PitchBook

# Investors just don’t wanna have funds-of-funds

## Traditional FoFs decline as LPs look beyond cookie-cutter allocations

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## Key Takeaways

- Funds-of-funds (FoF) fundraising activity in 2016 slipped for the fourth consecutive year, falling to the lowest level since 2003, and it appears that 2017 is primed for another downtick. Importantly, this comes at a time when fundraising for other private capital strategies has surged to near-record levels.

- FoFs face several criticisms from investors, but the most important is a history of lackluster performance. This bears itself out in the data: the median buyout fund for 2001–2013 vintages consistently outperforms the median FoF, suggesting that manager selection abilities of FoFs leave much to be desired.

- At this point, it seems safe to say that the traditional FoF model is all but dead; however, that doesn’t mean that FoFs are entirely doomed. Some FoF managers have revamped their approach and are now offering what are being billed as annual private equity programs while others have gravitated to niche areas, promoting themselves as a means for limited partners to enter unknown areas of the market.

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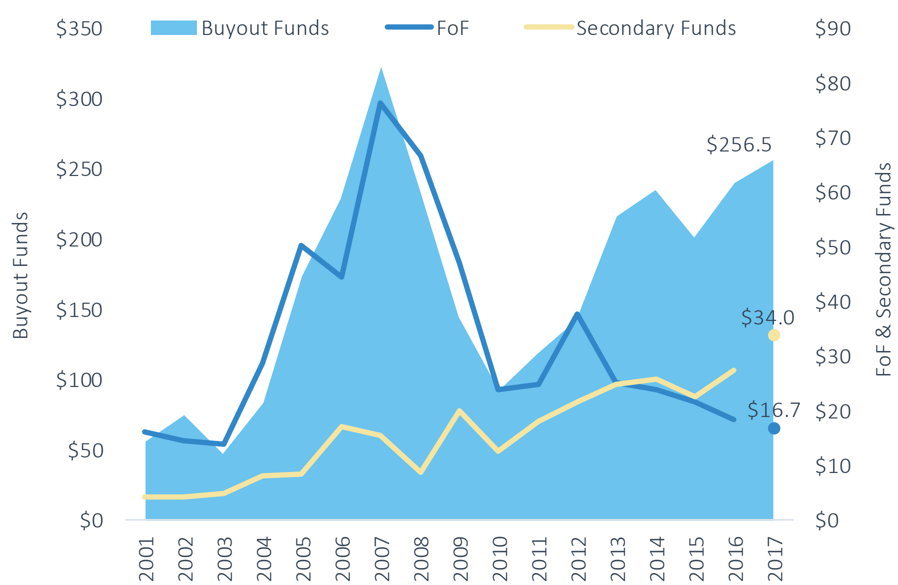
## Introduction

In recent years, alternative asset managers have spent considerable time rethinking the channels through which limited partners (LPs) access private capital funds. Highly sophisticated institutional investors have been the targets of many of these initiatives, including the advent of general partner (GP) stakes investing and the development of the secondaries market. At the same time, asset managers have continued innovating to make private capital markets more accessible for the masses, who now enjoy access points via liquid alt funds, publicly traded PE firms, and indices that mimic private market strategies. As investors have gravitated towards one side or the other, more traditional access options—namely FoFs—have suffered.

The disenchantment with FoFs is clear in the data: FoF fundraising activity in 2016 slipped for the fourth consecutive year, falling to the lowest level since 2003, and it appears that 2017 is primed for another downtick. Importantly, this comes at a time when fundraising for other private capital strategies has surged to near-record levels. At this point, it seems safe to say that the traditional FoF model is all but dead; however, that doesn't mean that FoFs are entirely doomed. Indeed, many firms have altered their approach to FoFs in recent years in response to the shifting private market landscape and the changing preferences of LPs.

