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Fund of Funds as a Tool of Economic Statecraft

Working Paper

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Executive Summary

Fund of Funds (FoF) investment approaches have evolved substantially over the past three decades, from mechanisms to facilitate returns and portfolio diversification to more recently serving as instruments of deliberate economic statecraft. Originally popularized through mechanisms like secondary market investments buying stakes in funds from investors seeking liquidity, to becoming formalized as a mechanism to spur venture capital and close investment gaps, FoF today are a means to simultaneously advance economic growth, secure technological sovereignty, and achieve geopolitical objectives. In other words, they are a tool of economic statecraft i.e. the strategic use of economic tools by a state to achieve foreign policy and national security objectives.

We trace out the evolution of FoFs from their early venture capital applications through contemporary usage as an instrument for directing national innovation activities and especially regional innovation ecosystems toward strategic priorities including screening foreign capital threats, and scaling domestic production capacity. Through analysis of case studies including Israel's Yozma program, Saudi Arabia's sovereign wealth-backed SVC, the NATO Innovation Fund, and the UK's National Security Strategic Investment Fund, we demonstrate that FoF represents a distinct and increasingly important tool within a broader toolkit of economic statecraft interventions that are of increasing relevance to nations and regions seeking to scale economic activities towards clear national priorities. Of particular relevance is the way in which these programs can be designed to achieve multiple economic statecraft objectives

simultaneously: building domestic venture capital capacity where market failures exist, directing innovation toward priority sectors aligned with national security, identifying and excluding adversarial capital flows, and ensuring strategic technologies reach industrial-scale production.

That said, FoF programs remain vulnerable to political capture and implementation failure i.e. falter in the Boulevard of Broken Dreams as vividly documented in Lerner's analysis of failed government VC initiatives. We therefore conclude with an evaluation of successful models and implementation approaches that combine professional fund manager selection, mandatory co-investment requirements, expert vetting, and clear measurement frameworks.

1. Introduction

The relationship between capital allocation and economic growth has long concerned governments, whose policymakers have established a range of public policy tools designed to support private capital markets and overcome market failures in service of economic growth. In recent decades attention has focused on increasing investment in emerging technologies and the support of innovation ecosystems where deep tech and other innovation-driven enterprises flourish through the provision of private (equity) capital - most notably venture capital at the seed through to growth stages, prior to IPO or acquisition.

In recent years, national security concerns, driven in large part by the shifting geopolitical landscape, have placed technological innovation - and especially the role of startup ventures in creating and scaling that innovation - in the spotlight. It is now regarded as a direct input into potential defence capabilities, and innovations in priority technology areas are now regarded as a source of power and strategic autonomy, and their absence a source of vulnerability. As a result, the funding of startup ventures in key areas of technological innovation, specifically the direction and scaling of those

ventures towards key priority areas and the protection of those ventures from adversaries has become a policy priority. In meeting the goals of the emerging geopolitical logic, governments face a novel challenge: how to systematically build, direct, and secure ventures in their innovation ecosystems without suppressing the entrepreneurial dynamism that makes them valuable - in other words how to balance political direction setting with the market. Fund of Funds (FoF) investment structures have emerged as a critical tool for addressing this challenge, enabling governments to achieve multiple objectives - economic competitiveness and geopolitical power - simultaneously through a single policy mechanism aimed at startup ventures.

Of course, as with any other policy lever, the effectiveness of tools of economic statecraft rest on understanding the core instrument - in this instance the Fund of Funds investment vehicle, the incentives and interests of private sector capital, and the degree to which government intervention is needed to shape outcomes towards the desired objectives. As an investment vehicle that allocates capital to other investment funds rather than directly to individual ventures, the FoF structure has the inherent flexibility to explicitly integrate concerns about technological sovereignty, defence industrial capacity, and protection against adversarial capital flows. This structure is not novel—institutional investors have used FoF approaches for decades to manage portfolio diversification and access. And indeed, the application of FoF structures by governments as instruments of deliberate policy has been part of the evolution of national policy around innovation ecosystems and startups. But where once such programs focused narrowly on economic development, contemporary FoF initiatives by the public sector are now combining both economic competitiveness and national security objectives in their remit.

This evolution is neither accidental nor marginal. As we demonstrate, FoF has become embedded within a broader toolkit of economic statecraft interventions that include targeted research and development investments, capital gains tax structures,

intellectual property regimes, export controls, and foreign investment screening. The strategic value of FoF lies in its ability to focus closely on startup ventures in priority sectors/technologies. Moreover, its structure accomplishes what direct state investment in startups cannot: it harnesses professional investment expertise, market discipline, and private capital, while simultaneously advancing public objectives by setting out the priorities for investors without making individual investment decisions.

