An Undying Love Affair with Funds of Funds

I have always had a soft spot for funds of funds ("FoFs"). Maybe it is because my private assets career started as FoFs were making real inroads in the industry. It could also be because I consider FoFs a cherished segment of my personal network. Or maybe it is because I regard the research of the FoFs that have kept a purist mentality (despite the pile-on tsunami of negative sentiment) to be amongst the most clear-headed.

These days, most FoF managers cringe when categorized as "funds of funds" - many of them have developed canned responses or intense rebuttals to justify why the "fund of funds" moniker is not an adequate description. It is amazing how a strategy that was such a highly regarded and useful tool for private assets portfolio building just a few years ago, has seemingly overnight become some sort of pariah. I strongly believe that FoFs, in their purest essence, have nothing to be ashamed of because their important place in the ecosystem is forever immortalized, and quite frankly, very difficult to replicate.

In the heyday of FoFs, the purpose they served was right on cue - with a slew of positive attributes that solved many investors' anxieties around private assets investing.

- These vehicles gave novice and/or experienced private assets investors a path to gain exposure to private assets managers in an efficient and effective manner.

- Investors could use a FoFs investment as a core part of a portfolio and then invest directly (through primary funds) in satellite managers around the core.

- Investors could also use a FoFs vehicle as the opportunistic part of a portfolio to gain access to alternative return characteristics that did not exist in the traditional realm.

- There was also the astute ability to use FoFs as an educational tool to learn and understand the idiosyncrasies of the asset class and then eventually strike out with a primary investment approach after a comfort level was built.

- Some investors even used FoFs strictly as a means to gain exposure to some sectors or geographies that warranted superior expertise (venture, growth, small-buyout, real assets, etc.) and/or an on-the-ground presence (China, Europe, Africa, etc.).

- Administratively, FoFs streamlined a hassle-filled private assets investment process, because although the investor was gaining exposure to multiple funds, the actual investment shows up in their portfolio as one line item. This was a convenient alternative to investing individually in multiple vehicles which would generate multiple line items and the headaches (paperwork, tax filings, capital calls, distributions, etc.) that come with that.

There were many other flavors and variations of the uses of FoFs, but the gist revolved (and still does) around having a flexible remedy that solved/fulfilled the investment issues/needs of investors in a burgeoning alternative asset class.

However, it was never all gravy with FoFs. Some investors dismissed their existence from the outset, and some investors grew weary soon after dipping their toes in these new waters. The negatives that have

been associated with FoFs are many and are also well documented. I have described them in the past as "low hanging fruit negatives" that involve very little critical thinking, but nevertheless, they are relevant enough to reiterate. These include:

- The persistent fee-upon-fee censure that renders FoFs inefficient because they are just too expensive. It is unlikely that this charge will ever let up. FoFs managers charge a fee for their services while also paying management fees for underlying strategies. These combined fees act as a drag on returns, lowering the eventual net returns.

- Overdiversification is another negative that has plagued FoFs. This argument states that although the implied diversification obtained from investing in a FoFs strategy is a good thing for downside protection (as the performance of no one fund or specific underlying fund investment will overly affect the portfolio), FoFs have a high potential to become overdiversified. Overdiversification can lead to middling returns that may not be consistent with the higher returns expected from an asset class that is illiquid and has a long duration.

- Duration is another real and sometimes perceived detractor from the attributes of FoFs. Because FoFs have a commitment/investment period (time allocated to committing to underlying funds) which is usually about three years, and underlying funds also have a commitment/investment period for deal execution which ranges from three to five years, the overall duration from start to finish of a FoFs could be extremely lengthy. This duration exacerbates the illiquidity factor which is an already contentious issue associated with private assets investing.

- Another critique related to the duration point is something that has soured many investors to the prospects of FoFs. In some instances, it has caused some FoFs managers to close shop. This has to do with the tenor of private assets investing, and it makes some strategies, such as venture capital, more susceptible to criticism in a FoFs context. Strategies that require managers to reserve relatively larger amounts of commitments for follow-on investments (or strategies that are more prone to investment staging/staggering), tend to deal with limited partner ("LP") pushback when they return to market to raise a subsequent fund. This is because the previous fund has likely just called (for investment) a small amount of capital, with the remaining to-be-called capital reserved/designated for follow-on investing. So, for example, a FoFs manager could be 30% called for a vehicle, but still have to come back to raise a subsequent fund because the remaining 70% is "spoken for" in terms of future designation. This is not an efficient scenario for the LPs of FoFs because they would have to commit to a subsequent fund without their prior commitment being fully invested.

