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Back to basics with funds of funds

By Charles Soulignac of Fondinvest Capital

Funds of funds remain of key interest

The year 2009 was a challenging one for all sectors of private equity fund-raising. However, the impact of last year's difficulties on funds of funds has not been as pronounced as with direct funds, and investors' appetite for such vehicles remains strong. Certain factors can explain this phenomenon.

First, in such a difficult fund-raising environment, funds of funds are seen as an effective way to enable investors to take advantage of private equity while controlling risk. More than simply providing investors with a well-defined strategy, funds of funds select the best performing managers, enable access to funds that investors normally could not join due to insufficient asset allocation or market knowledge, and provide stronger diversification in terms of manager, segment and geography.

Second, funds of funds meet the needs of a wide array of investors. Whether it's investors with a small allocation to private equity or newcomers seeking an entry point to the asset class, funds of funds are now widely utilized by large and experienced investors to diversify components of their portfolio.

Finally, if we consider current market conditions and the concentration of teams that will inevitably affect the general partner community over the next few years, there is another compelling reason for investors to entrust their private equity allocations to experienced fund-of-funds managers. Even in tough investment climates, it is difficult for investors to access the best funds if they've not already built a relationship with a particular manager – and funds of funds provide that access.

Thinking differently to successfully assess primary investment opportunities

As a direct consequence of the global financial crisis, the assessment of primary investment opportunities has changed, undeniably making it a more difficult task to evaluate funds launched in 2010 and 2011.

Traditional track-record analysis, which provides insight into prior funds' performance, seems to have gone out of favor as funds launched in 2005 and 2006 manage to achieve few exits or exits that don't give limited partners a sense of the entire portfolio. Analysis of performance indicators at the fund level will likely show strong volatility and therefore analyzing the underlying companies and following their evolution over time will be key to assessing both the health and the value creation within the portfolio.

Moreover, those selecting a fund will need to consider the history of management teams in a different light. Without a doubt, many teams are evolving to adapt to the new environment, and staff turnover has been one of the main adaptations. Rather than focusing on team stability, other factors such as key skills, motivation and entrepreneurial characteristics will need to be examined.

Considering these changes, fund selection will be performed much like it was in the 1980s – when first-time teams were unable to demonstrate meaningful track records or exhibit stability in staffing levels. Going forward, assessing the merits of a GP will imply a careful analysis of the quality, morality and skills of the team, rather than the portfolio quality of the last fund raised.

Is a refocus on fundamentals the path to performance?

Over the past five years, the private equity industry has experienced aggressive growth, both in terms of assets under management and the amount of capital invested. Without exception, all segments of the private equity industry have pursued the same race for volume, with the managers of some funds closing on increasingly larger deals and launching the biggest funds they've ever raised. Even funds of funds were engaged in this frantic race.

The bigger the better became the rule, with little concern about whether a strategy was adequate or the investment style was drifting too far afield. Some teams opportunistically extended their activity to the real-estate and hedge fund sectors to meet the growing demand of LPs. At this point, private equity entered its industrializing era and deviated from its basic raison d'être.

Conversely, some teams decided not to respond to pressure to grow their fund sizes, and have continued to pursue their core strategy, raising funds in the same range they did in the past and focusing on value creation to provide performance. In other words, they stuck to their private equity fundamentals and denounced the excesses of their high growth brethren.

However, describing the current private equity market as a two-tiered system would be wrong as both strategies – volume versus fundamentals – are in fact complementary from an investor standpoint. But the question of which strategy has the most stable performance remains.

About the author

Charles Soulignac is the founder and managing partner of Fondinvest Capital. He started the fund-of-funds business in 1994. He formerly managed investments in private equity funds and direct equity investments for CDC Participations. He also has previous experience in industry, consultancy and finance. He has been a member of the European Private Equity and Venture Capital Association board of directors and its investor relations committee.