To provide a roadmap for decision-makers wishing to deploy FoF interventions as a tool for economic statecraft, and to lay out guidelines for its effective use (including lessons from history and experience), this paper proceeds as follows. Section 2 establishes our conceptual framework, explaining what FoF structures are and why they matter for policy. Section 3 traces the historical evolution of government FoF programs, beginning with Israel's pioneering Yozma initiative and progressing through the development of sovereign wealth fund approaches. Section 4 analyzes contemporary applications of FoF as an explicit tool of economic statecraft, with particular emphasis on how programs like the NATO Innovation Fund and the UK's NSSIF integrate security screening, sector direction, and scale-up objectives. Section 5 addresses the identified vulnerabilities and implementation challenges that threaten FoF program success, drawing on empirical research about government venture capital intervention more broadly. The conclusion synthesizes these findings and considers implications for future policy design.

2. Understanding Fund of Funds

2.1 Definition

A Fund of Funds (FoF) is an investment vehicle that invests in other investment funds rather than directly acquiring securities or (equity) stakes in individual companies. As a result, a FoF becomes a limited partner (LP) in multiple funds building up a portfolio of

such funds. In the venture capital context, a decision-maker within a FoF (typically in the private sector known as a General Partner or GP) commits capital to multiple venture capital funds (often selected to operate across different areas of technology, sector or even geography). This is in contrast to a traditional venture capital GP who is a Partner in an individual venture capital fund that makes active investment decisions about the allocation capital across a portfolio of ventures. To put it differently, the unit of investment for the leader of a FoF is a Fund while the unit of investment for the leader of a Fund is a venture. This second-order intermediation creates structural differences from direct investing that prove consequential for the delivery of financial outcomes and the delivery of (multiple) policy goals.

Although the distinction between FoF and direct venture capital investment appears modest, it carries significant implications. Where a traditional VC fund maintains 20-30 portfolio companies and hands-on operational involvement with founding teams, a FoF maintains positions in 10 or more funds and engages on a regular basis with those funds' management teams rather than with entrepreneurs directly. Moreover, the engagement with the Funds in the FoF portfolio operates through serving as a “Limited Partner” meaning some but limited influence over direct investment choices. In contrast, the role of a Fund manager with his or her portfolio companies is as a Board member with deeper and more extensive decision-rights. The FoF role creates what might be termed a "one step removed" quality that fundamentally alters incentive structures, information flows, and governance relationships.

2.2 Fund of Funds as a Policy Tool

FoF structures have existed in various forms since the early 1980s to provide exposure to the venture capital asset class for pension funds and institutional investors with capital to deploy but without the expertise or desire to construct venture portfolios themselves. But in the early 1990s, governments (notably Israel) recognized the

potential of FoF as a policy tool for crowding in private sector capital and driving economic growth.

The FoF structure can be thought of as a type of direct government investment scheme allocating public money, in contrast to and often as a complement to legal instruments such as Capital gains taxes that are regarded as an important instrument for stimulating venture capital markets[1]. As a means of shaping direct public capital allocation, FoF becomes policy-relevant through several mechanisms.

- First, FoF is an opportunity for government capital providers to diversify their own investment activities (e.g. via pension funds or sovereign wealth funds) into a private asset class that requires significant expertise and experience to build.
- Second, FoF provides a means for governments to achieve portfolio exposure and insights into a particular sector without requiring deep sector expertise. This proves particularly valuable for governments or multilateral institutions seeking to understand a sector but lacking internal capabilities.
- Third, FoF creates a focus and natural leverage of resources into sectors of particular policy relevance: a government commitment of €100 million as a FoF investor may unlock €300-500 million in total fund capital, achieving substantial economic impact with constrained public budgets thus bolstering venture capital activities in selected sector, technology, or region.
- Fourth, FoF provides an opportunity to influence the capabilities and practices of investment managers i.e. GPs. Through its participation in a Fund, government FoF allocators can require certain training activities (to upskill) e.g. in the case of new managers or require security clearances e.g. for defence investors as a condition of a FoF investment. As important, government participation can set standards for venture capital increasing the professionalization of the activity in markets new to VC.

[1] Gompers and Lerner (1998), and Poterba (1989)

- Fifth, and in all instances outlined above, by delegating investment decisions to professional fund managers rather than government officials, FoF mitigates—though does not eliminate—the risk of politically-driven capital misallocation (i.e. the agency costs associated with government activities)[2].

Taken together, the characteristics of FoF make the operational approach more robust that a direct investment alone. At the policy-level, FoF are particularly useful for overcoming"market-failure" —i.e. addressing those activities in the economy where market mechanisms alone produce insufficient private capital deployment. They make FoF equally useful, however, for achieving "market-directing" objectives—channeling capital toward sectors, technologies, and geographies that governments determine strategically important but that pure market mechanisms may not prioritize.

