Don’t Call It a Comeback

THE EVOLUTION AND ENDURING RELEVANCE OF FUNDS OF FUNDS

JEFFERIES PRIME SERVICES WHITE PAPER

Jefferies

Don’t Call It a Comeback

THE EVOLUTION AND ENDURING RELEVANCE OF FUNDS OF FUNDS

Bad Rap, Good Partners

Few corners of finance have shifted as strongly in the last decade as that occupied by funds of funds (FoF). These pools of capital, after dominating the early years of the hedge fund industry’s growth, have more recently witnessed client redemptions and skepticism about the potential for long term partnership from some alternative fund managers. But a recent Jefferies study indicates that many of the headlines reporting the demise of these allocators are: misplaced at best, inaccurately reflect how much these firms have changed, and where they sit in the alternatives fund ecosystem today.

> *Don’t Call It a Comeback* explores the enduring importance of alternatives funds of funds – and lays out the critical role they play in the alternatives ecosystem.[i] Quite in opposite to the negative headlines, funds of funds serve a critical function in supporting early stage managers, much like venture capital does for companies. In fact, it could be argued that later stage investors directly benefit and *rely* on this contribution, as it facilitates emerging managers’ building of track records. And in many cases, funds of funds also allocate much “stickier” capital than many perceive from days past.

Funds of funds are some of the oldest and most mature alternatives allocators. But many suffered considerably in the wake of the global financial crisis, witnessing broad based redemptions as their own clients worked to meet capital requirements. They also experienced skepticism around “fees on top of fees,” and in some cases lacked diversification and unique product offerings.

In response, many diversified and evolved their operating footprints and the solutions they offer to clients. The funds of funds complexes that endured and operate today manage nearly $650 billion of assets, and serve an important function providing early stage capital that allows the other allocators the benefit of being able to take a “watch and wait” approach before writing their own tickets.[1] While FoF *used* to primarily serve as a access point for asset owners who had a hard time gaining entry into popular hedge funds, today they are much more customized in providing bespoke solutions to clients.

It is our hope that *Don’t Call It a Comeback* details the current role funds of funds play in the alternatives space and contributes to the discussion around the constantly shifting capital flows in our global economy.

Shannon Murphy
Head of Strategic Content
Shannon.murphy@jefferies.com
+1.212.336.1139

Lily Calcagnini
Strategic Content
lcalcagnini@jefferies.com
+1.212.323.7596

Leor Shapiro
Global Head of Capital Intelligence
lshapiro@jefferies.com
+1.212.336.6267

[i] We broadly refer to “alternatives” funds of funds to capture the diverse products they invest in across the industry, but the bulk of assets remain in hedge fund products.

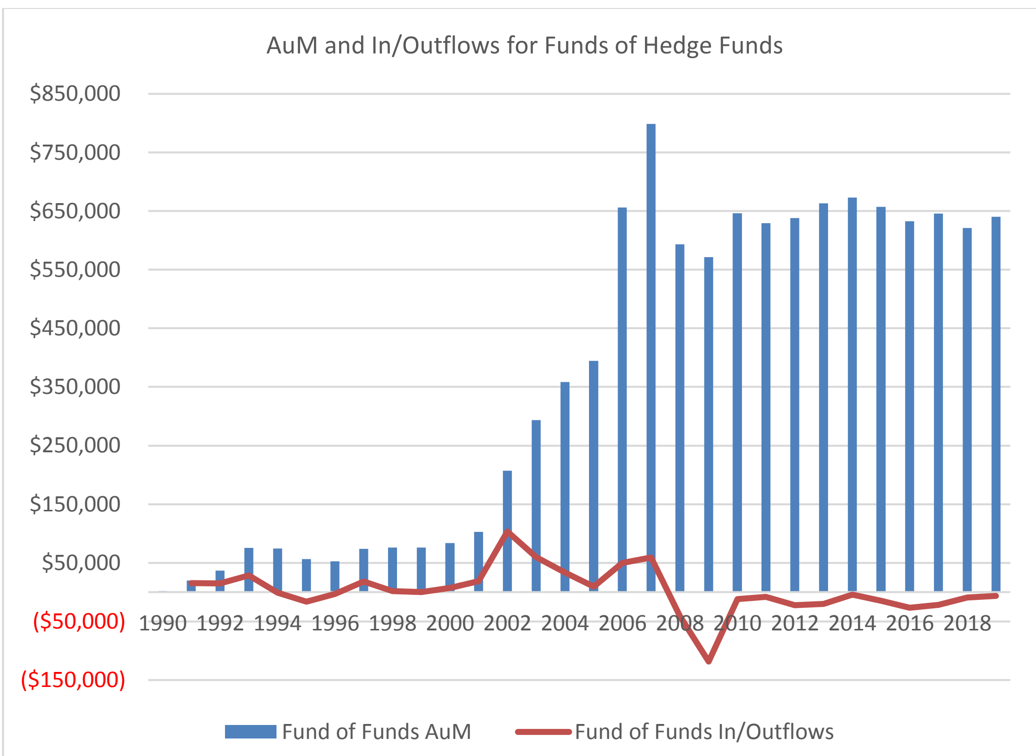
FUNDS OF FUNDS: PERSISTENCE OF ASSETS, IF NOT FLOWS

