. Ultimately, they want know that GPs are sharing the risks with them openly, evaluating them realistically, and addressing them proactively.

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