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Emerging Managers: Good Buy or Good Bye?

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Emerging Managers: Good Buy or Goodbye?

In investors' continuing search for alpha, the following question almost always arises: Does size matter when selecting hedge funds? In other words, is there more alpha generated by small funds than large funds? If so, what are the potential trade-offs in terms of volatility or operational risks? In recent years, the question has been expanded to include fund age, as investors wonder if younger funds generate more alpha than older funds.

This paper attempts to answer some of the performance- and risk-related questions surrounding emerging managers, including:

- **What is the stratification of available funds by age and size? What is the opportunity set within each group?**
- **How have smaller funds performed against medium-sized and large funds, both on a return-only basis, and based on risk-reward profiles?**
- **How have younger funds performed against mid-age and older funds, both on a return-only basis, and based on risk-reward profiles?**
- **Are there certain environments in which the various age and size groups perform better?**
- **Does size or age matter more in equity, fixed income or commodity strategies, or do performance advantages exist across the board?**
- **Is there a performance differential between young and small funds and old and small funds?**
- **What do the survival statistics look like for small and young funds versus their larger and older peers?**
- **What are the particular challenges faced by small or young managers?**

To answer these questions, we constructed a number of indexes using data from commercially available databases. In addition, we surveyed more than 200 managers of small and/or young funds to supplement the quantitative information. (While the results and conclusions reached within this document are based on the information reported by these hedge funds, which we hope to be representative of all hedge funds in general, it should be noted that information from other hedge funds may have led to different conclusions. Also, the constructed indexes are based upon past performance and past performance is not necessarily an indication of future performance.)

Methodology

For this study, we relied on the following information:

- Performance indexes we created for small, medium and large hedge funds, using compiled historical monthly returns from three leading commercially available hedge fund ("HF") databases, Hedge Fund Research (HFR), BarclayHedge and HedgeFund.net databases
- Performance indexes we created for young, mid-age and old funds, using compiled historical monthly returns from three leading commercially available HF databases, Hedge Fund Research (HFR), BarclayHedge and HedgeFund.net databases

  - Indexes were run from January 2001 through December 2010
  - Indexes were constructed with simple averages and were not asset-weighted
  - Small funds were defined as having less than $100 million (mn) under management (AUM); medium funds were defined as having $100 mn to $500 mn AUM; large funds were defined as having over $500 mn AUM
  - Young funds were defined as having a track record of less than two years; mid-age funds were defined as having a track record of two to four years; old funds were defined as having a track record of more than four years
  - Funds were reclassified from month to month depending on their size or age.
- Additional indexes of young and small; old and small; and asset class-focused funds were created using similar methodologies
- To mitigate survivor bias, we included fund information from both the BarclayHedge Global HedgeSource database and the BarclayHedge Graveyard database. The Graveyard database contains information on funds that have stopped reporting, including funds that have become defunct and funds that have closed to new investment for any reason. While the inclusion of this database does not fully mitigate the survivor biases that are inherent in any hedge fund data-based study, including graveyard data is widely considered to be one of the best available methods of minimizing survivor bias in historical data sets.
- A survey of emerging manager funds was conducted by Barclays Capital Strategic Consulting Group. More than 200 firms responded.
- Ongoing dialogue with HF managers and institutional investors
- News articles, research reports / commentaries and analyses, books

Key Findings

- The supply of small funds remains high, with small funds representing more than 68.4% of the hedge fund universe.
- Young funds are not as plentiful. Funds with more than a four year track record represented more than 50% of the hedge fund universe at year-end 2010.
- On average, small funds outperform mid-size and large funds.
- During significant "flight to quality" events, such as the tech wreck of 2002 and the mortgage crisis market crash of 2008, large funds outperformed small funds.
- In addition, while the top quartile of small funds outperformed the top quartile of large funds, the bottom quartile of small funds significantly underperformed the bottom quartile of large funds, making fund selection in the small fund category more critical.
- Young funds generally outperform mid-age and old funds, and over the last ten years have generated a compound annualized return nearly four percentage points higher than their older peers.
- Young and small funds outperform old and small funds on a consistent basis, both in terms of absolute and risk-adjusted returns.

- Age of the fund seems to matter the most in fixed income-focused strategies, where the performance and Sharpe ratio differentials are the highest.
- Size of the fund seems to matter the most in commodity/macro-focused strategies, where the performance and risk-adjusted return differentials are the greatest.
- Emerging managers report their top concerns (in order) as Marketing, Asset Raising, Compliance, Investor Relations, and Back Office Tasks.
- 65.1% of emerging managers feel that investor interest in emerging managers is "low" or "very low."
- 41.3% of emerging managers feel that investor interest is likely to improve over the next 12 months. Young funds are the most optimistic about improvements in investor interest.
- While it is difficult to calculate survival rates, smaller funds appear to have a higher rate of closure than large funds.
- The survival rates for young funds and old funds for the period studied appear similar.