3. Historical Evolution: From Economic Development Tool to Economic Statecraft Instrument

The strategic application of FoF mechanisms has evolved substantially over four decades, progressing from purely financial instruments focused on investor diversification toward policy tools explicitly integrating wider economic development objectives such as venture capital for innovation ecosystem building, with more specific and directed objectives such as national security, deep technology, climate etc. This evolution reflects three critical factors: the maturation of venture capital markets reducing the need for basic market-building FoF; the emergence of sophisticated sovereign wealth funds seeking to deploy capital strategically; and most critically, the rising salience of start-up led technological competition as a source of both economic and military power.

[2] As outlined in Boulevard of Broken Dreams (2009) by Lerner.

Examples of each of these phases of the deployment of FoF by government provide insights into today's best practices, the continued challenges of government 'venture capital' activities and the opportunities for creative and effective use of the tool by nations and regions today.

Figure: Overlapping Evolution of Fund of Funds Mechanisms (1980s-2025)

Phase	Period	Primary Objective	Secondary Objective	Government Role	Key Examples
Early VC Era & the Yozma Experiment	1980-2000	Economic Returns & Diversification with an initial foray into Economic growth	Portfolio Access	Minimal to none. Yozma as exception	VCFA (1982), Adams Street, Coller Capital, Yozma
Government Development Phase	2000-2020	Economic Growth & Ecosystem Building	VC Market Development	Active Investor & Market Builder	Saudi SVC, EIF, Nordic SWFs
Transition & Specialization	2015-2020	Strategic Sector Direction	Economic Growth + Ecosystem Security	Strategic Capital Director	BBB Expansion, EU Programs, Defence Tech Initiatives
Economic Statecraft Era	2020-2025	Economic Security & Strategic Advantage	Exclude Adversarial Capital + Industrial Scale-Up	Security-Conscious Capital Allocator	NATO Innovation Fund, UK NSSIF, Quantum Fund

This progression demonstrates that each successive phase builds upon and adds complexity to earlier approaches, with security concerns increasingly prominent alongside economic ones. Early FoF mechanisms served purely financial purposes; government involvement introduced development objectives; contemporary programs integrate explicit security mandates.

3.1 Venture Capital Fund of Funds (1982) to Yozma (1993)

Fund of Funds as a pooled investment vehicle with a focus on venture capital (rather than other asset classes) was pioneered by the Venture Capital Fund of Funds (VCFA) in the 1980s. They established a secondary market for private equity interests, buying stakes in existing funds rather than direct companies, thus establishing the concept of investing through funds. According to VCFA (in 2025), they have raised 10 venture/growth equity secondary funds totalling $1 billion of AUM with a focus on purchasing equity in mature, private, high growth venture/growth equity secondaries. Throughout the 1980s and 1990s, firms like Adams Street Partners and Coller Capital built substantial businesses on this insight, acquiring limited partner (LP) interests in existing venture funds through secondary transactions and providing institutional investors access to venture exposure without requiring direct fund selection capabilities.

As FoF activity grew, few governments paid attention. Israel stands out as an exception. Its Yozma program, established in 1993, stands as one of the first government-initiated FoF programs, representing both a remarkable policy success and the paradigm that would inspire subsequent initiatives globally. Initiated under the leadership of Eitan Wertman and backed by then-Science Minister Shimon Peres out of the Office of the Chief Scientist, the program confronted a specific market failure: Israel possessed a growing technology sector and engineering talent, a rise in the formation of startup ventures but virtually no domestic venture capital capacity.

The problem was not the complete absence of capital flow, but rather that the incentives of the existing (venture) capital providers were misaligned with those of local policymakers. American venture capitalists had begun investing in Israeli technology companies during the 1980s, but with a key objective: identify promising Israeli entrepreneurs, develop companies, and then facilitate acquisition by or relocation to the United States. This "brain drain" produced economic gains for Israeli entrepreneurs

individually but failed to build domestic innovation capacity nor establish VC capacity within Israel. The country possessed innovation inputs (talented engineers and entrepreneurs, some market demand for novel solutions, infrastructure to support startup ventures) but not early-stage capital focused on retaining or scaling the resulting ventures.

Yozma's structure addressed this through deliberate government design[3]:

- Total capitalization: $100 million in government allocation for FoF;
- Direct government fund: $20 million invested in the Yozma Fund itself to engage in limited direct investment activities and to support FoF activities headed by Yigal Erlich who had resigned from serving as Chief Scientist to lead the privately established Yozma entity[4];
- Yozma FoF capital: $80 million to invest in approximately 10 individual VC funds that could match government funds with private investor commitments from reputable international VCs with $1.5 of private capital for every $1 from the government. Funds were generally focused on ICT and biotech;
- Fund manager requirements: All participating funds required managers with proven VC experience; government did not attempt to pick winners among management teams;
- Return structure: For profitable funds, the government's investment could be purchased back by private investors (functioning as a structured loan), with all upside accruing to non-government LPs—effectively capping government gains while amplifying private investor returns;
- Learning: Yozma Fund Managers participated in the LP activities in each of their selected FoF sharing insights, experience and building capability;
- Time-limited: The program operated for 5-7 years as originally envisioned, with explicit sunset provisions;
- Success trigger: By 1998-2000, the program had successfully catalyzed sufficient private investor interest that the government exited entirely.