Capital raised ($B)




Source: PitchBook
*As of 11/17/2017

## Stuck in the Middle

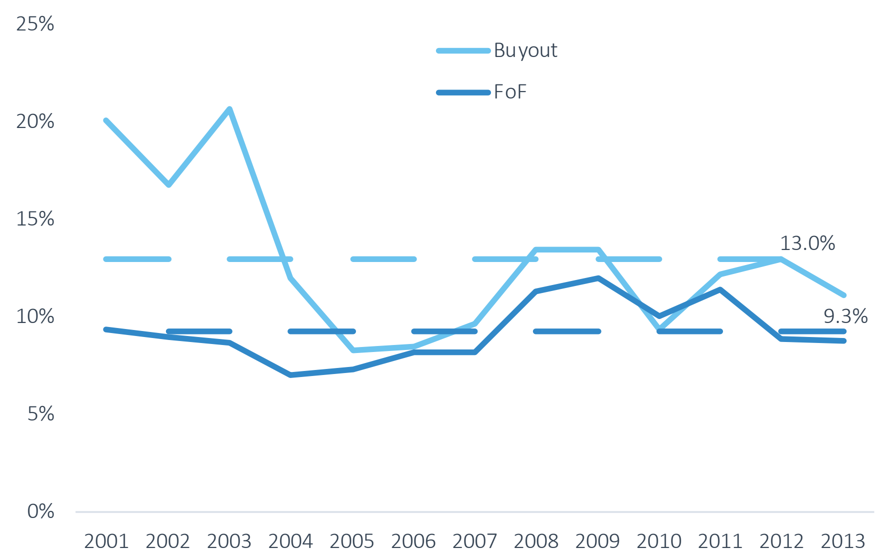
*It is difficult enough to find one superior manager, let alone the dozen or more that it takes to fully allocate a FoF.*

When it comes to active management—whether in private or public markets—there is inevitably going to be a wide range of skill and alpha potential amongst managers. To that end, one of the main selling points of FoFs is their ability to identify and access top-caliber managers. Underlying GPs and their funds must be evaluated on a range of criteria to determine the risk/return potential. In many ways, choosing GPs is akin to picking stocks, bonds or any other type of investment, but with the added challenge of assessing factors such as the GPs' succession plan and workplace culture, which are crucial to consider when committing capital for a decade or more.

As such, what may be overlooked is that the manager selection process undertaken by FoFs represents an active management strategy in and of itself; it is difficult enough to find one superior manager, let alone the dozen or more required for full allocation by a FoF. This bears itself out in the data: the median buyout fund for 2001-2013 vintages consistently outperforms the median FoF, suggesting that manager selection abilities of FoFs leave much to be desired[1].

1: While FoFs allocate capital to a wide range of underlying fund strategies, all of the performance comparisons in this note are conducted against buyout funds.

Median global IRR by fund vintage




Source: PitchBook
*As of 11/17/2017. The dotted line represents the long-term average.

### FINDING AN EDGE

The performance story changes when looking at VC funds, the returns of which have lagged FoFs—a finding that corroborates recent research[3]. While all of the data in this note looks at FoF in aggregate, the outperformance of FoFs over VC funds holds even when examining our subset of venture-specific FoF.

Unlike generalist or buyout-focused FoFs, VC-focused FoFs are a small subset of the FoFs universe, suggesting that FoFs may have an advantage in more niche areas where there is both less competition and a higher dispersion of returns amongst managers, which makes the selection process more critical. While there has yet to be a proliferation of targeted FoFs, many firms are now raising FoFs dedicated to specific regions and underlying strategies, including debt and real assets.

3: Harris, Robert S. and Jenkinson, Tim and Kaplan, Steven N. and Stucke, Rüdiger, Financial Intermediation in Private Equity: How Well Do Funds of Funds Perform? (May 11, 2017). Darden Business School Working Paper No. 2620582. Available at SSRN: https://ssrn.com/abstract=2620582 or http://dx.doi.org/10.2139/ssrn.2620582

One reason why FoFs struggle to identify top-tier GPs is that their evaluations are often calibrated to mitigate the potential of committing to a bottom-decile/quartile manager, which likely equates to screening out managers with a riskier profile. The implicit logic is that it's better to err on the safe side and be content with "hitting doubles" than to trek further out on the risk spectrum and be in danger of "striking out."