Introduction

With many institutional investors still struggling to recoup losses and bridge underfunding gaps, the search for alpha remains heated. In 2010, most assets that flowed into the hedge fund industry went to large, established funds, but a growing pool of academic research (and seeder capital) argues that the most significant alpha generation occurs in newer, smaller funds. According to one emerging fund manager, "Most investors know that smaller managers can outperform and most investors "need" (rather than just want) outperformance.."

"It's difficult to market ourselves to large institutions and consulting firms as an 'alternative' manager and be taken seriously, even if our track record and performance is attractive. They prefer styles that fit into a tidy box."

While many studies have asserted that small funds do outperform larger funds, our analysis shows that this many not always be the case. Certainly, despite this supposed understanding about emerging manager outperformance, actual allocations to emerging funds remain low. "As a smaller fund without a huge marketing department, it's difficult to market ourselves to large institutions and consulting firms as an 'alternative' manager and be taken seriously, even if our track record and performance is attractive. They prefer styles that fit into a tidy box," stated another manager.

Maybe, however, there are two sides to the emerging manager coin. This paper attempts to determine just how compelling the argument is for smaller, younger managers. What do investors stand to gain (or lose) in moving towards a particular age or size grouping? In addition, we look at how size and age may impact funds focused on different asset classes, as well as differences in survival rates, and the challenges faced by emerging manager funds.

Stratification of the Hedge Fund Universe by Size and Age

From a supply standpoint, small managers offer investors a significantly larger selection of funds than their mid-size or large brethren. Looking at the size distribution of funds in our selected HF databases at December 2000, December 2005 and December 2010, one can see that small funds are more populous than large funds by a wide margin. In fact, as of year end 2010, small funds represented 68.4% of the number of funds in the entire HF universe. Mid-size funds comprised an additional 23.6%, while large funds

made up only 8.0% of the total hedge fund universe. (It should be noted that, while large funds are relatively few in number, they control the lion's share of industry assets; a recent report from HFR shows that HFs over $500 mn in size account for over 85% of total HF assets.)

As a result, investors who maintain minimum size restrictions for their hedge fund investments may find their universe somewhat, or even severely, curtailed. With a $500 mn AUM minimum requirement, the data we examined yielded fewer than 600 available funds/fund classes. The number drops dramatically as one climbs into higher size stratifications. For example, a 2009 PerTrac Financial Solutions study based on nearly all of the commercially available databases found only approximately 200 single manager funds with more than $1 billion AUM. The universe of available funds is further diminished when one considers the number of funds that are no longer open to new investment. While this was less of a concern in 2009 and 2010, it is likely to become more problematic as more large funds close as assets near historical highs.

The story is different for young funds. Ten, and even five years ago, young funds were almost as populous as old funds. In fact, as of December 2005, young funds were almost neck and neck with old funds, with 36.0% and 37.6% of the overall hedge fund universe, respectively. However, the market crash in 2008 seriously curtailed new fund launches, and the supply of new managers is just now beginning to recover. In fact, Hedge Fund Research (HFR) recently reported that new fund launches outstripped fund closures in 2010 for the first time in three years. They report 935 new fund launches, compared with 743 fund closures. As a result, at the end of 2010, new funds comprised only 24.7% of the overall hedge fund universe, while old funds accounted for just over half of all funds, at 50.7%. Therefore, investors looking for funds with more than four years track record should have little problem locating one, while younger funds are in shorter supply.

Figure 1: Universe Stratification by Size and Age based on Number of Funds

	Year End 2000	Year End 2005	Year End 2010
Small	80.6%	66.3%	68.4%
Mid-size	15.3%	25.7%	23.6%
Large	4.1%	8.0%	8.0%
Young	34.9%	36.0%	24.7%
Mid-age	28.6%	26.4%	24.6%
Old	36.5%	37.6%	50.7%