[3] Avnimelech, Kenney and Morris (2004)
[4] Klingler-Vidra, Kenney and Breznitz. (2016)

The results proved transformative. Within a decade of Yozma's inception, Israel's venture capital industry grew from essentially zero domestic capacity to over $10 billion annually. More significantly, Israeli-founded companies increasingly remained in Israel through growth stages and international exit, retaining employment and technological capacity within the country. Yozma demonstrated that properly-structured government FoF investment could jumpstart venture capital market development without requiring the government to exercise direct investment decision-making authority.

3.2 Privately-led Government enabled Ecosystem-Building

The success of Yozma inspired subsequent governments to adopt similar approaches, but a second wave of FoF development emerged not only from small nations with market failures, but also from resource-rich sovereigns with large capital pools and broader development ambitions. Saudi Arabia's venture capital program and later initiatives by Nordic SWFs represent this second phase.

In 1997, five years after the Yozma program, Australia established the Innovation Investment Fund (IIF) as a government initiative designed to boost early-stage venture capital for commercializing research. The government provided capital, which fund managers had to match with private funds, to invest in seed, startup, and early-stage companies. Investing in high-tech firms, providing management expertise, and facilitating research commercialization. The goals of the Australian program, as outlined by Cumming (2007) include[5]:

- To encourage the development of new technology companies which are commercialising research and development;
- To develop a self-sustaining Australian early-stage, technology-based venture capital industry;
- To establish in the medium term a revolving or self funding program; and

[5] Cuming (2007)

- To develop fund managers with experience in the early-stage venture capital industry.

Much as with Israel's Yozma, the Australian IFF approach required that the ratio of Government to private capital must not exceed 2: 1; with at least 60% of each fund's committed capital invested within 5 years in R&D intensive ventures; but with a constraint that portfolio companies must not receive funds > $4 million or 10% of the fund's committed capital, whichever was the smaller. The government funds were distributed back (with interest) and additional profits shared on a 10:90 basis between the Government and private investors.

By 2000, around 7% of venture funds in Europe were government-controlled according to a study of over 119 funds in 17 countries (for the period 1998-2001).[6] In the UK, the UK Innovation Investment Fund (UKIIF), was created in June 2009 as a GBP150M FoF with the objective to drive economic growth and create highly skilled jobs in a post-2008 period.[7] Unlike Yozma which invested directly into underlying Funds, the UKIIF was structured to establish private FoFs with two created at the start:

- The Hermes Environmental Innovation Fund led by Hermes Private Equity was closed at GBP130m; GBP50m from the UK government and £80m of private investment. It focused on clean technologies for a low carbon economy.
- The European Investment Fund's UK Future Technologies Fund closed at GBP200m; GBP100m in UK government investment and £100m of European Investment Bank investment. It focused on life sciences, digital technology and advanced manufacturing sectors.

By 2011, the Hermes Environmental Innovation Fund had, as a FoF, allocated capital to five funds and the UK Future Tech Fund to five funds.

[6] Bottazzi, Da Rin, and Hellmann (2008)
[7] "Early Assessment of the UK Innovation Investment Fund (2012)

Continuing FoF momentum, in 2013, Canada launched its Venture Capital Action Plan (VCAP) - a $400 million federal initiative with a remit to expand venture capital across the Canadian economy. The structure was largely focused on investing in private-sector led FoFs so as to expand support to innovative Canadian firms. According to some analysis, VCAP catalyzed over $1.4 billion in total capital. Much akin to Yozma, but large in scale, Canada's VCAP deployed $390 million ($340M into new funds-of-funds and $50M into existing high-performing funds) and generally required private sector matching at a ratio of $2 in private capital committed for every $1 of government contribution.

By 2015, nations with significant Sovereign Wealth Funds (SWF) were raising the question of whether such large pools of capital should be used not simply to generate returns but also as a tool for economic development. A leading example is Saudi Venture Capital (SVC), established in 2018 under the leadership of Dr. Nabeel Koshak. This vehicle manages approximately $1.5 billion in assets with an explicit mandate to build domestic and regional venture capital capacity. Unlike Yozma's government-majority position, SVC operates as a subsidiary of the National Development Fund with explicit responsibility to develop Saudi Arabia's technology entrepreneurship ecosystem. SVC's structure reflects this developmental ambition:

