Fund-of-Funds: Cure or Disease?

[PI Fund-of-Funds]

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Dale Carnegie Dropout

In an effort to set an appropriate tone for my remarks, I'm going to start off by quoting two famous historical figures who, if they hadn't sunk into an even lowlier profession, would have made terrific venture capitalists. The first is Franklin Roosevelt, who so far as I know spent nary a single day of his hugely productive life working in the private sector, but who nonetheless must be regarded as one of the greatest turnaround artists of all time. FDR's son Jimmy had political aspirations of his own, and when he asked his remarkably successful father for some tips on public speaking, FDR replied with three cardinal rules: "Be sincere ... be brief ... and be seated." I promise to observe all three rules. The second person I'm going to quote was FDR's soulmate and contemporary Winston Churchill, who had rotten luck as an investor but who himself displayed repeatedly all of the attributes required for success as a venture capitalist. Although he got along famously with FDR, Churchill didn't get along well with a lot of American politicians and he especially loathed John Foster Dulles, who served as Eisenhower's Secretary of State. Indeed, when asked one day what he thought of Dulles, Churchill muttered, "He's the only case I know of a bull who carries his own china shop around with him." My assigned role here today is to spend a moment or two smashing some of the goodies in the metaphorical china shop that fund-of-funds sponsors have created. Actually, in an effort to heed FDR's advice to his son, I'm going to take a whack at just one particular piece of china, which is the notion that funds-of-funds can and do exert a positive disciplinary force on the private equity industry. Some of them do, I'm sure, but in many cases fund-of-funds are themselves an important root cause of the disease for which they claim to serve as a cure.

Cure or Disease?

In the unbiased opinion of the people who run them, funds-of-funds play a vital disciplinary role in the private equity marketplace. They purportedly do this by forcing general partners of the underlying funds in which they invest to do three crucially important things: one, adopt fee structures that make the GPs' interests as congruent as possible with the interests of their limited partners; two, eat their own cooking, so to speak, by investing a substantial portion of their own net worth in their own funds; and three, limit growth in assets under management as well as the number of deals done to levels consistent with their firms' staffing levels and deal flow. I assume that no one in this room would disagree that the three attributes I've just described — a fee structure that aligns a GP's interest with its limited partners' interests; a substantial commitment of personal funds to the partnership in question; and strict controls on both the amount of money raised and the number of positions in each portfolio — I take it that no one here would dispute that these are helpful if not essential prerequisites for success in the private

equity arena. Isn't it curious then that so very few fund-of-funds sponsors actually practice what they preach? In other words, if you were to apply the three litmus tests I just mentioned to the rapidly growing universe of fund-of-funds sponsors, you'd find that very few of them satisfy fully all three litmus tests, and a disturbing number flunk all three.

Painful Irony

At the risk of violating FDR's injunction to be brief, let me add one final point, which — like the main point I've already made — involves a painful irony. The irony is this: in many if not most cases, the most valuable service that a fund-of-funds sponsor offers to its clients is a service that would be largely unnecessary if the fund-of-funds industry did not exist. As we heard earlier, one of the big selling points for fund-of-funds is that they provide their own investors with access to managers whose own offerings are so oversubscribed that newcomers to the private equity arena have virtually no chance of snagging an allocation. This argument has some validity to it. But in all too many cases the offerings in question are "oversubscribed" for a peculiar reason: funds-of-funds as a group have told the general partners forming new partnerships that the fund-of-funds, and the institutions they advise, can absorb X millions of dollars — X typically being a number considerably higher than the GPs themselves were planning on raising.

Supply Creates Its Own Demand

In short, and in closing, the whole spectacle reminds me of what the social critic Thorstein Veblen said about a newly invented and very heavily advertised consumer product that he personally regarded as a waste of money. "Invention," said Veblen, "is the mother of necessity." Attracted by fat fees — and perhaps also the chance to attend a life's worth of lavish partnership dinners — an increasing number of bankers, investment bankers, financial consultants, and ex-politicians are throwing their hats into the fund-of-funds ring. Their schemes are inventive, but the investors they seek to help would have less need for their services if fewer fund-of-funds existed, and if some of them adopted sensible limits on their own assets under management.

Take Cover

To make it harder for members of the audience who run fund-of-funds to hit me with a tomato, I will now heed FDR's advice and be seated. Thanks for letting me roam around the china shop for a few minutes.