After more than a decade in which they added more than $360 billion to the hedge fund industry, funds of hedge funds then witnessed another decade of straight outflows – nearly totaling the same amount.[2] But even in the midst of considerable redemptions, something interesting happened: **after an immediate post crisis dip in 2008, funds of hedge funds bounced back and have experienced an enduringly persistent asset base.** In the face of redemptions – this is material. It means they are performing.

Funds of funds' assets peaked in 2007, managing nearly $800 billion; two years later, they bottomed out at $571 billion. In the decade since, as headlines have focused on outflows, a somewhat counterintuitive reality has also endured: **assets under management remain persistently higher, and continue to account for about 20% of all industry funds. And they continue to serve a critical role in the alternatives industry, providing vital early stage capital that allows emerging managers get to scale and build track records for other later stage investors to consider.**

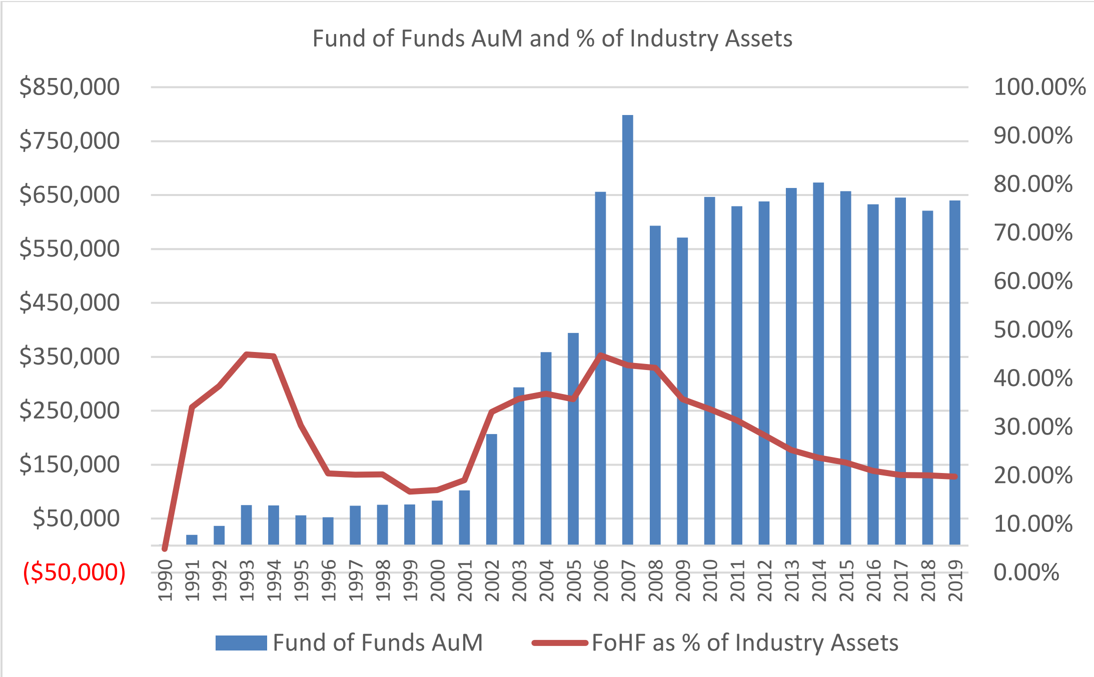
In reality, funds of hedge funds in- and out-flows (as is true for the broader industry) are typically a very small percentage of their ultimate growth or contraction. FoF's enduring existence is grounded in two realities: 1) they are serving their clients by offering differentiated products, and 2) they are performing sufficiently well to stave off more material outflows and maintain their asset base.

