A Metamorphosis: How funds-of-funds have adapted to a changing private markets environment

Once a thriving part of the private markets' ecosystem, funds-of-funds have faced a challenging decade as LPs have increased allocations to the asset class and brought investment decisions in house. Over recent years, however, funds-of-funds have recorded impressive performance as they have adjusted their approach and focused their product offering to provide specialised access to niche areas of the market.

What words come to mind when you think of funds-of-funds? Utilitarian, perhaps? functional? Maybe even pedestrian? Whatever it is, I'd bet exciting, visionary, and innovative aren't high on the list. The space has long been a stalwart of a segment of the market but has suffered as LPs have expanded private markets programmes and brought investment decisions in-house. Faced with these challenges, funds-of-funds have adapted their offerings, specialising and focusing on where they can most add value. These changes have paid dividends, with recent data showing that they have outperformed the private capital universe, even accounting for the double layer of fees that funds-of-funds entail. This article explores what's been driving this performance, and what this could mean for funds-of-funds' fundraising in the future.

Fundraising and performance peaks

Funds-of-funds reached a fundraising peak in 2007, when European managers raised an aggregate $22.7bn across 72 funds, according to data from Preqin. The following year was also strong, with 91 funds collecting $21.3bn. Since then, as the impact of the financial crisis hit and investors have focussed on manager selection to drive performance, funds-of-funds managers in Europe have averaged $10.6bn in aggregate commitments each year.

Although funds-of-funds have struggled to match historical fundraising activity, a recent report from PitchBook has found that they have generated strong returns for investors. According to this report, funds-of-funds deliver the most consistent performance of any private capital asset class, excluding private debt, defined by the smallest difference between top- and bottom-decile IRRs. Not only this, but the IRR of bottom-decile funds-of-funds was the highest among all private capital asset classes.

This report also found that funds-of-funds have outperformed private capital in Q1 and Q2 of 2021, returning 49.3% vs 43.0% for private capital. The strategy has outperformed over three- and five-year horizons too, returning 20.9% over three years (vs 17.4%) and 17.9% over five years (vs 16.3%). Given the perceptions around funds-of-funds, this finding raises eyebrows, and it’s worth exploring the factors that have driven this outperformance.

Facing challenges

Traditional funds-of-funds, which offer LPs exposure to a diversified cross-section of private capital markets, were a key part of many LPs portfolios. They offered LPs the opportunity to outsource the specialist knowledge that is required to invest in private markets, and with the asset class forming a relatively small portion of LPs total portfolios, this opportunity made sense for a lot of institutional investors.

After the financial crisis, with interest rates dropping to historic lows and yield on other asset classes falling in tandem, private markets became a larger part of LPs portfolios. Many brought investment decisions in-house and chose to focus on accessing the highest-performing managers. Consequently, the dual layer of fees that funds-of-funds entail became less viable for LPs, and funds-of-funds struggled to differentiate themselves and articulate how they added value to some of their former investors.

Narrowing focus and opening access

Faced with these headwinds, many established funds-of-funds managers have adapted to offer LPs increasingly specialised products, for example running fund-of-funds platforms focused on technology or healthcare funds, accessing managers in a specific geographical region, or on emerging managers. These specialist verticals require dedicated teams with the expertise and depth of knowledge necessary to diligence managers operating in narrow niches, and specialist funds-of-funds allow LPs to outsource this.

The increasing specialisation offered by funds-of-funds has become a strong selling point, as it opens access for LPs to opportunities that could not be considered as a standalone investment. This could be because of a lack of expert knowledge required to diligence the opportunity, a fund size that's not compatible with the size of tickets the LP can write, or because the LP doesn't back emerging managers.

This access to managers operating in niche sectors and geographies has been crucial in the outperformance that funds-of-funds have displayed. 2019 research by Cambridge Associates showed that sector-focused funds outperformed generalists by an IRR of 4.7%. Sector-focused funds returned 22.6% vs 17.9% for generalists on investments made between 2001 and 2014. Funds-of-funds with the ability to identify and back the highest-performing sector-specific managers can access the additional alpha these managers generate, producing higher returns for their LPs.

An additional key role that funds-of-funds managers are playing in moving the private equity industry forward is in opening access to the asset class up to a much broader range of individual investors. Last year HarbourVest extended its partnership with Vanguard, which now provides qualified individual investors access to the asset class via HarbourVest's funds-of-funds and buyout platforms. In Europe, Moonfare has pooled the assets of 25,000 individual investors to invest in a curated portfolio of top-tier private equity funds. It parallels the fund-of-funds model, but for accredited individuals rather than institutional investors. Moonfare currently manages more than £1.2bn, and in January launched in the US, where it aims to reach the country's 1.1 million very high net worth individuals.

A resurgence?

As private markets have evolved, funds-of-funds have adapted to their changing environment. Besides the diversified, broad access they have traditionally offered, they now also offer targeted access to specialised managers operating in market niches that can be difficult for LPs to access themselves. This fulfils the need that many LPs have to access alpha-generating opportunities while lacking the internal bandwidth necessary to do this in-house. This increasing specialisation is reflected in the impressive returns that funds-of-funds have generated recently. The funds-of-funds model also offers the opportunity for individual investors to access the superior returns that private markets offer and open access to a vast pool of additional capital for private funds managers.

Funds-of-funds have combined recent impressive returns and positive net cash flow since 2013 with introducing private investments to a huge number of qualified individuals. These factors should translate into a sustained rebound in fundraising for funds-of-funds managers and breathe life into a segment of the market that looked like it may become a thing of the past.