

Funds of funds: a brief history

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Funds of funds are such a fixture on the current private equity landscape that it is difficult to remember that they are a fairly recent phenomenon. Though institutional private equity vehicles trace their roots back to the 1940s (see the Timeline at the end of this article for more details), the private equity market remained too shallow to support funds of funds vehicles until the 1970s. Large investment vehicles are creatures of the last decade, and this decade of growth has seen a tremendous amount of change and a proliferation of strategies to deal with that change.

Definition and rationale

Even with an investment product as ubiquitous as a fund of funds, it is useful to go back to first principles and define what exactly we mean by a fund of funds vehicle. According to VCExperts.com, a fund of funds is

"A fund set up to distribute investments among a selection of private equity fund managers, who in turn invest the capital directly. Fund of funds are specialist private equity investors and have existing relationships with firms. They may be able to provide investors with a route to investing in particular funds that would otherwise be closed to them. Investing in funds of funds can also help spread the risk of investing in private equity because they invest the capital in a variety of funds."

The key reasons investors look to fund of funds are embedded in that definition:

- *Specialist expertise*
The due diligence process for investing in private equity funds is both complex and arcane. (Private Equity International publishes a book – The Guide to Private Equity Fund Investment Due Diligence – which

details the complexities of fund manager selection.) Successful fund of funds managers have developed proven expertise in fund selection; expertise that it is difficult for smaller investors or new market entrants to quickly replicate.

- *Access*
Successful fund of funds managers have relationships with primary managers who have been successful in the past, and who may be difficult for new investors to access, especially in the venture capital market.
- *Diversification*
Given that many private equity funds have minimum commitments of \$5 million to \$25 million, it is often difficult for small investors to build diversified portfolios that offer protection in what is a volatile asset class. The vast majority of funds of funds are multi-manager vehicles that offer smaller investors managed diversification.

At the creation: separate accounts

The first fund of funds was formed in the 1970s as the number of primary fund offerings increased. However, the fund of funds market as a whole didn't become significant either in number or amount under commitment until the 1990s (see Charts One and Two for details). What is more difficult to track, however, are separate accounts. Commitments to separate accounts are not consistently included in these numbers, and separate accounts themselves were much more prevalent early on in the market.

A separate account is an agreement between a professional third party manager and an institutional investor crafted to a specific investment mandate. It can be documented by a simple contract between the parties

Chart One: Number of private equity funds raised

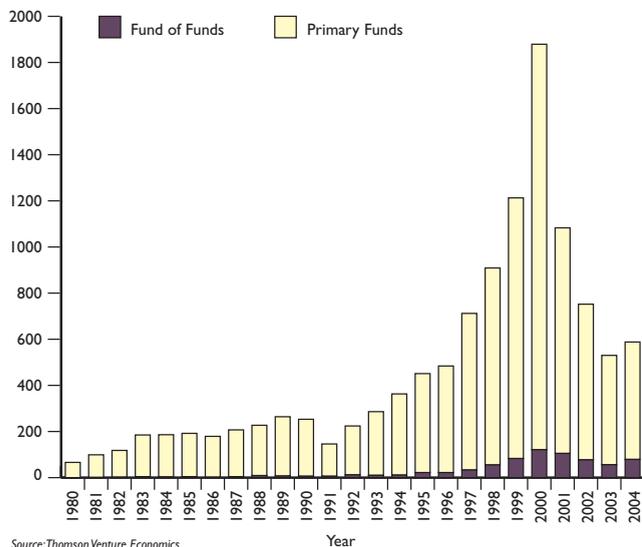
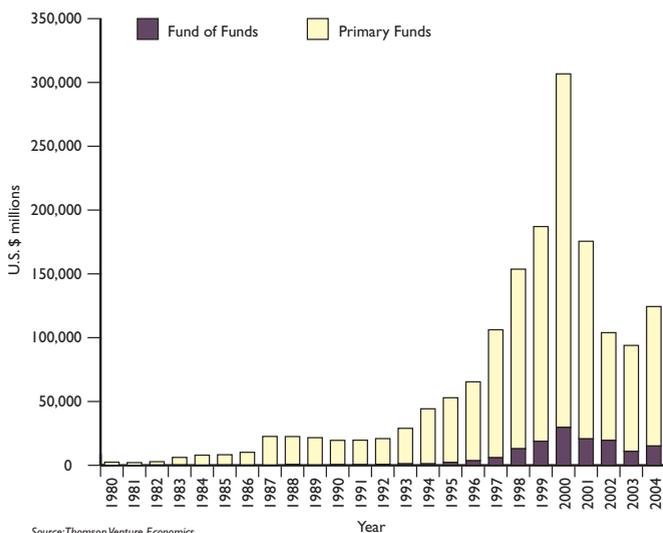


Chart Two: Amount of private equity capital raised



for a fixed duration, or it can take the form of a fully structured fund of funds vehicle that has a single investor. Even when structured as a formal fund of funds, there is little information publicly available on separate accounts as they are agreements only between the two parties and generally include confidentiality provisions.