Table 1: AuM and In/Outflows for Funds of Hedge Funds



Source: HFR, Jefferies

Table 2: Funds of Fund AuM and % of Hedge Fund Industry Assets



Source: HFR, Jefferies

As a percentage of industry assets, funds of funds account for about one-fifth, a level last seen in 2001. This is a healthy and enduring percentage, and the industry overall has benefitted from diversification of its investor base.

We expect these numbers to stay range bound in the near future, as hedge fund industry assets continue their measured creep up. **These assets are a critical component for the vitality of the alternatives industry, as funds of funds play a more active role in early stage allocation than others. Family offices and funds of funds can account for about 80% of emerging manager day 1 and early stage capital – prompting the question: does this create a free rider problem?[3] Later stage allocators who need a one to three year track record (or longer) have a broader and more diverse group of managers to choose from as a direct result of funds of funds support of new launches.**

If Funds of Funds and Family Offices account for ~80% of early stage capital, they play a critical role in this industry.

Without this support, a smaller, much less diverse group of managers would have the capital to launch.

Later stage allocators directly benefit from the early stage resources funds of funds provide – allowing them to take a wait and see approach, while shouldering less of the business risk of these funds.

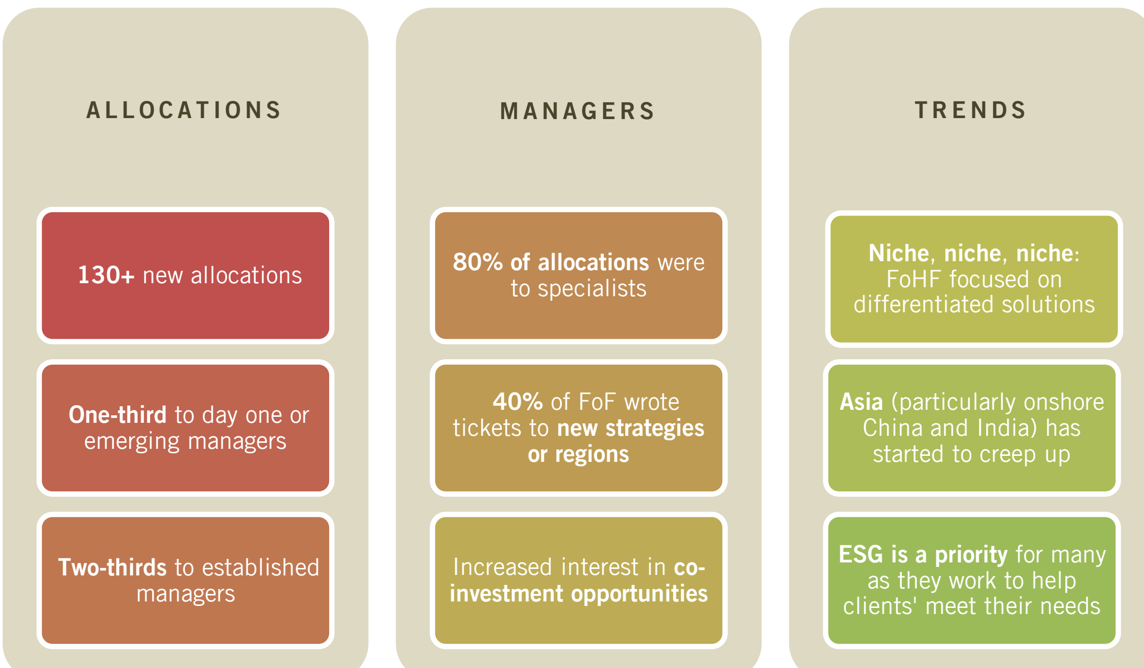
HOW ACTIVE IS ACTIVE? 2020 LANDSCAPE

Jefferies surveyed 25 funds of funds across the spectrum and globe to get a snapshot of recent activity. Some are large household names with long track records of success, endurance and reinvention. Others are smaller and emerging funds of funds, helping with specific mandates for diverse clients.