- 90% of capital allocated to FoF investments in other venture funds, 10% to direct co-investments in promising startups
- Incentive sweetening: SVC originally offered to waive up to 90% of its carried interest in funds where it participated, later reduced to 60%, creating substantially higher return potential for co-investors
- Geographic focus requirement: SVC capital earmarked for funds must prioritize Saudi-based startups or international ventures with significant Saudi operations
- Scale achieved: By 2025, SVC had invested in 35+ funds, with indirect exposure to approximately 525 startups and SMEs across the region
- Program specialization: Launched dedicated programs for accelerators, startup studios, and later-stage investments as ecosystem matured

The critical distinction between Yozma and SVC lies in their developmental stage and objectives. Yozma operated during a period when venture capital was nascent in Israel; SVC operates in a region where global VC exists but faces significant structural barriers to local deployment. SVC's higher tolerance for carried interest waiver reflects a deliberate policy choice to make participation in Saudi-focused funds sufficiently attractive to overcome investor hesitation about political risk, regulatory uncertainty, and limited exit opportunities in the Saudi context.

More recently, Nordic sovereign wealth funds have pursued similar strategies with different emphases. In 2025, Norway's Government Pension Fund Norway launched a NOK 15 billion ($1.4 billion) Nordic small-cap equity fund in 2025, representing an explicit strategy to maintain capital deployment within the Nordic region despite global investment opportunities. Denmark's participation in founding 55 North, a €300 million quantum technology venture fund co-anchored with Novo Holdings, represents sector-specific FoF deployment targeting quantum computing, sensing, and communications—technologies that Denmark identifies as strategically important.

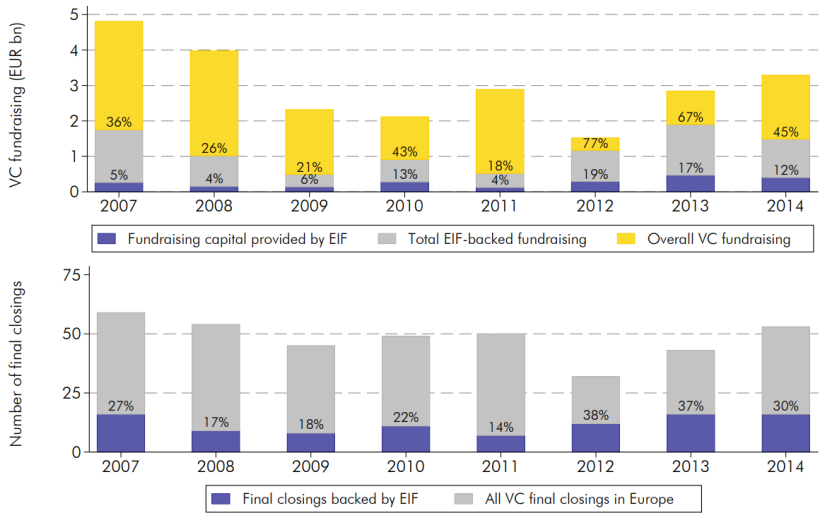
3.3 Multilateral Development Banks

Beyond individual nations, multilateral organizations have supported the development of FoFs, most notably, the European Investment Fund (EIF) which represents the world's largest government-backed FoF provider (with decades-long engagement across multiple European VC funds). Operating within the European Investment Bank framework, EIF is the primary mechanism through which the EU directs venture capital into Funds toward European countries, regions and companies.

EIF began its venture capital activities in 1997 with its first increase in VC in the 1999 biennium, following the centralisation of the EIB group’s risk capital activities under the management of EIF. The EIF started focusing heavily on structuring and investing in FoFs with the aim of building critical mass for European venture capital and countering

US competition, by supporting high-tech, regional funds. As its 2018 report notes, *"...governmental VC schemes seem to have been more successful when they acted alongside private investors, which would favour a governmental fund-of-funds set-up over direct public investments"* [8]

Figure 3: EIF support of European venture fundraising (cumulative fundraising at closing date)



Note: superimposed percentages indicate the share of EIF-provided fundraising capital and EIF-backed fundraising respectively, over the total VC fundraising in the period

The report demonstrates the expansive role of EIF across the European landscape (see above). And by 2014, EIF-backed investments represented 41% of total VC investments in Europe, up from 29% in 2007. Direct EIF contribution to total European VC reached 10%. EIF's portfolio reached 2,934 startups in seed and early-stage investments, with top-20 European hubs attracting 83% of investment amounts.

Designing its programs to identify and fill market gaps, specifically to crowd-in private capital, EIF has used a variety of FoF approaches. Since 2004, its key national FoF programs have included programs for seed, early and even growth stage activities.