This bias manifests itself in a variety of ways, with one of the most common being the propensity of longstanding FoFs to simply re-up with existing managers rather than taking a comprehensive look at the full slate of opportunities. This is a particularly suspect strategy given that recent research has shown a lack of performance persistence in PE[2]. Additionally, many FoFs have historically exhibited an aversion to first-time managers, despite the fact that debut funds have historically outperformed follow-on vehicles; however, this sentiment is beginning to change in some cases as FoFs strive to innovate (see sidebar).

2: Harris, Robert S. and Jenkinson, Tim and Kaplan, Steven N. and Stucke, Rüdiger, Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds (February 28, 2014). Darden Business School Working Paper No. 2304808; Fama-Miller Working Paper. Available at SSRN: https://ssrn.com/abstract=2304808 or http://dx.doi.org/10.2139/ssrn.2304808.

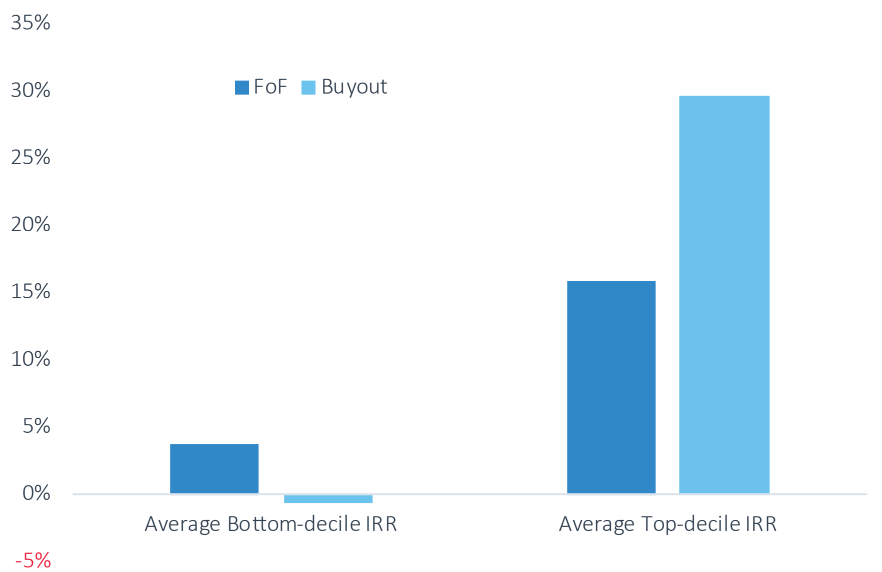
*While FoFs may offer a "higher floor," they also have a "lower ceiling"; the average top-decile IRR for FoFs is 15.8%, well behind the 29.6% for buyout funds.*

## No Risk, No Reward

FoFs' tendency towards risk aversion should theoretically lead to the selection of fewer outlier managers, meaning that the returns of FoFs in aggregate should have a "higher floor" than the underlying strategies in which they invest—and this is indeed what we find. From 2001–2013, the average bottom-decile IRR for FoFs is 3.7%, compared to -0.7% for buyout funds.

But higher risk often translates into higher potential, so the corollary of reducing outliers on the left end of the distribution is that managers with the potential to deliver superior alpha may also be screened out. So, while FoFs may offer a "higher floor", they also have a "lower ceiling"; the average top-decile IRR for FoFs is 15.8%, well behind the 29.6% for buyout funds.

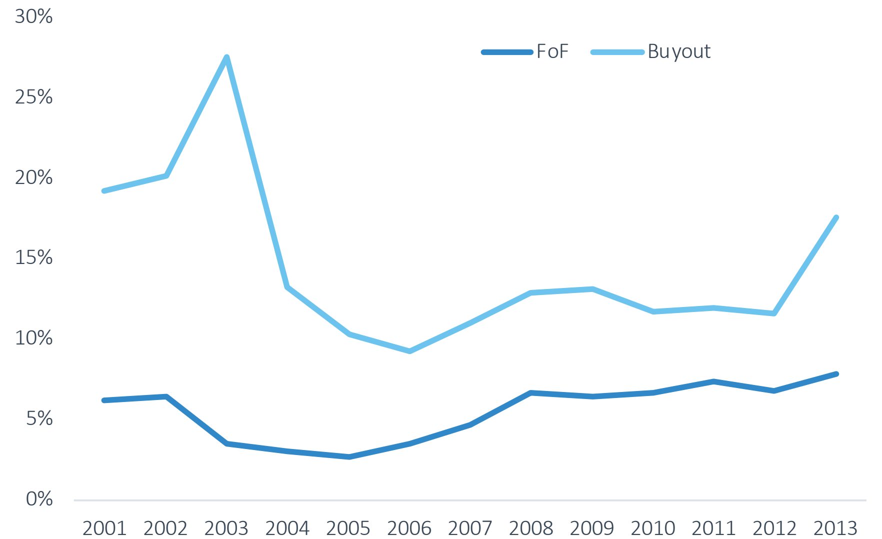
Average top & bottom-decile IRR hurdles for 2001-2013 vintages




