YOUNG VENTURE CAPITAL SOCIETY

Deep Pockets: Fund of Funds--More than Diversification

February 6, 2006

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Fund of Funds (FoFs) are typically cited as diversification vehicles for smaller investors. The conceptual framework for the vehicle is relatively simple: investors allocate money to a manager that then pools all of the capital and commits it to several different funds. Asset pooling increases the diversification buying power of the investors because they are able to gain exposure to more funds than they would normally be able achieve under more traditional arrangements.

In addition to increased diversification buying power, investors are essentially retaining the services of a manager who is also attempting to add alpha through selection of either established or emerging manager. The FoF manager typically charges the investors an additional layer of fees in return for these asset management services.

What is often omitted from the aforementioned discussion is that large investors utilize FoFs for other purposes as well. Within the Limited Partner (LP) community, there is a consistent buzz about gaining access to top-tier funds. The complaint of many LPs is that top-tier Venture Capitalists (VCs) are usually in a position where they do not need to raise assets for their new funds because their preexisting investors are more than willing to re-up.

Some larger LPs are willing to pay a FoF manager the additional layer of fees if the fund manager has access to the top-tier VC funds. In addition to access, FoFs can serve as vehicles to deploy large amount of capital quickly. This proves useful when the asset allocation changes and an investment officer has a tremendous amount of new capital that needs to be put to work as quickly as possible.

Despite the abovementioned sense of urgency, the investment officer needs to be prudent during the manager selection process. The search usually begins with traditional manager allocation arrangements. Many of the larger firms will retain the services of a gatekeeper, consultant or advisor in order to assist during the due diligence process. Nevertheless, the short list of potential funds is typically scrutinized by the investment officer and eventually presented to a board or overseeing body.

As one can imagine, time can be absorbed quickly during the many iterations involved in this process of initial meetings, follow-up, internal recommendations and presentations, legal review, board approval, etc… All the while, millions of dollars can be sitting relatively idle.

In an attempt to streamline this process, an investment officer may consider targeting larger FoFs that are in a position to take on a significant allocation. Since FoFs are considered to be diversified vehicles, it may be easier for the investment officer to convince the relevant parties that the allocation should be larger than the position that is normally undertaken with a direct manager relationship. Some firms opt to never take positions larger than X% of fund size and/or $Y million. The investment officer may be able to convince the powers that be to remove this cap because the firm is indirectly gaining access to many funds, not one.

At the end of the day, the additional layer of fees is negligible in comparison to millions of dollars getting held up in committee because not enough funds are getting through diligence. In all reality, the ‘idle’ moneys would be invested in some sort of marketable security. The more noteworthy concern is that the firm’s portfolio management strategies may not come to fruition if the asset allocation targets are not met.

As one can see, FoFs provide a critical economic function on behalf of both small and large LPs. Conversely, the importance of new and upcoming VCs to establish relationships with FoFs as a way to gain indirect access to the institutional portfolios that typically skip right over first time funds and funds that are too small to be on their radar.