EIF's role in Germany exemplifies this approach. In early 2000s, the German ERP-EIF Facility - a partnership with the German Federal Ministry of Economics and Technology -

[8] https://www.eif.org/files/records/eif_wp_34.pdf

was established to invest as a FoF in a range of funds across technology areas. More recently, the LfA-EIF Facility was established as a major fund-of-funds program in Bavaria, Germany (by the LfA Förderbank Bayern - the Bavarian Development Bank) and the European Investment Fund (EIF) to bridge equity financing gaps for technology-focused SMEs and startups by investing in venture capital funds. This demonstrates the role of FoF as a regional as well as a national instrument that has inspired similar initiatives across Europe. Around the same time, the German GFF-EIF has expanded EIF's role in Germany to growth stage activities. GFF-EIF is a major German initiative, part of the €10 billion German Future Fund (Zukunftsfonds), managed by the European Investment Fund (EIF) to provide up to €3.3 billion in late-stage growth equity for fast-growing German companies, focusing on digital, clean-tech, and life sciences sectors to help them scale and become global leaders. It fills the "second equity gap" for scaling up firms by investing in growth funds and directly co-investing, boosting innovation and Europe's tech ecosystem.

Of significant importance is the European Tech Champions Initiative (ETCI), launched in 2023. ETCI is a flagship fund-of-funds concept developed by the European Investment Fund (EIF) to address Europe's chronic growth-stage financing gap for technology companies. It embodies EIF's focus on large-scale, pan-European growth capital platforms that crowd in private institutional investors and reinforce Europe's technological sovereignty. Capital for the first phase of the initiative was anchored by the EIB Group and a group of EU Member States.

In operational terms, the ETCI is a pan-European, market-driven fund-of-funds managed by the EIF, investing in large "mega-funds" and specialised growth funds that, in turn, back European scale-ups across AI, cybersecurity, quantum, deep tech, green technologies and biotech. The model leverages EIF's core capabilities: selection and due diligence of fund managers, portfolio construction, and alignment of public policy objectives with private-market incentives through performance-based criteria

On the back of the results of ETCI, the EIB Group and EIF have moved to ETCI 2.0, which is explicitly embedded as a cornerstone of the EIB Group's TechEU programme. This upgrade is characterised by higher own-commitments from the EIB and EIF Boards—amounting to around €1.25 billion for the new phase—and an explicit mandate to bring in new institutional investors alongside additional Member States, thereby strengthening public–private partnership features and further scaling the initiative.

EIF's role extends beyond capital provision. The institution provides "aligned capacity building activities"—technical assistance, governance guidance, and expertise transfer to portfolio fund managers—that accelerate professional venture capital market development in less mature ecosystems. This combination of FoF capital provision with technical assistance and market development services distinguishes multilateral FoF programs from purely financial interventions.

4. A Contemporary Turn- Fund of Funds as Economic Statecraft

The decade from 2015 to 2025 witnessed a fundamental transformation in how governments conceptualized and deployed FoF mechanisms. Where earlier programs focused on economic development objectives (building VC markets, ensuring sufficient capital availability, capturing economic growth benefits), contemporary programs explicitly integrate security objectives alongside or even ahead of economic ones. Three motivations drive this evolution: directing innovation toward strategic technological priorities, securing regional and national ecosystems against adversarial capital, and enabling the industrial-scale production of strategic technologies by leveraging the industrial base of partner nations.

4.1 Directing Innovation: Sector- and Technology-Specific FoF

The desire of governments to direct innovation towards key sectors and technologies is not new. And the use of venture capital to drive startups towards specific challenges faced by national security and defence customers has been pioneered by the U.S. In-Q-

Tel (founded in 1999). However, it is only recently that industrial policy has started to use FoF mechanisms as a way of shaping the direction of venture capital allocation towards startups in fields of specific national importance. Most recently, Denmark's recent establishment of 55 North - the world's largest quantum technology venture fund at €300 million - provides a sector-specific focus on technologies considered to be a priority for Denmark, and a way to complement significant public sector spending on research and development. The explicit national security rationale is clear: quantum represents a foundational technology where Europe currently lags both the United States and China in research and commercialization capacity.

Co-anchored by Denmark's Export and Investment Fund (EIFO) and Novo Holdings, 55 North targets quantum computing, sensing, and communications—technologies Denmark identifies as critical to European independence from US technology dominance and Chinese competitive encroachment. The fund will make 25-30 investments across these domains, having already backed companies including IQM (Finland) and Kiutra (Germany). EIFO's FoF participation aims to build the European quantum ecosystem to ensure the continent possesses independent quantum capabilities.

With a mandate to invest into dual-use solutions for NATO Allies' major challenges in defence, security and resilience (DSR), the NATO Innovation Fund (NIF) is a multi-sovereign venture fund which makes FoF investments (as well as direct investments). It was established as a private fund by all NATO members in 2023, with €1 billion in commitments from 24 NATO member states who serve as Limited Partners. Its formation was inspired by the need to catalyze the DSR market and especially dual-use startup ventures with deep tech solutions (recognizing under-investment in these areas especially relative to the United States). Unlike previous FoF programs designed to support venture capital broadly across sectors, NIF explicitly targets ventures and venture funds in critical technologies—quantum computing, advanced materials,

autonomous systems, space, biotechnology, hypersonic systems, and next-generation communications with a focus on applications in defence, security and resilience.

