

SPUR THOUGHTS ON FUNDS-OF-FUNDS

Funds-of-funds provide institutional investors with a number of significant investment and economic benefits, some of which have been documented in academic research.¹ Outperformance across any investment segment is dependent upon selectivity - more so within private equity broadly and venture capital in particular. Historically, the performance differential between the upper and lower quartiles has been substantial. The upper quartile IRR benchmark for venture capital funds averaged 20.2% from 1981 through 2008 while the lower quartile benchmark averaged 2.6% per Cambridge Associates U.S. Venture Capital Index and Benchmark Statistics March 31, 2012. In addition, the fund over fund persistence of relative outperformance by top venture investors has been well documented.

As specialist managers, venture capital fund-of-funds managers have a level of expertise as well as a depth and breadth of relationships that may not be available to finance professionals with broader mandates and greater time constraints. In particular, venture capital is an asset class in which the venture firms are small groups that rely heavily on their networks to identify deals and to select their limited partners. Patience, persistence, and the ability to respond quickly to opportunities are essential for any highly selective strategy and will be hallmarks of successful implementation for a venture capital investment program.

Venture capital funds-of-funds can provide superior portfolio construction, which may be difficult to attain without a steady mandate, appropriate timeframe, and adequate and consistent capital and professional resources. Approximately 15-20 individual fund commitments are necessary to create a sufficiently diverse portfolio of venture capital fund investments. Because most venture funds have multi-million dollar minimum commitment amounts, an institution without the ability to commit more than \$100 million per three or four year investment cycle, may find it difficult to achieve a similarly diversified portfolio. Funds-of-funds enjoy a broader view of the investment universe and employ dedicated resources in the selection and construction of a diversified portfolio. Additionally, venture capital funds-of-funds can help alleviate excessive and impulsive investments in “flavors of the month” - those opportunities that have been capturing media attention.

Venture capital investments are by their nature long-term, high risk, illiquid assets that require the investor to commit funds in a limited partnership for ten or more years. Selection and access is critical and it may take several years to establish the right connections before a commitment is made. With appropriate procedures and processes, the knowledge gained by a dedicated and cohesive full-time team will contribute and inform an evolving institutional memory, which in turn, should effect continued improvement of investment decisions. Conversely, smaller organizations that rely on one or two investment professionals committed to private equity investments may suffer loss of important and instructive “lessons learned” as well as the key personal relationships upon the departure of an individual.

Because much of the information about the performance and the progression of portfolio companies, as well as venture capital team dynamics, is “soft” and may be difficult or sensitive to convey, adequate monitoring is essential for any venture capital investment portfolio. For venture capital partnerships, it is important to attend annual meetings, one-on-one meetings, as well as serve on select advisory boards to get an understanding of partnership dynamics and the development of portfolio companies. The aggregate time and costs associated with monitoring can be significant, especially for international investments.

Many institutional investors also find it difficult to hire, compensate, or retain the best talent in the venture capital sector. Because venture capital firms tend to be small organizations and the key individuals remain the same fund over fund, personal relationships are a critical part of venture capital investing, contributing significantly to identifying, evaluating (especially due diligence) and accessing opportunities. Building and maintaining these personal relationships is a time intensive proposition that requires significant travel and personal interaction.

Finally, their level of activity and commitment allows funds-of-funds to establish and maintain relationships with top service providers. This may be important with respect to pricing, as well as “mind share” and the ability to receive high quality and timely legal, banking, accounting, and distribution management services. Funds-of-funds are also able to amortize the cost of specialized software over a larger base of assets and potentially provide significant cost savings relative to an investor that hires or purchases the dedicated resources necessary to successfully implement a direct investment program.

Therefore, when considering the cost of locating, selecting, accessing, negotiating, and monitoring venture capital relationships, a fund-of-funds manager becomes a cost effective way to gain exposure to top-tier venture capital funds that have consistently provided long-term returns far outpacing the public markets and other private investments (per Cambridge Associates, the 15-year performance for early-stage venture capital was 47.0% versus 7.1% for the Dow Jones Industrial Average as of March 31, 2012) .

Spur Capital Partners is a fund-of-funds manager that brings over 75 collective years’ experience to the venture capital market. The Directors work closely with the general partners of the funds in which Spur has invested and currently sit on a number of domestic and international venture capital advisory boards.

Additional Resource:

[Do Funds-of-Funds Deserve Their Fees-on-Fees?](#)

ⁱ Ang, Andrew, Matthew Rhodes-Kropf, and Rui Zhao. "Do Funds-of-Funds Deserve Their Extra Fees?" *Journal of Investment Management* 6, no. 4 (Fourth Quarter 2008).