

SUMMER
2025

5647.199

4096.56

3010.33

4333.55

2745.31

SURVIVAL OF THE FITTEST?

Real Estate Thrives in Fundraising
Despite Underperformance



Jared Chase
PREA

Why do investors put up with poor performance from real estate managers when they don't with buyout and venture capital managers? Limited partners (LPs) may prioritize factors other than internal rates of return (IRRs) when selecting real estate managers, find Tim Riddiough, James A. Graaskamp Chair in Real Estate, Wisconsin School of Business, and Da Li, Riddiough's Research Assistant and recent PhD student, in a new paper. They spoke with Jacques Gordon, Director of the Graaskamp Center for Real Estate at the Wisconsin School of Business, about real estate's high survival rate, why it might have come about, and the directions in which recent and future research in this area is pointing. PREA's Jared Chase shares highlights of their conversation.

Unnatural Selection

The conventional industry narrative is that fund investors seek out top-performing managers, whose unique skill is revealed through a growing track record of outstanding returns. Over time, less-skilled fund managers are deprived of new capital, exiting the market as their more-capable peers remain in a survival-of-the-fittest model. Riddiough and Li applied this model to private equity real estate for the first time, alongside buyout and venture capital firms.

"We decided to look at the industry as a whole as fund managers entered and exited." —Tim Riddiough

What did they find? Buyout and venture capital largely follow the Darwinian model. Real estate, however, does not—even non-core strategies that should outperform. After the fourth fund in a series, underperforming managers do not get chopped at higher rates; instead, they continue to raise capital.

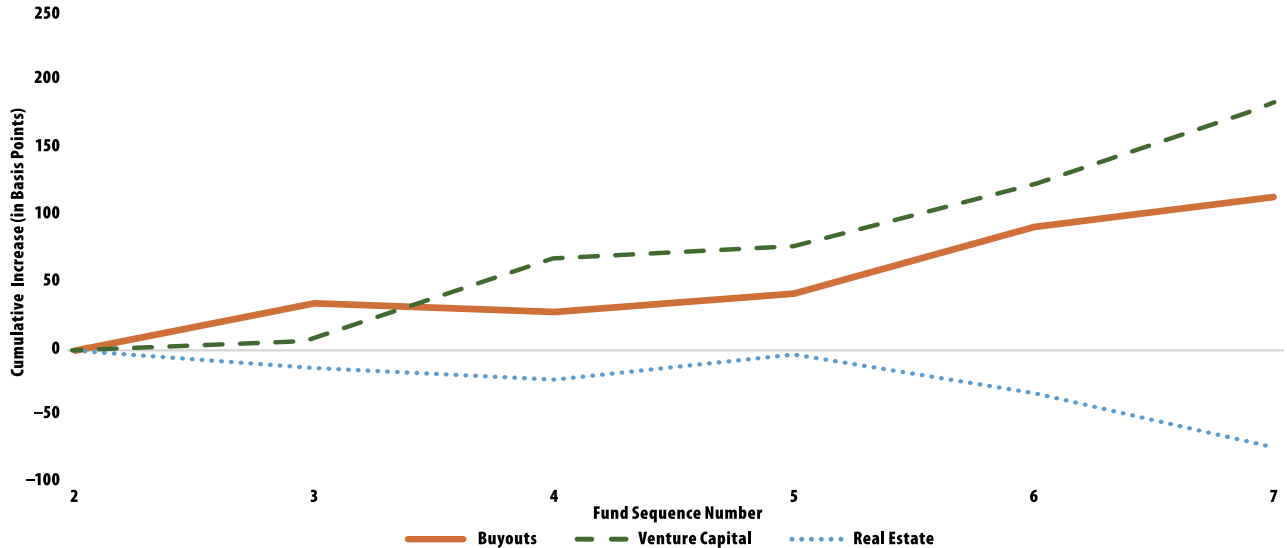
This has implications for the risk-adjusted performance of subsequent funds. In real estate, Riddiough and Li found, neither positive lagged performance (earlier returns above zero) nor fund sequence number had a systematic bearing on later returns. However, negative lagged historical performance regularly led to negative returns in later funds, producing the positive coefficient shown in Exhibit 1.

Exhibit 1: The Combined Effects (from a Regression) of Last Fund Performance, Fund Size, and Fund Sequence (LP Selection) on Risk-Adjusted Performance

	Buyout	Venture Capital	Real Estate
Lagged Performance (+)	Positive	None	None
Lagged Performance (-)	None	Positive	Positive
Fund Size	Negative	None	Negative
Fund Sequence Number	None	Positive	None

Source: Tim Riddiough and Da Li, based on data from Prequin

Exhibit 2: Cumulative Effects of Fund Manager Selection Over a Seven-Fund Sequence



Source: Tim Riddiough and Da Li, based on data from Prequin

They found evidence of diseconomies of fund size in both real estate and among buyout firms, meaning bigger funds generally underperformed. Within real estate, private fund returns lagged those of REITs, notable for those expecting an illiquidity premium for private real estate.

