PRIVATE ASSET MANAGEMENT

Reaffirming the Value of a Fund of Funds in Targeting the Middle Market

The enduring value proposition of FoF managers resides in their ability to screen, identify and gain access to the best performing managers

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The conventional wisdom back in the early 2000s was that private equity's middle market represented one of the most difficult segments for investors, marked by too many general partners (GPs) to choose from. As it turned out, however, this era helped establish a compelling case around the value of funds of funds (FoFs). This is in part due to the consistent outperformance of the top quartile middle market managers – far easier to recognize in hindsight – but also because fund of funds managers could bring to bear the skillset required to manage the breadth of a segment that otherwise overwhelmed understaffed pensions and high-net-worth investors.

Thomas Meyer and Pierre-Yves Mathonet in their 2005 book "Beyond the J Curve," mapped out the complexity that LPs face in selecting, investing and monitoring a diversified portfolio of private equity funds, which is only made more challenging by the substantial gap that exists between the top- and bottom-performing managers. Moreover, according to Preqin data, the highest standard deviation between the top- and bottom-quartile managers is found in funds with total commitments below $500

million. This speaks to the idiosyncratic alpha that is uniquely available to middle-market investors, but also underscores the inherent risks for part-time PE investors.

Indeed, for success, curation is key, requiring awareness of which GPs are in the market, access to the most attractive funds available, and the analytical capabilities to assess a universe comprised of over 3,200 active managers. This is where the value proposition offered by FoFs becomes obvious, particularly at a time when the best funds are oversubscribed and often closed to new investors within mere months of being launched.

Awareness and Access

For many, the easiest and most compelling argument for fund of funds investments relates back to diversification, as an investment across 10 top-quartile managers provides far better risk-adjusted returns than a bet on one or two funds in the same vintage year. Often overlooked, however, is the need to identify those managers that can actually deliver outperformance.

When most observers discuss the strong risk-adjusted returns that characterize the asset class, the assumption, typically, is that everyone can access the same top-quartile funds, with IRRs of between 20% and 30% depending on the vintage year. However, many of the best funds will be oversubscribed and difficult to access.

Forty percent of all the buyout funds in the market last year closed within six months or less, according to Preqin and nearly all top-quartile funds finished above target or were oversubscribed. This is why access is so critical and can be quite elusive for those investors not in the market every day and in contact with GPs regularly.

Analysis and Expertise

Access, though, can only get investors so far. The analysis and resources that go into due diligence are also key components as conviction can be hard to come by based on past performance alone. Quantitative analytics firm PERACS, for instance, found that a full 76% of PE funds could “truthfully” claim to be top quartile through using at least one publicly available data source and manipulating the vintage year for the fund. PERACS also found that IRRs can distort fund performance and that more than one out of every five funds that avows to be top quartile is making the claim erroneously. Adding to the confusion are other studies demonstrating that since 2000 there has been little in the way of persistence among top-quartile funds, translating into returns from successive vehicles that are statistically indistinguishable from the rest of the market. All of this underscores just how difficult it can be for fund investors to identify and gain access to managers that actually outperform.

Execution and Managing the Details

Many prospective investors will often overlook the bandwidth required to stay on top of the market. In just the lower middle market, for instance, there are typically around 250 different managers fundraising every year. In order to amass a portfolio of 10 or 12 fund investments across three or four vintage years requires due diligence into roughly 1,000 funds over that period of time. This includes meetings with GPs, calls to portfolio-company management teams, negotiating fund terms and ultimately making commitments to three or four funds in a given year. Just negotiating the terms can be a job unto itself. Understanding what is “market” and what isn’t can make a critical difference in the total returns for limited partners and also ensures that interests remain aligned throughout the life of the fund.

This is just the front-end work. Managing and reporting the underlying valuations of assets, understanding tax implications, and executing the wire requests and capital calls also requires its own team with a specialized skillset.

A Truly Active, Hands-On Strategy

As long as the middle market private equity sector is delivering the outperformance necessary to meet the growing liabilities and pressures facing investors, the asset class is well worth the extra effort. This is particularly true in what has become a low-return environment with few if any alternatives to generate the tax-efficient alpha promised by the asset class. But PE is also the furthest thing from a passive strategy. If investors don’t have the resources and wherewithal to commit to the space, the best alternative is to invest in a fund of funds manager with the skill and expertise to invest.