Source: Strategic Consulting Analysis

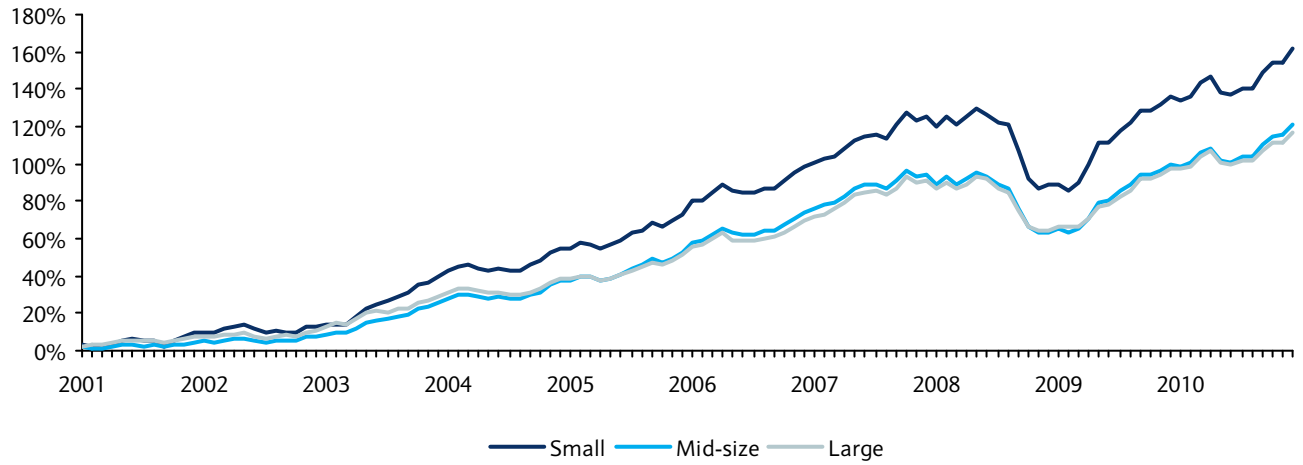
Fund Performance by Size

One of the questions that investors and managers alike spend time pondering is whether fund size has a positive or adverse effect on fund performance. To shed light on that topic, we began by creating three size-based hedge fund indexes. First, we combined the hedge fund performance records from the Hedge Fund Research (HFR), HedgeFund.net and BarclayHedge commercial databases into a single "master" database. We then removed duplicate hedge fund records, as well as records for funds of hedge funds (FOFs). We then ran reports to find both the monthly return and the monthly fund size for each fund from January 2001 to December 2010.

Each available fund was categorized into an index each month based on its then-current fund size. Funds with less than $100 mn AUM were placed into a small funds index funds while $100 mn to $500 mn AUM funds were placed into a mid-sized fund index. Funds with over $500 mn AUM were placed into a large fund index. Funds that did not report AUM for a particular month were excluded from that month's indexes. Non-USD-denominated fund sizes included in the study were converted into USD before the indexes were created.

As a result, the fund sample for each index varied from month to month. On average, the small fund index contained 3,143 funds per month, while the mid-size and large indexes contained 1,100 and 350 on average, respectively. The results from the full period for each index are shown below in Figure 2.

Figure 2: Cumulative Returns of Sized-Based HF Indexes, Jan. 2001-Dec. 2010



Source: Strategic Consulting Analysis

It is perhaps easier to see in the calendar year performance shown below in Figure 3 that the average small fund has outperformed its larger peers in all calendar years except two: 2002 and 2008. It is interesting to note that these were particularly difficult periods for the markets, and periods when investors were likely to experience a "flight to quality" that, at least in 2008, extended to hedge funds investments as well as stocks.

Figure 3: Calendar Year Returns of Size-Based HF Indexes 2001-2010

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Small	9.31%	3.42%	23.49%	11.16%	11.60%	14.43%	13.78%	-16.10%	24.52%	11.36%
Mid-size	4.48%	3.16%	16.62%	9.08%	11.42%	13.85%	11.79%	-15.78%	21.89%	10.76%
Large	7.12%	3.60%	16.13%	7.13%	9.60%	12.40%	12.42%	-13.94%	20.08%	9.64%

Source: Strategic Consulting Analysis

Over the full period, the average small fund was the clear winner in terms of absolute performance, generating a compound annualized return (CAR) of 10.12% over the 10 year period. Mid-size funds were the runners up, with a CAR of 8.26%, narrowly edging large funds' 8.04% CAR.

When looking at the volatility of returns, however, large funds were the clear leaders with a 5.28% annualized standard deviation, while mid-size and small funds generated standard deviations of 5.61% and 6.70%, respectively. The higher degree of risk among small funds is also illustrated by the small fund index's maximum drawdown of -19.07% versus a less drastic -15.10% for the large fund index. Looking at performance on a risk-adjusted basis, as measured by Sharpe ratio, we find the three size classes in a virtual tie, ranging from 1.45 to 1.49. The full 10 year risk-reward table for each index is shown in Figure 4.

Figure 4: 10 Year Risk/Return Statistics of Size-Based HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Small	10.12%	6.70%	1.48	-19.07%
Mid-size	8.26%	5.61%	1.45	-16.90%
Large	8.04%	5.28%	1.49	-15.10%

Source: Strategic Consulting Analysis

Looking Beyond Averages

Of course, the average performance of small, mid-size and large funds do not tell the entire tale. To get a clearer picture, we also looked at the top and bottom quartile performance for each group. Perhaps not surprisingly, small funds led the pack when looking just at the top 25% of returns within each group each month. Top quartile small funds produced a CAR of 99.30%, while top mid-size and large funds returned 71.26% and 59.98%, respectively.

However, when we look at the bottom quartile performers, the story is exactly opposite. Large funds in the bottom quartile performed more than ten percentage points better than their smaller peers, with a CAR of -27.58% versus -39.07% and -32.06% for small and mid-size funds, respectively. In addition, large funds produced the best Sharpe ratio of the three groups when looking at these potential worst case scenarios. Bottom quartile large funds produced an annualized Sharpe of -3.22 versus small funds' -3.90. (See Figure 5.)