Its 20% investment allocation to FoF has already included funds such as Alpine Space Ventures (space sector focus), OTB Ventures (deep tech in Central Europe), Join Capital, and Vsquared Ventures. With oversight from its 24 LPs - variously represented by SWFs, Ministries of Defence and Ministries of the Economy (as well as NATO observers), the FoF and direct investment ensures alignment with Alliance security interests and sector direction without exercising direct investment control. The decision-making power remains with professional fund managers, but the capital flows follow clearly articulated strategic priorities. This represents a deliberate policy choice: rather than government venture capital funds making direct investment decisions, governments commit to FoF structures where professionals manage capital but capital flows toward government-identified priorities.

4.2 Securing Ecosystems: Adversarial Capital Screening and Look-Through Provisions

The second major development in contemporary FoF as economic statecraft involves using FoF structures to secure innovation ecosystems and especially startup enterprises and venture capital funds against adversarial investment. This responds to the distinct concern that as venture capital has globalized, Chinese state-backed funds (including entities like China Investment Corporation, SAIC Capital, and Baidu Ventures operating under China's Military-Civil Fusion Strategy) have increasingly invested in Western startups, particularly in dual-use technologies where commercial applications overlap with military capabilities.

The UK's National Security Strategic Investment Fund (NSSIF) exemplifies this security-oriented approach to FoF allocation. Operating through the British Business Bank since 2018, NSSIF makes direct and FoF investments. Its FoF activities focused on "dual-use" and defence and security relevant technologies—sectors where venture investment may

advance both commercial and military applications. NSSIF's distinctive security features include:

- Fund manager vetting: Fund managers must undergo security vetting with at least one General Partner required to obtain security clearance;
- Look-through authority: Security-cleared GPs can share sensitive information about company IP, technology trajectories, and investor composition with NSSIF, enabling early identification of adversarial capital;
- Information sharing: NSSIF can communicate concerns about IP leakage or foreign acquisition risks to portfolio companies, providing educational functions beyond capital provision

The NATO Innovation Fund also requires significant ‘protection’ focused security mechanisms: Both direct and FoF investments rely upon "rapid but extensive analysis of other co-investors" to determine whether co-investment capital originates from adversarial nations. Where adversarial capital is identified, FoF positions provide leverage to exclude such capital through "look-through" provisions or to remove it where already present. Given its role as a private rather than public sector fund (like NSSIF), NIF’s approach emphasizes rapid due diligence on all co-investors and structural provisions ensuring NATO-aligned capital retains decision-making control.

The effectiveness of such screening of course depends on information availability and leverage to change outcomes. Where traditional venture capital funds move quickly with minimal transparency regarding co-investor composition, security-oriented FoF programs introduce additional decision layers. This creates potential friction: startup founders seeking capital urgently may prefer faster traditional investors over security-conscious FoF managers introducing delays. Successful programs mitigate this through pre-vetted co-investor networks, streamlined decision processes, and clear criteria for what constitutes problematic capital.

5. Implementation Challenges and Vulnerabilities: Lessons from Empirical Research

Despite the evident appeal of FoF mechanisms for policy implementation, government venture capital programs face systematic implementation challenges. Typically, however, these failures stem not from FoF structures themselves but from how governments implement them.

"Political capture" is the most pervasive failure mode: when governments maintain direct investment authority - rather than delegating to professional managers - local political officials often steer capital toward politically-favored industries or regions rather than toward ventures with strongest commercial prospects.

This pattern appears especially pronounced in direct venture investing, where lack of specialized expertise combines with political incentive structures to produce capital misallocation. FoF structures mitigate this risk by allowing for professional manager selection. That said, where the government directly selects which venture funds to back, political criteria may still influence selection. Competitive processes for FoF manager selection—where multiple applicant fund managers compete for access to government capital—or more professional selection approaches introduce market discipline into fund selection while still permitting the government to establish strategic priorities.

A persistent tension in government-backed FoF programs involves balancing legitimate government strategic priorities against the requirement that FoF remain sufficiently profitable to sustain capital returns and demonstrate market discipline.

Programs that excessively prioritize non-commercial objectives above return generation face several consequences:

- First, they may crowd out private capital whose investors may not wish to deploy capital alongside government-backed investors who prioritize non-return objectives;

- Second, they may fail to develop strong, scalable ventures because they are not able to bridge towards more commercially-oriented capital that is necessary for the entire idea to impact venture journey;
- Third, they may simply continue to create pressure for government subsidy.

On the other hand, FoF programs that excessively prioritize commercial objectives may, reasonably, be thought of as crowding out private sector capital because the government-backed funds are in effect subsidizing the market.