Many of the earliest fund of funds providers – including Adams Street (previously Brinson), Crossroads and HarbourVest – actively provided separate accounts to large institutional investors early in their careers. For these large investors, separate accounts were a way to tap into third party expertise and leverage internal staff at a point where private equity was just beginning to develop as a market; experienced professionals with a background in fund due diligence were very rare. For the separate account providers, relationships with large institutional investors allowed them to quickly increase assets under management – even though the fees on separate accounts were usually lower than those on a multi-party fund of funds because of the pricing power large investors commanded.

Multi-investor fund of funds

It was just this pricing dynamic – combined with an increase in private equity investments by a number of new market entrants – that led to a decline in the use of separate accounts and the beginnings of an increase in both the number of funds of funds and the amount of money committed to them in the early 1990s. This was growth from an admittedly small base; it wasn't until 1992 that more than a billion dollars was raised for funds of funds in a single year (see Chart Two). Multi-investor funds of funds provided several advantages to fund managers:

- Pricing**
 With multi-investor funds of funds, negotiating power shifted from the investor to the fund manager. The 'wholesale' discounts available to large investors were not usually available on multi-investor funds.
- Assets under management**
 By tapping into a number of smaller investors simultaneously, fund managers were able to more quickly build their base of assets under management. When combined with the better pricing margin available on a fund of funds vehicle, overall profitability grew.

- *Efficiency*

For a fund of funds manager, managing a large pool of money with a single investment mandate is much more efficient than managing multiple, uniquely designed separate accounts at the same time. With a single global mandate, a fund of funds manager can deploy more capital into fewer funds, minimising time spent on due diligence, making larger commitments with each individual underlying fund and developing stronger relationships with general partners during the process.

At the same time, large investors who had been active separate account investors grew more sophisticated and began to invest directly in funds. These investors added internal staff focused on private equity, and supplemented resources as necessary by hiring one of a growing number of non-discretionary consultants who offered due diligence assistance, but at a fraction of the cost of separate account or fund of funds managers.

The late 1990s explosion: new funds and new structures

Beginning in the mid 1990s, the boom in interest in the Internet and venture capital drove step increases in private equity investment generally, and funds of funds specifically. In 1995, annual fund commitments in North America and Western Europe broke the \$50 billion barrier for the first time, with nearly \$53 billion in commitments being raised. By 2000, the annual total had risen almost six fold to \$306 billion. Over the same period, funds of funds commitments increased even more dramatically, from \$2.3 billion in 1995 to \$29.7 billion in 2000. Not only did the size of fund of funds commitments increase, but the number of funds also grew significantly, from 22 raised in 1995 to 122 raised in 2000, the peak for both those numbers.

This growth in capital commitments was matched by growth in innovations as new entrants sought to distinguish themselves in a crowded and undifferentiated market. The Timeline at the end of this article spotlights some specific examples of innovation, but trends of note during this period include:

- *Increasing use of secondaries in primary funds of funds*

A few primary fund of funds managers – such as HarbourVest and

Pantheon – had invested in secondary positions from very early in their history. In the late 1990s, more and more managers began to follow suit, not only to differentiate their funds from others, but also to manage the J-curve. Purchasing secondaries mitigates the losses that occur early in the life of most primary vehicles, where fund fees and expenses are not yet offset by realised gains. Many funds of funds' client bases had a significant component of new market entrants who may understand the J-curve intellectually, but haven't lived through it.

- *Publicly traded vehicles*

Another issue for new private equity investors is illiquidity. A few publicly traded fund of funds vehicles were launched in the late 1990s to address this issue and to attract new investors to the asset class. These were often targeted at retail investors with little or no access to private equity investments. The most successful of these vehicles were the trusts listed in the London market (which has a significant history of single primary funds trading as trusts). Other efforts listed in Switzerland and the US developed significant performance problems that ultimately harmed the attractiveness of the entire sector.