Figure 5: 10 Year Risk/Return Statistics of Size-Based HF Index Quartiles 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio
Top Quartile Small	99.30%	8.93%	7.99
Top Quartile Mid-size	71.26%	7.01%	7.88
Top Quartile Large	59.98%	6.70%	7.18
Bottom Quartile Small	-39.07%	12.22%	-3.90
Bottom Quartile Mid-size	-32.06%	10.57%	-3.54
Bottom Quartile Large	-27.58%	9.73%	-3.22

Source: Strategic Consulting Analysis

As a result, it seems investors should choose their small funds wisely. If they select winners, they have the potential to win big, but if they falter, the downside is comparatively greater than large funds.

"It seems that during periods of uncertainty investors are happier to invest with larger managers which have reopened due to poor performance..."

In addition, large funds have proven themselves when the markets are rocky, and investors have taken notice. According to one hedge fund manager we surveyed: "It seems that during periods of uncertainty investors are happier to invest with larger managers which have reopened due to poor performance. They feel, somewhat annoyingly, that their risk diminishes with the larger funds and are prepared to substitute a perceived lower risk for a lower performance." In this case, however, it may be the perception causing the reality.

As much as smaller funds may have some performance advantages over large funds, they may also be disproportionately affected when the market takes a nosedive. Redemptions that larger funds may be able to pay out in cash may require the liquidation of positions at an unfortunate time for funds that have all of their capital deployed. In addition, the burden of investor relations increases during times of market turmoil, which smaller fund companies may be ill-equipped to handle. Small funds may also have a greater reliance on their service providers, which may face stressors of their own during a market crisis.

Performance Characteristics of Small and Large Funds

As noted above, market environments impact small and large funds in different ways. Certainly, there are characteristics of small funds that may cause outperformance, but also traits that may exacerbate losses. Large funds, on average, tend to underperform small funds, but possess attributes that may make them a more conservative bet, and safer havens in times of market turmoil.

Small Fund Pros

- Due to the relatively small amount of capital they have to deploy, small funds can choose to invest only in their top-tier investment ideas.
- Smaller funds almost always have smaller position sizes within the markets. As a result, they can theoretically be more nimble, entering and exiting positions faster than a larger fund with a more substantial position.
- These smaller position sizes also tend to attract less attention in the markets. This means that smaller funds often don't face competitive pressures such as short squeezes or position crowding.
- Small funds may be able to exploit smaller market inefficiencies.

Small Fund Cons

- Infrastructure and controls may not be developed, and additional operational risks may exist.
- Small funds may take more risks to attract assets.
- Small funds may not have access to the research and resources that large funds can exploit.
- Small funds tend to attract less institutional money, have less headline risk, and therefore may take more chances.

Large Fund Pros

- Institutional profile of their investor base may make the manager more conservative, thus generating steadier, predictable performance.
- The infrastructure for a large fund is generally more developed than that of small funds. This may reduce operational risks.
- Large funds usually have an extensive investor relations team, which may make communication with investors more robust and efficient, especially in times of market uncertainty.
- Large funds may have more access to leverage, research and other resources that can help them navigate the markets.

Large Fund Cons

- Large fund managers may have to look outside their initial area of expertise in order to keep capital at play, becoming in essence a multi-strategy shop once they get to a certain size.
- The business of running a fund is more complex as the fund size increases. Larger funds with institutional investors may require more infrastructure, more service providers, more IT, more human resources, and so on. Concentrating on these aspects of the business can take the manager's eye off the ball, resulting in lower performance.
- The fund could become more concentrated, as it tries to keep capital in top-tier investment ideas. These concentrated positions can generate larger losses should the investment idea not work out.
- Larger fund managers may farm parts of their capital out to less experienced managers, which may hinder the performance of the fund.

At the end of the day, it is important to remember that both small and large funds carry their own sets of trade-offs between potential strengths and weaknesses.