Successful programs resolve these tensions through explicit structural features. Yozma's buyback provisions—permitting private investors to repurchase government stakes in profitable funds, allocating all upside to non-government LPs—created a mechanism ensuring that profitable funds remained genuinely commercial while the government could capture a limited return. Saudi VC's carried interest waiver similarly accepts reduced government returns in exchange for ecosystem development and capital direction toward Saudi-based ventures. NIF's provision of additional 'platform' benefits - in the form of securing against adversarial capital and providing a signpost into clear strategic priorities, allows the fund to drive strong commercial outcomes within a clear strategic framework. These explicit trade-offs between return maximization and strategic objective achievement prove healthier than attempting to achieve both simultaneously without structural accommodation.

Beyond the expertise selection of fund managers and a clear articulation of the strategic purpose of FoFs capital allocation, several other factors predict successful government FoF programs:

- Mandatory co-investment requirements: Programs requiring non-government investors to invest (often over 75% of the capital) alongside state-backed FoF contributions introduce market discipline, making it economically costly to pursue purely political objectives;
- Professional expertise requirements: Fund manager teams possessing relevant domain expertise will ensure greater success. While there are opportunities to

back new investors (GPs) or new teams in uncharted sectors, government should not attempt to substitute market-tested management talent;
- Clear performance metrics: Successful FoF programs driving specific, measurable objectives (number of portfolio companies, return targets, employment generation, technology development milestones) enable objective evaluation and clear strategic focus.
- Sunset provisions: Lastly, incorporating time-limited programs that explicitly plan for government exit create exit discipline and force consideration of whether government support remains necessary as markets mature.

6. Implications for Policy Design

The evolution of Fund of Funds from economic development mechanisms to tools of explicit economic statecraft has several implications for policy design and international competition.

First, FoF represents a distinct innovation in statecraft tool design. Unlike capital controls, export restrictions, or foreign investment screening mechanisms that operate through prohibition or constraint, FoF operates through affirmative capital provision with clear strategic direction. This proves particularly valuable where governments seek to build capacity rather than merely constrain adversaries—where the objective involves developing independent technological capability rather than simply preventing adversary access.

Second, effective FoF programs require professional investment expertise, competitive processes, and acceptance of market discipline. The temptation to use FoF mechanisms to direct capital toward politically-favored ventures or regions proves substantial, however, when governments deliberately design institutions insulating professional fund managers from political pressure while maintaining meaningful strategic direction at the capital allocation level, FoF is a powerful tool for change.

Third, contemporary geopolitical competition increasingly operates through ecosystem development rather than through directed state activity. As technological advantage is distributed across innovation ecosystems with differing levels of maturity, governments must invest in ecosystem building—not simply research centers or manufacturing facilities themselves, but also the venture capital and funding mechanisms that allow private actors to build such connected communities. FoF mechanisms represent a cost-effective approach to such ecosystem development relative to direct state investment.

Fourth, security-related FoF programs introduce new forms of governance complexity. Combining venture capital investment with national security assessment requires institutional capabilities that most governments lack; the emergence of programs like NSSIF and NIF represents an effort to develop such capabilities. The sustainability of security-oriented screening depends on information access and decision speed; programs that introduce excessive friction in capital deployment risk causing the best ventures to seek capital from less security-conscious investors.

7. Conclusion

Fund of Funds investment structures have evolved from financial mechanisms for portfolio diversification by private sector fund managers into instruments of economic growth and today, deliberate economic statecraft. This reflects broader changes in how governments understand economic competition and security in an era where prowess in technological innovation at scale, not simply ingenuity, determines both economic competitiveness as well as defence and security capability.

The trajectory from Israel's Yozma program through contemporary initiatives like NATO Innovation Fund and UK NSSIF demonstrates that FoF mechanisms can address multiple policy objectives simultaneously: building venture capital capacity in markets with insufficient private funding, directing innovation toward sectors governments identify as strategically important, screening capital flows to exclude adversarial

investment, and ensuring strategic technologies reach industrial-scale production. These objectives coexist but are not always perfectly aligned —returns and strategic direction may not always drive in precisely the same direction - in terms of technologies, geographies and markets—but the FoF structure provides mechanisms for managing such tensions.

Empirical evidence suggests that FoF success is not simply about a clear articulation of the strategic goals of government-backed FoFs, but also on specific implementation features: professional fund manager selection, co-investment requirements, expert vetting, competitive processes, and explicit measurement frameworks. Programs that neglect these features replicate the failure patterns identified in Lerner's research; those that implement them systematically can achieve substantial policy change.

As geopolitical competition intensifies and technological innovation emerges as a central axis of state power, FoF mechanisms are becoming increasingly important tools within the broader toolkit of economic statecraft. The question for policymakers is not whether to use FoF mechanisms—competition dynamics make some form of capital direction almost inevitable—but rather how to design and implement them in ways that achieve strategic objectives while maintaining the professional expertise and commercial discipline that make venture investment valuable. This represents a complex institutional challenge that will define innovation policy for the next decade.