The patterns seen in the real estate sector take a cumulative toll. Whereas buyout and venture capital fund selection is accretive to performance, adding 18 and 35 basis points (bps) per year on average, respectively, in real estate, fund selection subtracts an average of 14 bps annually (Exhibit 2).

“Why would an LP re-up a fund series after a subpar vintage year?”

—Jacques Gordon

Why Is Real Estate Different?

In Riddiough and Li’s paper “[Persistently Poor Performance in Private Equity Real Estate](#),” they proposed possible explanations for their findings, as did PREA Institute participants during a discussion of the paper at

this year’s Institute in Chicago. Among the explanations put forward are these:

Special Terms

The acceptance of lower headline returns could be explained by the inducements some managers offer, such as lower fees or side letters conferring access to coinvestment and other opportunities.

Risk and Volatility

Half of real estate holdings are held by pension funds, whereas the holdings of buyout and venture capital, at 10%, are considerably less. Therefore, the risk and volatility preferences of pension funds may predominate in real estate:

■ Pension funds may particularly value the net-asset-value smoothing that real estate offers. Lower volatility has value. This explains why underperformance versus REITs is often ignored.

“The investor may be trading off net-of-fee return in order not to have to observe volatility.” —Tim Riddiough



■ The fiduciary duty of prudence set forth in the Employee Retirement Income Security Act of 1974 (ERISA) focuses the attention of pension fund investors on reducing risk, perhaps leading to stickiness in their general partner (GP) relationships to limit their downside exposure.

“LPs really stick with the name brand through thick and thin, perhaps with the expectation that in bad markets the [managers] aren’t going to lose more money than anybody else, so the [LPs’] downside is limited.”

—Tim Riddiough

People Power

■ Perhaps it’s an agency issue: brand names matter, and LPs who previously worked as GPs might give their one-time employers a leg up.

■ Formal and informal relationship networks are important in the real estate industry and could help explain these findings. In fact, in a 2024 paper (“Good Versus Bad Networking in Private Equity Pension Fund Investment”), Li and Riddiough examined how strong investor networks relate to better manager selection, lower risk investments, and better performance. Conversely, they found weaker networks correlate with worse outcomes.

“[Through certain networks, investors] are more likely to be locked up in preexisting relationships, so they keep investing in the follow-on funds raised by the same fund manager.”

—Da Li

Could It Be About Benchmarking?

Following the finance literature, Riddiough and Li benchmarked the performance of real estate, buyouts, and venture capital to liquid, exchange-traded assets in their paper. Gordon questioned this approach, given that so many real estate investors benchmark against private market indices. The authors offered several explanations:

- Li and Riddiough adopted an asset pricing model, incorporating beta to account for REIT market exposures. This is a standard approach in the finance literature, which assumes that investors in private markets expect an illiquidity premium versus listed securities.
- Leverage, liquidity, and development factors all point to higher levels of risk for private real estate, suggesting that it should, if anything, outperform REIT-based benchmarks.
- The authors found the same results when using IRR as the performance criterion.

Managers Course Correcting?

Gordon asked about the possibility that investors retain underperforming managers with the understanding that the latter could change their strategies in subsequent rounds, boosting performance. While more evidence is needed to support that hypothesis, Li and Riddiough agreed it is possible that managers could use such opportunities to “get back to basics” with smaller fund raises, fix any problems of style drift, or rotate into advantageous sectors.

Follow-Ups and New Frontiers

Riddiough and Li recently published two RERI-funded papers that illuminate their earlier findings:

- “[Search Frictions, Fund Manager Skill, and Net-of-Fee Performance in Private Equity](#)” develops and deploys a model that links manager search frictions, adverse selection, and net-of-fee profitability.
- “[Good Versus Bad Networking in Private Equity Pension Fund Investment](#),” mentioned earlier, looks at the strength of investors’ networks and how they relate to the likelihood of manager lock-in, to the investment risks undertaken, and ultimately to investment performance.

Looking forward, the authors have a forthcoming paper in the *Journal of Portfolio Management* that will delve into many of the benchmarking, risk aversion, and other explanations for GP persistence covered in this article.

Riddiough and Li welcome opportunities to examine asset-level data and other unique or proprietary information to add to this groundbreaking line of research.

PREA wishes to thank Tim Riddiough, Da Li, Jacques Gordon, and all who shared their insights at the 2025 PREA Institute for adding valuably to participants’ understanding of real estate fund performance and persistence ■

Jared Chase is the Staff Writer and Editor at PREA.