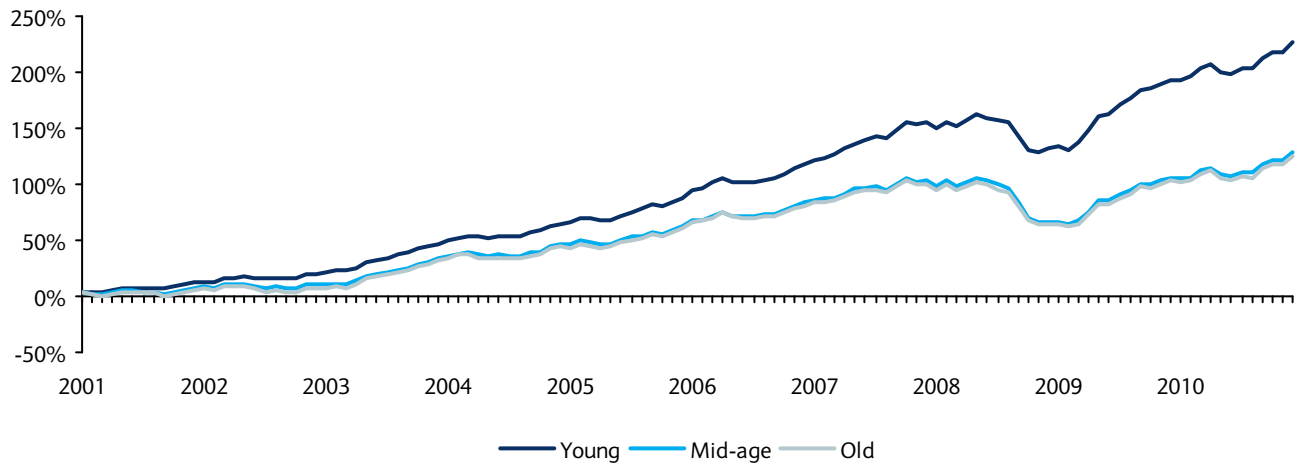
Performance by Age of Fund

To examine how a fund performs as it ages, we created three age-based indexes from the same master hedge fund database used in the size study above. The fund age master database was created from the Hedge Fund Research, HedgeFund.net, and the BarclayHedge commercial databases. Reports were then run to find the monthly return for each fund from January 2001 through December 2010. All funds were categorized each month based on its then-current fund age and divided into three classes: funds with less than a two year track record, funds with two to four years of performance, and funds with more than four years of performance. A simple mean of all monthly returns in each of the three categories was calculated for each month. The sample of funds included in each of the three indexes varied from month to month. The young fund index contained, on average, 1,895 funds per month, while the mid-age index and old fund indexes contained 1,481 and 2,360, respectively. The indexes that were created using this information are shown below in Figure 6, while the performance for each calendar year included is shown in Figure 7.

It's important to note that the factor examined here is the age of the *fund*, not of the fund management company. The young fund index, for instance, may contain in any

given month a fund recently launched by a well-established fund manager who also has other funds in old fund index.

Figure 6: Cumulative Returns of Age-Based HF Indexes, Jan. 2001-Dec. 2010



Source: Strategic Consulting Analysis

Figure 7: Calendar Year Returns of Age-Based HF Indexes 2001-2010

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Young	12.02%	7.42%	22.42%	12.01%	14.16%	15.81%	17.21%	-9.10%	26.36%	11.04%
Mid-Age	7.49%	2.60%	20.69%	9.99%	10.47%	13.30%	11.48%	-18.67%	23.88%	10.75%
Old	6.10%	0.72%	23.11%	9.90%	10.85%	13.07%	10.58%	-17.71%	23.30%	10.95%

Source: Strategic Consulting Analysis

Much like the size-based indexes, the age-based indexes show remarkable consistency across years. In all calendar years except 2003, when the performance differential was less than 100 basis points, the young funds outperform their older peers. Even during periods of market crisis, when small funds struggled, the young funds handily outperform older funds. In fact, in 2008, the worst year for small funds, the young funds bested older funds by more than seven percentage points.

On an annualized basis, the outperformance of young funds is even more pronounced. In Figure 8, you can see that over the past ten years, young funds have generated a compound annualized return (CAR) of 12.55%, besting mid-age and older funds by nearly four percentage points. Young funds have also provided greater predictability of returns and better risk-adjusted returns, as denoted by standard deviation and Sharpe ratio, respectively. Young funds generated an annualized standard deviation of 5.52% and a Sharpe ratio of 2.18. In comparison, mid-age funds yielded a standard deviation of 6.60% and a Sharpe ratio of 1.29. Old funds performed the worst of the three groups, with a standard deviation of 6.96% and a Sharpe ratio of 1.21.

Figure 8: 10 Year Risk/Return Statistics of Age-Based HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Young	12.55%	5.52%	2.18	-12.92%
Mid-age	8.59%	6.60%	1.29	-20.52%
Old	8.48%	6.96%	1.21	-20.51%

Source: Strategic Consulting Analysis

Outperformance Across the Spectrum

Unlike small funds, which outperformed large funds on average, yet underperformed in the bottom quartile, young funds outperform their older peers across the board. Young funds in the top quartile produced a CAR of 94.44%, with a Sharpe ratio of 8.91. In contrast, top-performing old funds produced a CAR of 90.62%, with a Sharpe ratio of 7.48.

At the same time, young funds outperformed at the bottom of the heap as well. The bottom quartile of young funds generated a CAR of -33.52%, while mid-age and old funds returned -37.50% and -38.61%, respectively. The Sharpe ratios for bottom quartile young and old funds were a virtual dead heat, at -3.85 for young funds and -3.88 for old funds. For more statistics, please see Figure 9.

Figure 9: 10 Year Risk/Return Statistics of Age-Based HF Index Quartiles 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio
Top Quartile Young	94.44%	7.70%	8.91
Top Quartile Mid-age	87.68%	8.85%	7.34
Top Quartile Old	90.62%	8.92%	7.48
Bottom Quartile Young	-33.52%	10.28%	-3.85
Bottom Quartile Mid-age	-37.50%	12.60%	-3.59
Bottom Quartile Old	-38.61%	12.12%	-3.88

Source: Strategic Consulting Analysis

Why Do Young Funds Outperform?

Since young funds have consistently outperformed mid-age and old funds, one must wonder what competitive advantages they offer. Although it is difficult to pinpoint any specific overwhelming advantage, there are perhaps two primary reasons why younger funds may outperform their older peers.