- It has been voiced by many primary funds that FoFs are not their favorite class of investors. It is important to stress that the FoFs being referenced in this scenario are the ones that maintain selectivity and have to be efficient with the dollars they raise - this leads to a high bar for commitments. Other FoFs (the ones that have become by choice or necessity, everything to everybody) are quite loved by primary funds because of subdued selectivity and a constant flow of capital. The more selective FoFs can come across as fickle to primary funds that tend to prefer some level of certainty regarding re-ups. This perceived fickleness sometimes puts FoFs lower on the desirable LP totem pole, with endowments, foundations, pension funds, etc. usually beating them out for allocations. Consequently, there is a belief amongst some LPs that FoFs don't necessarily get the best access to proven funds.

FoFs have not stood by quietly in the face of all the tumult. They have fought to maintain a place in the ever-evolving private assets ecosystem. Some of their responses have included:

- A somewhat aggressive approach to j-curve (time it takes a private assets fund to start showing a positive return) mitigation which in turn blunts the double layer of fees indictment. FoFs managers have used an impressive amount of ingenuity to create portfolios that generate distributions more quickly, decrease overall fund duration, reduce the additional fee drag, and potentially enhance returns. All this has been done by the FoFs designating varying portions of their portfolio to secondary investments and/or co-investments, and other ingenious methods that have included first-mover/size fee breaks, profit-sharing from seeding underlying strategies, etc.
    - Secondary investments generated from underlying primary fund holdings were/are a no-brainer for FoFs to exploit. These produce faster returns, the acquisition discounts help reduce the double fee drag, and in some cases blind pool risk is alleviated.
    - Co-investments in underlying fund deals are usually executed on a no-fee and no-carry (devoid of potential incentive payout) basis. This gives increased potential for alpha (excess returns) when/if the investment is successful as well as reduced fee drag.
    - First-mover/size fee breaks and profit-sharing of underlying funds' economics reduce fee drag and add to aggregate fund returns.
    - Another very interesting evolution of FoFs is the proactive secondary sale of vehicles usually in the latter years of their fund lives. This is a brilliant solution to the duration critique, and it has the potential, when timed correctly, to generate/crystallize strong returns as well as free up capital for investors to commit to the manager's subsequent vehicle.

- Other FoFs have pivoted to an all-inclusive approach fully embracing the desire for numerous investors to outsource almost all their private assets investing. These all-inclusive FoFs managers have created diversified (many strategies in one vehicle), as well as wide ranging sector focused (venture, growth, buyout, real assets, secondaries, co-investments, geographically specific, etc.) strategies, to satisfy every whim or desire for LPs. You could call them a one-stop-shop private assets solutions buffet.

- As proof of further division/delineation, a die-hard group of purist FoFs have chosen to double down on their expertise and flex even harder on their skill sets. This group continues to, above all, stress due diligence excellence, build concentrated portfolios, and wholeheartedly target outsized returns with a chance to compete directly with primary standalone funds. Some in this cohort also strategically dabble in the secondary and co-investment mechanisms to accentuate competitiveness, but high-quality exposure and thorough research continue to be their North Stars. Some of these purists have also carefully added vertical and horizontal strategies to their arsenal as a means of cementing their supremacy in a particular space (usually a sector or geography).

As I have emphatically stated or moderately insinuated throughout this composition, my affection for FoFs is very deep-rooted. There is something unique that develops when an entity has a singular mission that is constantly being honed. Unlike most other private assets investors, the sector-focused (venture, small buyout, healthcare, China, Africa, etc.) or acutely opportunistic (seeking the very best investments regardless of sector) FoFs that have managed, against immense odds, to remain undiluted in terms of

strategy proliferation, provide an extremely rare degree of clarity. These FoFs are forced to continuously think about the opportunity cost of every single dollar they raise. This never-ending opportunity cost calculus is a treacherous road to traverse - it calls for immaculate intellectual honesty that can sometimes lead to severed relationships (with anticipatory potential underlying funds) and reputational damage. Nonetheless, these folks have chosen to pursue a higher truth that lives within thorough research and the belief that being a fiduciary comes with unwavering integrity. How can any true student of investing not be enamored by these characteristics?

I have a strong view that quality information is what leads to strong choices. FoFs have historically had more access to primary fund information than their LP peers. This information includes ecosystem intelligence, returns/attribution dissection, relevant comparative datasets, market gossip, etc. I believe the FoFs managers that choose to maintain and refine their selectivity by rigorously and judiciously using relevant aggregated information, will continue to gain access to high quality funds and increase their probability of generating outsized returns.

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November 19th, 2023.