

Fund of Funds of Fundss of Fundsss, or, Intermediation runs Wild.

There was a time not long ago when we heard about “disintermediation.” Technological advances and advanced degrees made it increasingly possible for smaller groups and even individuals to receive and process increasingly sophisticated information. As a result, the banker, whose traditional function had been to protect investors and serve issuers with in-depth analysis and financial packaging, became in many cases less essential. The disintermediation phenomenon, which seemed to thrive in the 1990s, was manifest in web-based stock offerings direct to investors, in “cookie-cutter” asset securitizations that displaced more situation-specific bank loans, in M&A transactions marketed in data bases or directly between corporate staffs, and in advanced stock trading products available to individuals at discount rates.

With growing numbers of participants of increasing levels of sophistication, markets will theoretically become more efficient and high-profit opportunities more difficult to source. If so, then perhaps it was in response to a diminishing return scenario that money managers and other professionals were forced to institutionalize and develop narrow specialties, giving rise to the multi-trillion “funds” industry of today.

But what are fund managers if not intermediaries, and whence “disintermediation” in our “hyper-funded” environment? From this perspective, intermediation has only redefined itself, and may have become more widespread than ever. Whereas the past gave us mere bankers and brokers, the present has even invented a brand new go-between: the “fund of funds.”

As the complexity of hedge fund strategies and the number of private equity funds have increased, the decision to allocate capital to any of them has become increasingly complex. “Funds of funds,” which specialize in the analysis and efficient capital allocation to specific fund managers, thus serve the function of bankers... and if we were to think of a “fund” as a capital pool similar to a bank, the fund of funds “bankers” are “bankers to banks.” Continuing on this train of thought just a bit further, there is an added intermediary tier even beyond this point, as funds of funds themselves are scrutinized and “funded” by insurance companies and endowments, all of which are really funds too.

While much of this phenomenon – in which funds fund funds that fund other funds that eventually fund a business – serves the purpose of risk reduction through diversification, certain questions may be worth pausing for. When an investment is sought from a fund, how many behind-the-scenes intermediaries along the chain described impact the decision? How much investment autonomy does a hedge fund really have, when its capital may be called back at almost any time? How efficient is a market really, if added layers of intermediation not only impact decisions, but the expense ratios of capital put to work? In the last analysis, it may well be that the classic investment banker – the old-fashioned intermediary who helps clients sift through this evolving financial labyrinth – is now more necessary than ever, despite (or because of) a movement that started out as “disintermediation.”

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