These groups were responsible for **more than 130 new allocations in 2019 – among our most active allocator groups by organization**. This intuitively makes sense – by definition, funds of funds make allocations to new funds in an ongoing basis. They can differentiate by finding new and emerging managers, and creating unique combinations of funds, vehicles or investment exposures. But what may be particularly interesting, is that **many believe funds of funds' capital today is far "stickier" than in past years**.

Of 2019 allocations, a **full third were to day one or emerging managers**. As one FoF allocator told us, "In some ways, we are like venture capitalists. We play in early and day 1 markets, and hope to hit it big with some, do well with more, and we fully recognize not all these investments will be home runs. Our job is to not miss identifying the guys who make it big – and if we can get in with them through Founders' or other preferred share classes, all the better."

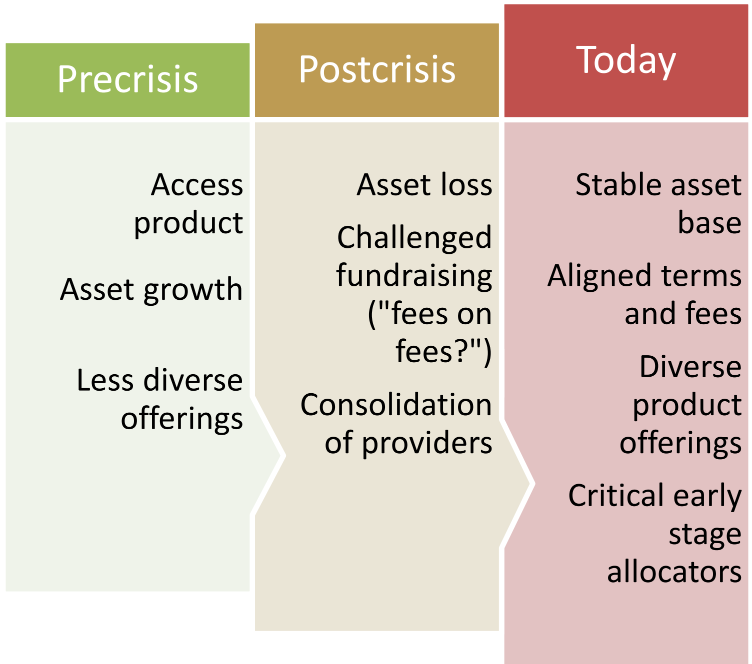
Figure 1. Key Highlights of 2019 Jefferies Fund of Funds Allocation Survey



The shifts funds of funds themselves have experienced is not unique – we continue to hear they are reviewing the portfolio to consolidate managers if there is considerable overlap in portfolios to free up capital for new or specialist managers. The funds of funds that have survived the outflows and consolidation across the industry have **largely done so by differentiating their product offerings for clients**. Many of the funds we spoke to explicitly outlined the increase in resources that are dedicated to finding new, niche and specialist managers. While the number of "blockbuster" launches has declined in recent years, more than one fund of fund raised the point that there is a very rich and interesting new generation of managers (and products) emerging.

We heard **numerous examples of launching specialist products focused on: health care specific, Asia, and ESG funds of funds – among others.**

TRANSITION TO TODAY



We have seen funds of funds go through a transition that witnessed clients redeeming in the wake of the global financial crisis, and become *much* more sensitive to the idea of paying "fees on top of fees." After a few years of asset loss and firm consolidation, this corner of our industry as emerged as a strong and critical player.

They have:

- Aligned terms and fees to more effectively serve their clients
- Consolidated organizations to create global advisory powerhouses
- Built new data competencies to help advise clients on portfolio construction, benchmarking and investments
- Refocused on early stage investments, providing essential day one capital to a diverse stable of managers, enabling their growth and serving as an important lifeblood of capital for the broader industry, and
- Witnessed a more stable capital base. While there may be a smaller amount of net redemptions, withdrawals have slowed and the fund of funds asset base has remained enduringly resilient in recent years.