- Young funds are more likely to have lower AUM, which means many of them can capitalize on the same set of opportunities offered to small funds (see page 8).
- At the same time, some young funds are newly launched products offered by established fund management companies, which may lend those funds some of the same benefits as large funds.
- Simply stated: strong performance attracts assets. As a result, it has been suggested that newer, hungrier managers, who know their future hinges on their first one to two years of performance, are more likely to live for their

fund, reacting swiftly to market up and downturns, taking opportunities, but also obsessively mitigating losses. It has been postulated for years that older funds, who are more comfortably established, may adopt a longer-term perspective and a more risk-averse mentality, resulting in lower returns.

It has been suggested that newer, hungrier managers, who know their future hinges on the first one to two years of performance, are more likely to live for their fund.

This does not mean, however, that young funds are without risk. Certainly, as much as they share many of the potential benefits of small funds, they also mimic the potential risks as well. Young funds are untested, and often without well developed infrastructure on which to rely. The sense of "team" may not have had time to develop (unless the group has worked together in prior jobs), and this can be a burden as well. All in all, past performance does not guarantee future results, and any young fund should of course be subjected to the same rigorous due diligence as a mid-age or older fund.

What about Young, Small Funds versus Old, Small Funds?

If young funds generally outperform older funds, and small funds generally outperform larger funds, the question arises whether young, small funds have a significant advantage over older, small funds. To help address this question, we constructed two additional size-and age-based benchmarks. Using the same methodologies described above, we created an index for funds that have a track record of less than two years **and** less than $100 mn AUM. There was an average of 474 funds per month in the young, small index. We also created an index for funds with a track record longer than four years but with less than $100 mn AUM, which contained an average of 623 funds per month.

Figure 10 shows the annual returns for each of the two indexes. As you can see, the young, small funds index outperformed the old, small fund index in all annual periods, save one. In 2010, the old, small funds narrowly edged their younger peers. The difference in performance was extremely slight, at only seven basis points.

Figure 10: Calendar Year Returns of Young, Small vs. Old, Small HF Indexes 2001-2010

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Young and Small	10.91%	4.17%	23.13%	12.22%	14.18%	16.30%	18.16%	-9.95%	25.86%	10.95%
Old and Small	6.95%	2.56%	22.02%	9.51%	11.38%	12.88%	9.77%	-17.72%	22.58%	11.02%

Source: Strategic Consulting Analysis

Looking at the annualized statistics in Figure 11, you can see further proof that young, small funds tend to outperform old, small funds. The young and small index produced a CAR of 12.16% over the ten year period, while the old and small index generated only 8.52%. From a volatility perspective, young and small funds posted standard deviation of 5.73%, compared with 6.98% for the older, small funds. Finally, young, small funds outperformed on a risk-adjusted basis as well, generating a Sharpe ratio of 2.04, which compares favorably with old, small funds Sharpe ratio of 1.21.

Figure 11: 10 Year Risk/Return Statistics of Young, Small vs. Old, Small HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Young and Small	12.16%	5.73%	2.04	-14.31%
Old and Small	8.52%	6.98%	1.21	-20.82%

Source: Strategic Consulting Analysis

Age, Size and How They Effect Funds in Various Asset Classes

One of the additional areas we wished to examine was whether size and age impacted funds differently, based on the primary asset class in which they invested. To do this, we created additional indexes, focused on the primary asset class of each fund in addition to age and size. We created three general asset class groupings within the master database described earlier: Equity, fixed income and commodity/macro. In general, we found that the same corollary held true across equity, fixed income and commodity/macro. Small or young funds outperformed larger or older peers on an absolute basis, regardless of the primary asset class of the fund. However, in the equity and fixed income classes, we once again find small funds indexes producing more volatile return patterns, as measured by standard deviation, than their large fund counterparts. Interestingly, small funds generally outperformed large funds by a narrower margin than young versus older funds. In addition, on a risk-adjusted basis, the Sharpe ratio range for small, mid-size and large funds was tighter than it was between young, mid-age and old funds.

Size/Age and Equity Funds

The size and age performance differentials for equity-focused funds were the tightest of the three asset class groups examined. The index of young funds with an equity focus generated a CAR of 11.52%, compared with mid-age and old managers which generated 7.46% and 7.17%, respectively. On a risk adjusted basis, this made the Sharpe ratios closer than in the other age-based, asset class indexes. Young equity-focused funds produced a Sharpe ratio of 1.73, while mid-age and old funds produced Sharpe ratios of 1.01 and 0.87, respectively. Please see Figure 12.

