



# Private Equity Fund of Funds Review

What is the role played by funds of funds in the current private equity market? Patrick Adefuye examines the latest fundraising statistics for these managers, including a look at their use of separate accounts and key performance information.

Funds of funds have traditionally played a key role in the private equity industry. When considering an allocation to private equity, many smaller, less experienced investors turn to fund of funds managers to help them access the asset class. Funds of funds allow LPs to benefit from the expertise and resources of fund of funds managers while requiring smaller commitment sizes and providing exposure to a variety of strategies and geographies. They also provide an important access point for investors looking to invest in strategies or geographies where they may not have previous experience, or where access to top fund managers may be challenging.

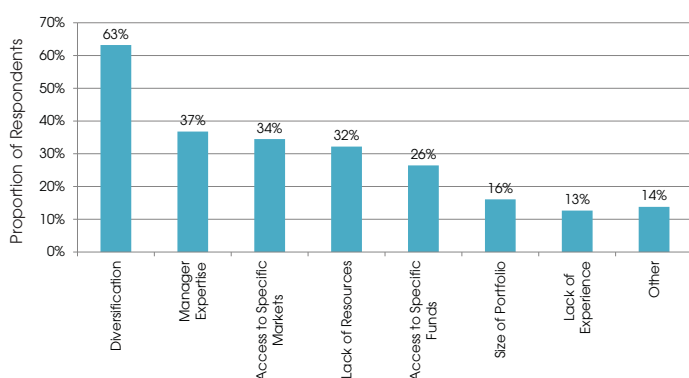
However, fundraising conditions for funds of funds have remained extremely challenging throughout 2012. In addition, as the private equity asset class continues to grow and mature, investors are becoming increasingly sophisticated, with many looking to invest directly in funds to avoid the double layer of fees associated with funds of funds. Direct investment also allows LPs to concentrate their private equity portfolios on the strategies and geographies they feel will provide them with the best returns. This desire among LPs for more control over their investments has led an increasing number of fund of funds managers to operate separate accounts and those that offer these services have invested more from separate accounts this year compared to last.

In this article, we explore the changing shape of the fund of funds industry, investor appetite for the sector and how managers are adapting to LP requirements.

## Fundraising Market

The global financial crisis has created a tough fundraising market for fund of funds managers. Investors have become more cautious, particularly those that are new to the asset class and most likely to invest with fund of funds managers. Others may not have capital available to make new commitments as a result of the slow exit environment and lower levels of distributions. In 2009, fund of funds

Fig. 2: Motivations for Investors Utilizing Funds of Funds



Source: 2013 Preqin Private Equity Fund of Funds Review

Fig. 1: Private Equity Market Share by Fund Type (Aggregate Capital Raised)



Source: Preqin Funds in Market

vehicles accounted for 11% of the aggregate capital raised in the private equity market, as shown in Fig. 1. Since then, the proportion of capital they accounted for has decreased year on year; in 2012 fund of funds vehicles accounted for only 4% of the capital raised for private equity funds. Buyout vehicles, which saw a decrease in the capital committed to them after the financial crisis, also saw a decrease in the proportion of total capital committed to private equity that they account for, from 35% in 2011 to 28% in 2012.

Throughout 2012, 72 fund of funds vehicles have reached a final close, raising \$13.9bn, representing a decrease on the 82 funds of funds that closed on an aggregate \$16.3bn in 2011. With 162 funds currently in market targeting an aggregate \$40bn, fund of funds managers face a challenging fundraising climate in the coming months.

## Investor Appetite for Funds of Funds

Despite a challenging fundraising environment, many investors in funds of funds remain committed to them, according to a survey of 100 investors in funds of funds conducted by Preqin in October 2012. Of those surveyed, 81% are either planning to make or considering making new fund of funds commitments over the next three years. This is a small increase compared to the 78% of investors in funds of funds which expressed similar intentions in October 2011. As shown in Fig. 2, the main motivation for LPs investing in funds of funds in the private equity asset class is to achieve diversification, with 63% of investors interviewed stating this as a factor (it should be noted that the majority of the investors surveyed, 62%, are relatively inexperienced investors which have made between one and ten fund investments in total). Notable proportions also cited manager expertise (37%) and access to specific markets (34%) as important motivations for investing in funds of funds.