WHAT LIES AHEAD

- **Will funds of funds continue to play a critical role in providing early stage capital to the next generation of successful alternatives founders**? How does the "shift to niche" impact how emerging managers think about their value proposition and where they sit in the competitive landscape?
- **Does the persistence of capital indicate we can expect a continuation of this in the next decade?** Funds of funds have performed sufficiently in recent years to maintain a fairly range bound and stable capital base. What remains to be seen is if their shift to specialists and niche managers fares well across a late cycle investing environment.
- **Will consolidation continue?** The majority of funds of funds we spoke to believes the most material consolidation in their industry has already occurred, and while there may be mergers or acquisitions still ahead, they will be smaller and more episodic than some of the headline deals of recent years.
- **Are certain funds of funds bellwethers for what will constitute success for the next generation of managers**? There are few other allocators as active in early and emerging managers than funds of funds. A closer look under the hood at these allocations may give an early indication as to what funds are well positioned for success in the years ahead.

How Jefferies Can Help

The alternative investment industry relies on new capital invested regularly with new and early stage managers. The bulk of this comes from funds of funds, who serve an enduringly critical role in assisting emerging managers in getting their firms off the ground, and to the point when later stage allocators can vet and review these organizations for future investment.

Jefferies has considerable expertise, resources and solutions to better help clients understand the role that funds of funds play in the next decade of our industry's maturation. We continuously map these organizations' shifts, mandates and discussions they are having with *their* end clients to understand the evolving needs of asset owners across the market. As you continue to deepen your understanding of funds of funds – and the role they play in the 2020 alternatives market – please let us know how we may help.

IMPORTANT DISCLAIMER

THIS MESSAGE CONTAINS INSUFFICIENT INFORMATION TO MAKE AN INVESTMENT DECISION.

Please contact your Jefferies representative for copies of the most recent research reports on individual companies.

This is not a product of Jefferies' Research Department, and it should not be regarded as research or a research report. This material is a product of Jefferies Equity Sales and Trading department, and intended for Institutional Use. Unless otherwise specifically stated, any views or opinions expressed herein are solely those of the individual author and may differ from the views and opinions expressed by the Firm's Research Department or other departments or divisions of the Firm and its affiliates. Clients should assume that this material is not independent of the Firm's proprietary interests or the author's interests. For example: (i) Jefferies may trade for its own account or make markets in the securities referenced in this communication (and such trading may be entered into in advance of this communication); (ii) Jefferies may engage in securities transactions that are contrary to or inconsistent with this communication and may have long or short positions in such securities; and (iii) the author of this communication may have a financial interest in the referenced securities.

The information and any opinions contained herein are as of the date of this material and the Firm does not undertake any obligation to update them. All market prices, data and other information are not warranted as to the completeness or accuracy and are subject to change without notice. Past performance is not indicative of future results, and no representation or warranty, express or implied, is made regarding future performance. The Firm is not providing investment advice through this material. This material does not take into account individual client circumstances, objectives, or needs and is not intended as a recommendation to particular clients. Securities, financial instruments, products or strategies mentioned in this material may not be suitable for all investors. Jefferies does not provide tax advice. As such, any information contained in Equity Sales and Trading department communications relating to tax matters were neither written nor intended by Jefferies to be used for tax reporting purposes. Recipients should seek tax advice based on their particular circumstances from an independent tax advisor. In reaching a determination as to the appropriateness of any proposed transaction or strategy, clients should undertake a thorough independent review of the legal, regulatory, credit, accounting and economic consequences of such transaction in relation to their particular circumstances and make their own independent decisions.

OPTIONS ARE NOT SUITABLE FOR ALL INVESTORS. Please ensure that you have read and understand the current options risk disclosure document before entering into any option transaction. The options disclosure document can be accessed at the following web address: http://optionsclearing.com/publications/risks/riskchap1.jsp. Please contact Peter Seccia Head of US Derivatives +1 212.707.6481.

© 2020 Jefferies LLC

[1] HFR
[2] HFR
[3] Jefferies Capital Intelligence team