- *Structured vehicles*

The most prominent structured vehicle of the period was Princess Private Equity Holdings. Structured as a bond backed by a portfolio of private equity fund investments, it was created to address specific needs of certain German investors who weren't allowed to invest in private equity directly but were attracted to the sector. The complex structuring required to create the vehicle heavily impacted returns – a problem with most structured vehicles trying to deal with the complexity of private equity.

In addition to the innovations noted above, there were two other major trends in the late 1990s that need to be noted:

- *Consultants – from advice to management*

As mentioned previously, in the late 1980s and early 1990s specialty private equity consultants began to appear, focused on providing advice and recommendations to institutional investors as a de facto extension of their internal staff. As demand for funds of funds dramatically increased in the late 1990s, most of these consultants

Chart Three: Largest fund of funds vehicles (1)

Fund	Size (\$ millions)	Vintage Year
ATP Private Equity Partners 2002 K/S	3,894	2002
HarbourVest Partners VI – Partnership Fund	3,030	1999
HarbourVest International Private Equity Partners IV – Partnership Fund	2,283	2001
HarbourVest Partners VII- Venture Partnership Fund (2)	2,000	2002
HarbourVest Partners VII- Buyout Partnership Fund (2)	2,000	2002
HarbourVest International Private Equity Partners III	1,717	1998
Horsley Bridge Fund VII (3)	1,572	2000
GS Private Equity Partners 2002	1,509	2002
Private Equity Holding AG	1,500	1999
European Strategic Partners II	1,360	2002
California Emerging Ventures II LLC	1,351	2000

1. Source: Thomson Venture Economics; size of funds raised in currencies other than US dollars have been translated for comparison purposes

2. These two funds were raised simultaneously, allowing investors to set their allocations between venture capital and buyouts; in many respects, these two funds represent a single \$4 billion pool of fund of funds capital

3. Original fund size

began to offer both fund of funds and separate account products, leveraging the due diligence expertise and general partner relationships that they developed as consultants to expand into higher margin lines of business.

- *Staff movements – from limited partners to funds of funds*

As the number of funds of funds increased in the late 1990s, the demand for experienced investment professionals to manage these vehicles also increased. Many large institutional investors who had increased internal staff in the early and mid 1990s experienced significant turnover in the late 1990s, as newly forming funds of funds attracted experienced staff with pay packages that were difficult for them to match.

After the boom: capacity, access, sector vehicles, and a return to separate accounts?

The late 1990s boom in private equity peaked with the Internet Bubble in 2000, and activity fell back to more normal levels thereafter (as detailed in Charts One and Two). With the turn in the market, different issues came to the fore for the fund of funds market that are still being resolved:

- *Capacity – how many funds of funds do there need to be?*

In a rapidly expanding market, this question barely arose as most new vehicles managed to attract some level of investor interest. In a contracting market, the question is always "Why do I need to invest in this fund?" That question can be especially difficult for funds whose first vehicles were launched at the top of the market and performed poorly, and who lack a longer track record with strong returns from the early 1990s.

Chart Three offers a listing of the largest fund of funds vehicles that have been raised to date and neatly illustrates the above point. Of the eleven funds on the list, five are HarbourVest vehicles, including three raised since 2001. HarbourVest is one of the most well established fund of funds players with a track record of over 20 years. Many investors would regard it as a safe pick in turbulent markets. Its long history allows it to argue strongly that it has consistent access via well-established relationships with primary fund managers – an argument that only a few very long-lived groups such as Adams Street, Horsley Bridge, and Pantheon can match.

- *Differentiation – access and sector vehicles*

To respond to the issue of too many funds of funds, managers are seeking to differentiate themselves even more intensely based upon unique general partner access or specific sector expertise. During the late 1990s, many of the funds being raised were widely diversified, including a mix of buyout and venture opportunities. Relatively few funds maintained the discipline that Horsley Bridge had in focusing solely on a specific sector – early stage venture capital – though that sector was quite broad in itself. Over the last three or four years many of the new vehicles created have been narrowly focused on such areas as emerging managers, small to middle market buyouts, or Asia. These vehicles seek to address specific areas of investor demand, and seek funding on the basis of those specific needs.