Source: PitchBook
*As of 11/17/2017

It should not be surprising that FoF managers tend to cluster tightly around the average, with the data showing that FoFs in aggregate have delivered LPs a narrower range of performance outcomes than primary funds. For vintages 2001–2013, the average spread between top and bottom-quartile funds was 15.5% for buyout funds, but just 5.5% for FoFs.

Top & bottom quartile IRR spread by vintage




Source: PitchBook
*As of 11/17/2017

## Value Added?

In many realms of finance, investors are often willing to sacrifice some return potential in exchange for lower variance. But this rationale may not apply in the same way to alternative investment strategies, to which many LPs allocate in an explicit search for alpha. While the performance of FoFs stacks up well against many traditional asset classes, LPs are loath to pay high fees to alternative managers that trail the pack, as is the case with FoF strategies compared to buyout funds.

Indeed, one of the biggest drags on FoF performance is also one of the strategy's main criticisms: the extra layer of fees. As LPs are fiercely negotiating with GPs of all types to lower their fees, the prospect of being charged twice is often a nonstarter. FoFs will counter that many of their costs are offset by discounts they're able to negotiate with the underlying GPs of primary funds, plus they can provide access to highly sought-after funds that are oversubscribed—but these arguments have not been enough to woo investors in light of the strategy's long-term underperformance. If LPs wanted average, they would stick to cheaper, more easily accessible and liquid asset classes.

*The FoF model in many ways represents a one-size-fits-all approach and is frequently marketed as a turnkey solution for novice LPs. But, of course, no two LPs are the same.*

FoFs will argue that their value proposition for LPs shouldn't be looked at solely through the lens of performance. To be sure, a crucial element to consider when allocating to private markets is the amount of resources that need to be dedicated to managing the portfolio—a task for which many LPs are ill prepared. Relationships with managers need to be established and nurtured, complex reporting is required, and the LP must grapple with unpredictable capital calls across numerous vehicles that are at different stages of their investment cycle. For LPs who do not have the will and/or ability to undertake these tasks, the fees may be justified and FoFs could be a viable solution.

## FoF à La Carte

Fees are not the only headwind facing the traditional FoF model, though. The FoF model in many ways represents a one-size-fits-all approach and is frequently marketed as a turnkey solution for novice LPs. But, of course, no two LPs are the same. Many LPs now want more than a cookie-cutter allocation to private capital markets; they want the ability to cater exposure across strategies and geographies, while also benefiting from closer ties to underlying GPs and opportunities to co-invest—a combination that most FoFs are typically unable to provide to their numerous LPs.

In order to meet LPs' increasing demands, many FoFs and advisors have increasingly adopted separately managed accounts (SMA) or so-called fund-of-one structures that allow for more specialization. Although they're pricier than a FoF, these accounts provide more flexibility and allow the LP to tailor the mandate to their specific needs.

