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PRIVATE EQUITY INTERNATIONAL

FRIDAY LETTER

Mar 22, 2019

Funds of funds: more relevant than ever

Once viewed as a dying breed, here are five reasons why funds of funds will stay relevant and justify that extra layer of fees.

The private equity industry has witnessed a cleaving in two of the fund of funds community in the last five years.

On one side are what could be thought of as the “true” fund of funds managers: usually smaller shops, boutique in feel, focusing on a particular community, be they LPs or GPs. On the other are increasingly large-scale asset managers who, in the eyes of some in the space – themselves included – ought no longer to be called fund of funds managers at all.

For these managers, commingled primary funds of funds have become a decreasing part of their business model, replaced by co-investments, directs, separately managed accounts and advisory as they’ve answered the call from limited partners for more bespoke products tailored to their individual needs and risk appetites.

Adaptation and evolution have become the norm for a group that has got comfortable with rapidly adapting technology, greater investor demand for transparency and downward pressure on fees.

So, we decided to pose a simple question: How will this new breed of fund of funds managers be adding value to the private equity industry in five years’ time? Here’s what we found out:

Connecting LPs with fundless sponsors: Many institutional investors want to get in on the ground floor with emerging managers. Funds of funds are in prime position to help them do this by backing the manager deal-by-deal before it raises a blind-pool fund. “No due diligence questionnaire can give you the same amount of familiarity with a GP,” says Elias Korosis, partner at UK-headquartered fund of funds Hermes GPE.

Becoming data monsters: Alongside investment consultants, funds of funds managers often find themselves sitting on decades of data. When artificial intelligence revolutionises private equity investing, FoFs could be at the vanguard. “Data and its presentation to the client and within the organisation is going to change private equity investing,” says Schroder Adveq’s Lee Gardella.

Tapping into defined contribution capital. Defined contribution pension plans are waking up to the reality that they will need to start allocating to private markets, some way, somehow. Funds of funds will be key to making it happen. “We’re the example of why this works, we’ve got 20 years of history with it,” says Theresa Whitmarsh, executive director of Washington State Investment Board.

Finding that small-cap alpha. The best performing funds are among the smallest by size, but beware: so are the worst performing ones, according to Cambridge Associates data. Finding those funds is painstaking work and best outsourced to a professional fund selector.

Being the gateway to co-investment. LPs want more co-investment, but it requires resource, track record and a specific skill set. The modern fund of funds manager has used its long-term GP relationships to become a master.

They may not look like the fund selectors of old, but the best examples are now using their skill sets and platform to cater to the needs of today’s institutional investor.

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