Continued investor interest in diversification, manager expertise and access to specific markets means that fund of funds investments will likely remain an important part of many investors' private equity portfolios, as well as an important route to market for investors seeking to make their maiden investments in the asset class.

#### Growing Importance of Separate Accounts

As those investors investing in funds of funds grow increasingly sophisticated, many are seeking a greater level of control over their fund of funds investments and are looking for customized access to the asset class. Fund of funds managers have sought to meet this demand, with separate account vehicles awarded by individual investors providing an important source of additional capital. A number of fund of funds managers include this tailored service as part of their offering to their investors, while some managers, such as Grove Street Advisors and BAML Capital Access Funds, invest solely through customized separate accounts. An example of a separate account is New Jersey Asia Investors Fund II (NJAI Fund II), New Jersey State Investment Council's mandate to fund of funds manager Asia Alternatives Management to invest in Asia on its behalf. The mandate, which was awarded in May 2011, is worth \$200mn, and will target multiple countries and regions in Asia, including Greater China, Japan, South Korea, India, South-East Asia and Australia.

Separate accounts allow investors to tailor their investments to specific investment strategies or themes. CalSTRS/BAML Capital Access Fund IV, for example, invests with managers that target underserved markets in the US, or companies that employ or are managed by ethnic minorities and women. As well as more control over their investments, separate accounts also often come with more favourable fees and terms than their commingled counterparts. These vehicles are becoming a more important part of the investment activity of funds of funds; Fig. 3 shows that of the 81 private equity fund of funds managers surveyed in October 2012 by Preqin, 32% indicated that they have invested more from separate account vehicles in the past 12 months than in the previous 12 months.

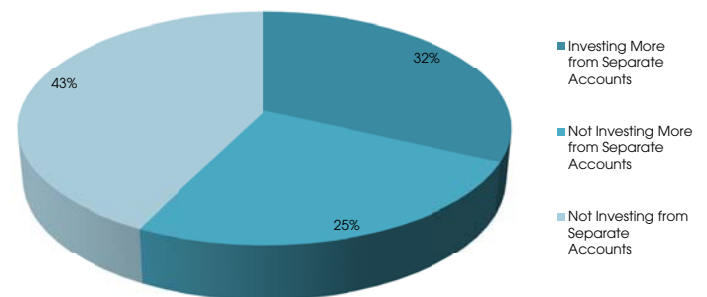
#### Performance of Funds of Funds

Investors are increasingly cautious about which managers they choose to commit to, with manager track record taking on even more importance in the recent economic climate. Although past performance is not a guarantee of future performance, looking at the relationship between a fund manager's predecessor and successor funds of funds demonstrate that the past performance of funds can give an indication of future fund performance.

Fig. 4 shows that 31% of top quartile fund of funds managers go on to produce a top quartile follow-on fund of funds, while only 17% of bottom quartile managers go on to produce a vehicle in the top quartile. Conversely, of the managers running a bottom quartile vehicle, 33% go on to manage a follow-on fund in the bottom quartile. This demonstrates how important it is for investors to build relationships with the top performing fund of funds managers, as they can be more likely to continue to perform well and provide investors with higher returns.

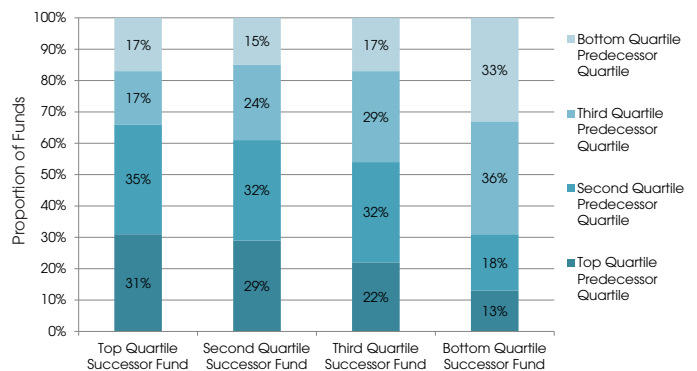
When looking at the overall performance of private equity, horizon IRRs provide a good indication of how the industry is performing over a defined period. They are calculated by treating the beginning net asset value as an outflow at the start of the period; further

Fig. 3: Proportion of Fund of Funds Managers Investing More from Separate Accounts in the Last 12 Months



Source: 2013 Preqin Private Equity Fund of Funds Review

Fig. 4: Fund of Funds - Relationship between Predecessor and Successor Fund Quartiles



Source: 2013 Preqin Private Equity Fund of Funds Review

contributions made during the period are also treated as outflows, while any distributions and the final net asset value are treated as inflows.