Figure 12: 10 Year Risk/Return Statistics of Age-Based Equity HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Equity Young	11.52%	6.46%	1.73	-14.79%
Equity Mid-age	7.46%	7.40%	1.01	-23.25%
Equity Old	7.17%	8.34%	0.87	-25.88%

Source: Strategic Consulting Analysis

In Figure 13, you can see that, on a size basis, the performance differential was even smaller. In fact, the size-based equity focused indexes produced the lowest performance and risk-adjusted differential of any of the strategy-based indexes included in the study. Small equity-focused funds produced a CAR of 8.61%, but mid-size and large funds didn't lag far behind, with compound annualized returns of 7.50% and 6.84%, respectively. In addition, small equity focused funds produced higher standard deviation than either their mid-size or large peers. As a result, small equity focused funds had the second lowest Sharpe ratio, at 1.14, lagging the mid-size funds 1.17 and barely edging the large funds 1.10.

Figure 13: 10 Year Risk/Return Statistics of Size-Based Equity HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Equity Small	8.61%	7.53%	1.14	-23.08%
Equity Mid-size	7.50%	6.40%	1.17	-16.87%
Equity Large	6.94%	6.31%	1.1	-16.09%

Source: Strategic Consulting Analysis

Size/Age and Fixed Income Funds

The performance differential for young fixed income-focused funds was one of the largest in our strategy-focused indexes. In Figure 14, you see that young fixed income-focused funds generated a CAR of 13.31%, compared with 8.46% for mid-age funds and 7.71% for old funds. Young fixed income-focused funds also produced the lowest standard deviation of the group. As a result, young fixed income-focused funds generated by far the highest Sharpe ratio at 3.31. Mid-age and old funds lagged behind with 1.68 and 1.31, respectively.

Figure 14: 10 Year Risk/Return Statistics of Age-Based Fixed Income HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Fixed Income Young	13.31%	3.82%	3.31	-7.59%
Fixed Income Mid-age	8.46%	4.93%	1.68	-18.36%
Fixed Income Old	7.71%	5.83%	1.31	-22.97%

Source: Strategic Consulting Analysis

When it came to size, however, the performance differentials within the fixed income-focused group were smaller, although still pronounced. Small fixed income-focused funds generated a CAR of 10.43%, compared with 8.12% and 8.33% for mid-size and large funds, respectively. On a risk-adjusted basis, small funds edged out large and mid-size funds, posting a Sharpe ratio of 1.99. (See Figure 15.)

Figure 15: 10 Year Risk/Return Statistics of Size-Based Fixed Income HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Fixed Income Small	10.43%	5.07%	1.99	-15.67%
Fixed Income Mid-size	8.12%	5.03%	1.58	-20.01%
Fixed Income Large	8.33%	4.86%	1.68	-16.00%

Source: Strategic Consulting Analysis

Size/Age and Commodity/Macro Funds

Finally, we looked at commodity/macro-based funds to determine what performance differentials existed across age and size stratifications. We found that the results for young commodity/macro-focused funds fit in between those of equity and fixed income-focused funds, while the size-based commodity/macro-focused funds were the best of the three asset class groups.

Looking at Figure 16, you can see that young commodity/macro-focused funds generated a CAR of 13.85%, compared with mid-age and old funds, which produced CARs of 10.90% and 10.61%, respectively. On a risk-adjusted basis, the young commodity/macro-focused funds also took the day, producing a Sharpe ratio of 2.38, compared with 1.64 and 1.25 for the mid-age and old funds, respectively. Small commodity/macro-focused funds produced the third-highest CAR of any of the asset class-based indexes, and the best of any of the size-based asset class focused indexes, at 12.37%. The Sharpe ratio for small commodity/macro-focused managers was 1.69, which outpaced both mid-size and large funds' that produced 1.26 and 1.05, respectively. See Figure 17.

Figure 16: 10 Year Risk/Return Statistics of Age-Based Commodity/Macro HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Commodity/Macro Young	13.85%	5.56%	2.38	-3.50%
Commodity/Macro Mid-age	10.90%	6.45%	1.64	-8.68%
Commodity/Macro Old	10.61%	8.40%	1.25	-7.93%

Source: Strategic Consulting Analysis

Figure 17: 10 Year Risk/Return Statistics of Size-Based Commodity/Macro HF Indexes 2001-2010

	Compound Ann. Return	Ann. Standard Deviation	Ann. Sharpe Ratio	Maximum Drawdown
Commodity/Macro Small	12.37%	7.09%	1.69	-6.28%
Commodity/Macro Mid-size	10.17%	7.97%	1.26	-9.15%
Commodity/Macro Large	7.91%	7.55%	1.05	-10.72%

Source: Strategic Consulting Analysis

Challenges for Emerging Managers

In addition to the quantitative analysis above, the Strategic Consulting Group also surveyed emerging managers to determine how they view their current and future opportunities and challenges. Based on responses from approximately 200 managers of young and/or small HFs, it is safe to say that emerging managers still perceive they face plenty of roadblocks.

