As a part of our context-setting series on key concepts from AVI's investment thesis and strategy, this article explores the features of Evergreen Fund-of-Funds (FoF) models, highlighting their advantages, challenges, and key considerations. It also discusses our approach to addressing potential obstacles.

TL;DR

As the Arbitrum ecosystem continues to scale, it requires a sustainable investment framework that balances long-term growth with the flexibility to respond to evolving market dynamics. To do this, a strategy-agnostic framework is needed for leveraging the DAOs treasury towards highly adaptable and strategic investment capital.

An Evergreen FoF provides a continuous, self-sustaining mechanism to enable the flow of funds between Arbitrum DAO and a diverse set of investment strategies, while recycling the returns by default. It is an open-ended model that can be complemented by closed-ended approaches through Captive and Non-Captive Vehicles, to strike the ideal balance between stability and flexibility for effective scaling.

Definitions

An Evergreen Fund is a perpetual investment model designed to enable a continuous replenishing of funds. Unlike traditional funds with fixed time horizons, evergreen funds focus on sustainability, adaptability, and long-term ecosystem alignment. With effective management, the fund can operate without requiring additional investments, ensuring a continuous return of value. Additionally, the parent entity may choose to provide further funding to enable new initiatives or can return the remaining funding to their treasury once the objective has been achieved.

On the other hand, a Fund-of-Funds pools capital to invest in other funds rather than directly in individual projects, leveraging the expertise of specialized fund managers to optimize returns and achieve strategic diversification. This approach opens doors to opportunities that might otherwise be out of reach, whether due to limited resources or lack of experience in certain areas.

Key Considerations

Evergreen Funds:

Advantages:

- Recycling Capital and Sustainability:

Evergreen funds reinvest returns to drive future growth, creating a stable capital flow that minimizes the overhead of fundraising cycles. This approach ensures the fund remains available while fostering continuous value creation.

- Cost Efficiency:

By reducing administrative overhead associated with launching new funds, evergreen funds streamline operations and maintain stability, enabling long-term financial support and innovation.

- Alignment with Ecosystem Goals:

Evergreen funds are particularly beneficial when they prioritize ecosystem benefits over financial returns, funding projects that foster innovation, expand market reach, and address systemic challenges. This strengthens the ecosystem while demonstrating blockchain's practical applications in new sectors.

- Treasury Flexibility:

Evergreen funds allow capital to flow in and out based on evolving needs, avoiding the pressure to deploy capital prematurely or hold onto it unnecessarily. For instance, a manager can withdraw capital during a downturn to address liquidity gaps instead of being locked into a rigid investment cycle.

Challenges:

- Incentives:

The pressure to drive exits of termed fund mandates is not as present, risking complacency on the side of the managers who may hold positions in companies too long in the case of direct investment. However, this can be avoided by deploying money in closed-ended investment vehicles, rather than direct investments, as discussed in sections below.

- Impatience:

The fund's performance cycle might become mismatched or poorly managed by the parent organisation, especially under

market conditions that are challenging. This might lead to slowing down of investments, divesting prematurely and even undermining the fund's sustainability and ecosystem impact.

Fund-of-Funds:

Advantages:

- Diversification and Scalability:

Spreads investments across multiple funds, reducing risk and ensuring reach into new markets and sectors without requiring extensive in-house expertise.

- Access to Expertise and Networks:

Leverages the knowledge of and networks of already setup and experienced fund managers to identify high-potential opportunities.

- Efficient Risk Management:

Lowers overhead by leveraging the expertise of external fund managers specialized in their fund's unique strengths and accountable to all LPs for high-quality decision-making. This approach optimizes diversified strategies and taps into broader free market capital with built-in accountability, while maintaining alignment with strategic objectives.

- Velocity:

Offers the ability to work with a network of narrowly specialised managers who are already set up allowing for rapid deployment in new spaces starting with smaller amounts.

- Aligned Inclusivity:

Maintains incentive alignment by using Arbitrum-only funding as the foundation, with a flexible structure that enables external LPs and co-investors to join as secondary participants in specific deals or smaller, narrowly focused programs, addressing misalignment issues common in other crypto ecosystem investment models.

Challenges:

- Additional Costs:

Layered management fees can reduce net returns.

- Reliance on Managers:

Success depends heavily on external fund performance and decision-making.

A Multi-Faceted Strategy: Maximize Strengths and Mitigate Weaknesses

As discussed in our article on Captive and Non-Captive Vehicles, combining approaches enables us to harness the unique strengths of each method while compensating for their respective weaknesses. This creates a cohesive, robust, and adaptable strategy that is greater than the sum of its parts.

Balancing Open-Ended and Closed-Ended Strategies

The unified Evergreen FoF approach results in an open-ended model that offers significant flexibility. This flexibility brings its own set of challenges, as discussed in the Key Considerations section. These challenges can be effectively addressed by incorporating closed-ended approaches in the individual strategies, on both the Captive and Non-Captive side.

- Open-ended strategies:

Offer the flexibility to inject and withdraw capital over time

- Close-ended strategies:

Operate on fixed time horizons, with capital locked in for the fund's duration

Additionally, traditional funds often reward performance through exit events, such as the sale of assets or the completion of a fund's lifecycle, creating a direct link between outcomes and compensation for fund managers. On the other hand, Evergreen Funds, with their perpetual structure and absence of definitive end points, can lack such explicit incentives, potentially leading to diminished focus or motivation over extended periods.

Closed-ended strategies address this challenge by introducing defined time horizons and measurable milestones. By incorporating clear terms and structured exits, these strategies provide fund managers with tangible goals and performance-based incentives.

The Synergy of Combined Evergreen and FoF Approaches

As mentioned, FoFs often incur additional costs due to layered management fees. When combined with an Evergreen approach, these costs can be mitigated by the reduced operational overhead and self-sustaining nature of the financial structure. Unlike traditional VC or CVC funds, which exhaust their capital over a fixed period, Evergreen Funds continuously reinvest returns back into the fund, which eliminates the need for frequent external fundraising, streamlines operations, and reduces administrative expenses.

In a similar manner, FoFs complement the Evergreen Fund's focus on ecosystem development over immediate ROI by prioritizing financial returns. These focuses work together to ensure capital is strategically allocated to projects that strengthen the ecosystem's foundation while simultaneously achieving competitive returns through diversified investments. When combined, as recommended for the structuring of AV, these approaches align purpose with profitability. This creates a strategy-agnostic framework, designed to adapt to dynamic market conditions.