- *A return to separate accounts?*

Interestingly, the trends of the last decade have led to some degree of renewed interest in separate accounts. Large institutional investors are usually well equipped to invest in large private equity funds, especially those where they have established relationships with fund managers. However, it is often more difficult for them to invest in smaller market niches – such as emerging venture capital managers or buyout funds seeking less than \$200 million in commitments – given their limited staff levels and need to invest large amounts of capital annually. For them, outsourcing through a separate account or sole limited partner fund of funds makes sense when trying to get exposure to smaller but attractive niche markets.

In the separate account category, there are two entirely different routes that

investors can take. One route is illustrated by CalPERS. In the late 1990s CalPERS undertook a major effort to expand its investment in the venture capital market. It hired Grove Street Advisors to implement the separate account program. CalPERS' size and relative lack of exposure to venture capital led to the creation of a massive program, and the California Emerging Ventures vehicle listed on the table of largest funds of funds is a result of that effort. As this program developed it also morphed away from a strict focus on venture capital to also include small middle market buyout funds.

More recent efforts in separate accounts have tended to be smaller and more focused. A good example was the Request for Proposal put to bid by CalSTRS seeking a manager for a \$100 million separate account focused on emerging managers, a program eventually awarded to INVESCO.

Summary

Over the last 25 years the fund of funds market has matured from a niche sector of private equity to a major source of funding for the industry. Along the way, it developed a complete set of product offerings, from globally diversified large vehicles offered by firms like Adams Street and Pantheon, to the large sector-focused vehicles offered by HarbourVest and Horsley Bridge, to smaller more focused vehicles such as LGT's fund targeting middle market buyouts in Europe, RCP's and Portfolio Advisor's similar vehicles in the U.S., and Parish Capital's emerging manager-focused fund. This trend will likely continue with the creation of new focused funds and separate accounts responding to a growing demand by larger, more sophisticated investors. This will result in more smaller, tailored efforts alongside those larger, well-established vehicles operating with a broader mandate.

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Probitas Partners is an independent provider of integrated, alternative investment solutions, offering an array of customised services that include placement of private equity funds and investment and liquidity management.

Private equity and funds of funds: a timeline

1946	American Research and Development Corporation ("ARD") founded by George Doriot and J.H. Whitney & Co. founded by Jock Whitney; institutionalised private equity investing begins, though it starts slowly
1968	Bull market for IPOs; ARD takes Digital Equipment Company Public generating an IRR of 101%, raising the profile of venture capital
1972	Kleiner Perkins raises \$8.5 million for its first venture capital fund
1976	The firm that will become Adams Street opens the Institutional Venture Capital Fund, its first fund of funds, with \$60 million
1977	KKR executes its first buyout transaction
1978	Capital gains tax rate slashed from 49.5% to 28%; Labor Department clarifies that pension plans can invest in private equity
1979	Horsley Bridge raises its first fund of funds, University Ventures, with \$33.3 million in commitments
1980	Total commitments raised for US and European private equity: \$2.5 billion; Total fund of funds commitments: \$0
1982	John Hancock Venture Capital Fund raised – precursor to HarbourVest
1982	Pantheon Ventures of the U.K. raises its first fund of funds
1986	HarbourVest completes its first secondary transaction within its fund of funds
1987	Formation of Pantheon International Participations PLC, a London quoted investment trust
1990	HarbourVest International Private Equity Partners raised; focused on non-US investments only
1990	Total commitments raised for US and European private equity: \$19.5 billion; Total fund of funds commitments: \$562 million
1996	Adams Street introduces an "annual" fund structure
1999	Princess Private Equity Holdings Ltd. is created as a structured fund of funds vehicle; zero coupon convertible notes are issued that are exchangeable into positions in a portfolio of private equity partnerships
1999	Grove Street Advisors launches California Emerging Ventures, the first in a series of three large separate accounts for CalPERS
1999	Private Equity Holdings AG, a large global fund of funds vehicle publicly traded in Switzerland, begins trading; management of the vehicle is later changed and the portfolio is restructured through a secondary sale as it falls on hard times
2000	MeVC Draper Fisher Jurvetson Fund, first publicly traded fund of funds vehicle in the US is launched; fund later dramatically restructured under pressure from investors
2000	Total commitments raised for US and European private equity: \$306 billion; Total fund of funds commitments: \$29.7 billion
2002	HarbourVest simultaneously raises a US Venture and US Buyout fund, allowing investors to set their own allocations between venture capital and buyouts; the two funds raise a combined \$4 billion
2003	CalSTRS publishes an RFP seeking a \$100 million separate account vehicle focused on Emerging Managers
2004	Total fund of funds commitments: \$15.1 billion for 77 funds