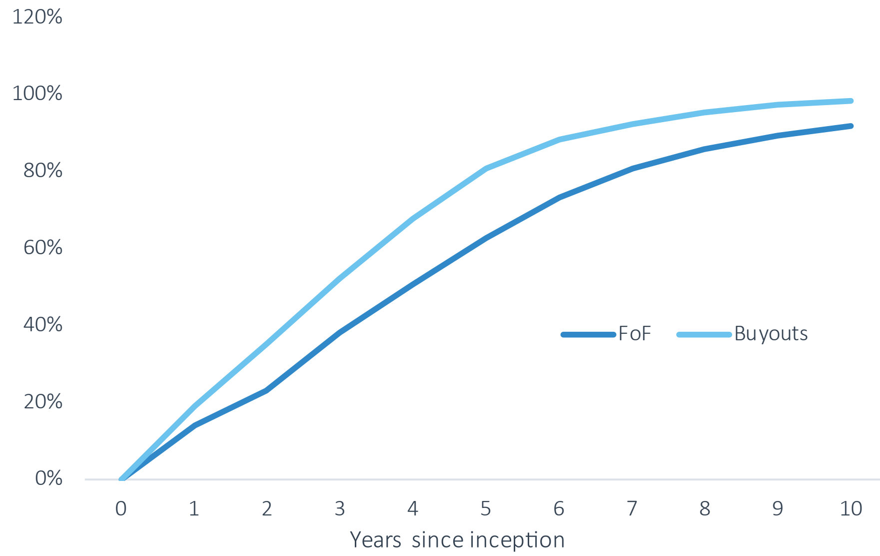
*The average FoF draws down just 63% of its capital five years after inception, compared to 81% for buyout funds.*

## Set It & Forget It

Another common criticism of FoFs is how long it takes these vehicles to deploy capital. Per the traditional model, a FoF spends a few years finding primary funds, which in turn have a predefined investment period (typically around five years) to deploy their capital. In the end, this translates to an extended timeline for FoFs; the average FoF draws down just 63% of its capital five years after inception, compared to 81% for buyout funds.

This can cause an issue for investors in what is already an illiquid asset class. Specifically, the slow drawdown poses risks from a capital allocation perspective, as commitments to private market funds should

Average called-down capital as % of fund size for 2001-2013 vintages




Source: PitchBook
*As of 11/17/2017

be distributed across vintages in order to achieve diversification across different points in the business cycle. Furthermore, LPs must find a way to efficiently allocate that capital while it is waiting to be called.

To that end, some FoF managers have revamped their approach and are now offering what are being billed as annual PE programs. Instead of raising massive vehicles every few years, these managers raise a new FoF each calendar year and strive to allocate committed capital under a truncated timeline. Examples of this strategy are proliferating quickly.

Abbot Capital raised its first FoF in the mid-1990s and experienced exponential increases in fund size as it raised subsequent vehicles every two to three years. Beginning in 2007, however, Abbot began to shift to an annual PE model with more frequent but smaller fundraises. The Goldman Sachs Alternative Investments and Manager Selection (AIMS) group has transformed in a similar fashion while Franklin Park has operated under the annual program model since its inception, offering investors a series of funds focused on venture and another that concentrates on international opportunities.

Other firms with annual programs include Hamilton Lane, The Investment Fund for Foundations (TIFF) and The Storebrand Group. Attempts to make this shift are apparent in fund names, with many firms changing their naming convention to distinguish vehicles by their vintage year, departing from the ubiquitous Roman numerals (e.g., "Private FoF 2017" instead of "Private FoF VIII").

## Who Needs Them?

Concerns about fees and customization are nothing new to FoFs, but the strategy is now facing a more existential question of whether they're still needed by LPs. As FoFs have attempted to stay relevant and differentiate themselves, some have gravitated to niche areas. This has led to small funds that bill themselves as a means for LPs to enter unknown areas of the market, with Asia and real estate being prime examples.

In addition to altering their investment approach, FoFs will likely need to target investors in novel ways if they are to persist. While FoFs increased in popularity during the fundraising boom of the early 2000s, the now widespread adoption of private capital funds by institutional LPs means that there's a dwindling number of inexperienced LPs in need of the services provided by FoFs. In fact, some of the most sophisticated LPs are building in-house PE teams that now compete against GPs directly for deals.

As institutional LPs graduate from FoFs, several prominent firms, including Blackstone and Apollo, have explicitly stated their desire to further penetrate the market of retail investors. This expansion will likely mark the next stage of the evolution of FoFs, as many of the current private market options available to retail investors are essentially forms of FoFs.