The performance of funds of funds over a one-year, three-year, five-year and ten-year period to March 2012 is positive, with horizon IRRs of 7.3%, 11.0%, 5.9% and 6.3% respectively. However, these horizon IRRs lag behind the private equity industry as a whole over one year, three years and 10 years (the 5.9% IRR for the five-year period to March 2012 is the same as for the industry as a whole). It is important to bear in mind that, compared to other private equity fund types, the performance data for funds of funds generally lag by one quarter due to the reporting of the underlying funds.

#### Fund of Funds Manager Consolidation

Consolidation among fund of funds managers has become a feature of the fund of funds industry, driven by the struggle to raise a vehicle in the current fundraising market as well as regulatory pressures faced by financial institutions active in alternatives. Consolidation has continued in the past year, with some prominent fund of funds managers adding to their expertise by acquiring other managers. Recent examples include BlackRock Private Equity Partners' acquisition of Swiss Re Private Equity Partners, FLAG Capital Management's acquisition of Squadron Capital and StepStone Group's acquisition of Parish Capital. AXA and Credit Suisse are



seeking to sell their fund of funds arms, AXA Private Equity and Credit Suisse Customized Fund Investment Group, evidence that consolidation is likely to continue as financial institutions adapt to new regulations and a slow fundraising environment.

#### What Does the Future Hold For the Fund of Funds Market?

In spite of the difficult fundraising market, funds of funds still have a significant part to play in the private equity industry, as they provide newer, inexperienced investors with diversified exposure to the asset class. Even more experienced investors seek to benefit from the expertise specific fund of funds managers have in emerging markets and niche strategies. Separate account services offered by fund of funds managers provide an element of customization for more sophisticated investors and are an important additional source of capital for managers; they are increasingly attractive to LPs that want to tailor their investments to specific needs and at the same time avoid higher fees and less favourable terms.

With investors more cautious about which managers they choose to back, the worst performing managers may struggle to raise new capital and become susceptible to losing key staff or to complete acquisition by other fund managers. Regulatory pressures may also add to consolidation in the fund of funds manager space; nonetheless, these vehicles are likely to remain an important aspect of many LPs' portfolios.

#### Subscriber Quicklink:

Subscribers can click [here](#) to see detailed profiles for 159 fund of funds managers currently in market.

This article draws upon information from the [2013 Preqin Private Equity Fund of Funds Review](#). The Review features detailed information on 238 fund managers, 21 listed funds of funds, 155 investors, and data and analysis on all aspects of the industry.

To find out more, or to purchase your copy, please visit:

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## 2013 Preqin Private Equity Fund of Funds Review



alternative assets. intelligent data.

The 2013 Preqin Private Equity Fund of Funds Review provides a comprehensive overview of the fund of funds sector, helping you to make better-informed decisions and maintain your knowledge of the sector. The 2013 Review is essential reading for all fund of funds managers, private equity firms seeking capital, investment consultants, institutional investors, placement agents, law firms and other private equity professional.

Key content includes:

- Manager Profiles: Detailed profiles for 238 fund of funds managers.
- Fund Profiles: Vehicle-specific details for each manager's recent and forthcoming funds.
- Sample Investments & Fund Preferences: On both a fund- and firm-specific basis.
- Performance: Key fund performance metrics for over 700 individual funds of funds.
- Listed Vehicles: Analysis and historic share price listings on 21 listed funds of funds.
- LP Investors: Detailed profiles for 155 LP investors currently investing in funds of funds and key investors to watch in 2013.
- Fundraising: In-depth listings of all funds of funds closed during 2011 and 2012 and funds currently raising capital.
- Analysis: Detailed analysis on all aspects of funds of funds.



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