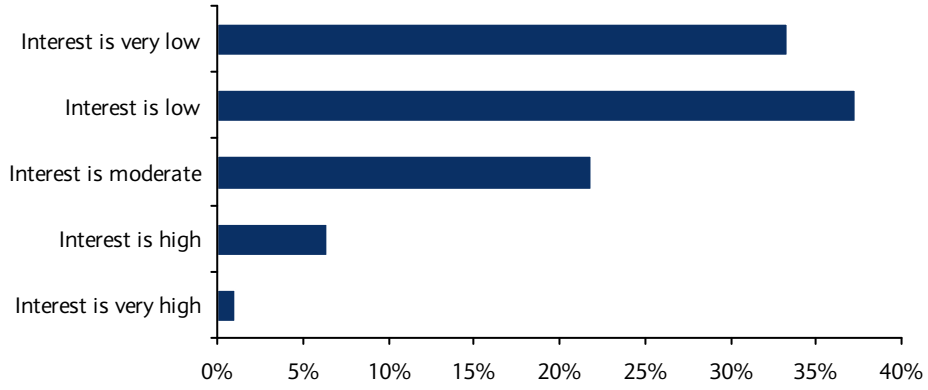
Indeed, marketing seems to be first and foremost on emerging managers minds, showing up as their number one concern. 66.7% of the managers that responded to our survey identified marketing as their biggest challenge. Another 15.9% wrote in that the related issue of asset-raising was their chief concern. Combined, more than four out of five respondents felt that growing and marketing their fund was their biggest challenge, leaving compliance and investor relations a distant second and third, at 5.0% and 4.5%, respectively. See Figure 18.

Figure 18: Greatest Challenges Currently Facing Emerging Managers

Source: Strategic Consulting Analysis

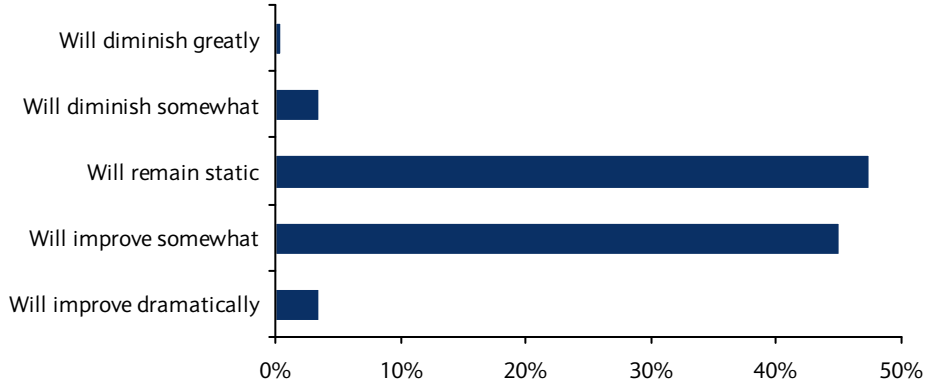
Furthermore, most of those emerging managers polled felt that the interest levels from institutional investors left something to be desired. In fact, in Figure 19 you can see that 70.6% said they thought that investor interest levels were currently either "low" or "very low." Looking out over the next 12 months, opinions were somewhat mixed. One manager stated that "As the Fund of Funds space works back from net outflows to inflows, and the largest hedge funds run out of places to invest, we expect a more advantageous capital raising environment to develop," however, not all funds were as optimistic. Small (but not young) funds had the most dour outlook, with only 42.2% stating they thought investor interest would improve in the next 12 months, and 57.8% stating they believed investor interest would either stay the same or decrease. Young (but not small) funds were more optimistic, with 52.2% expecting some level of improvement, and 47.8% expecting interest to remain stable – none indicated they expected to see interest decrease. Funds that are both young and small had the most positive outlook, with 59.0% expecting investor interest to improve over the next 12 months, and only 41.0% expecting it to stay the same or decline. See Figure 20 for responses from emerging managers overall.

Figure 19: Emerging Managers' Perceived Current Interest Level among Institutional Investors in Small Funds



Source: Strategic Consulting Analysis

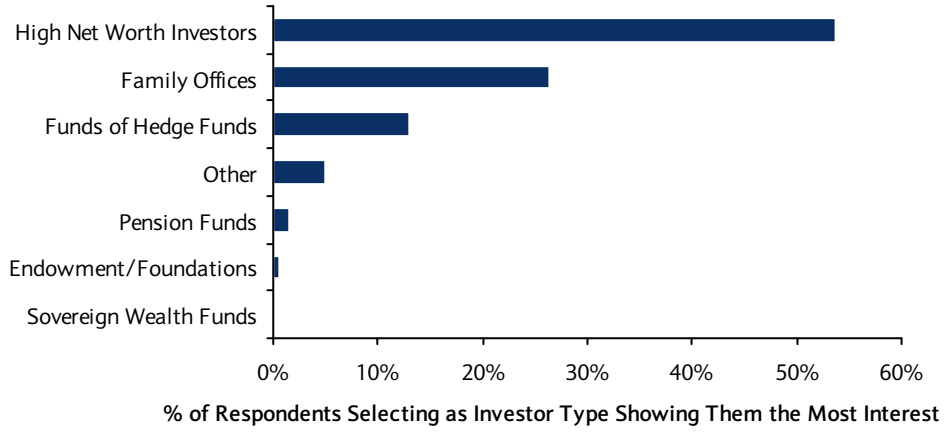
Figure 20: Emerging Managers' Predicted Interest Level among Institutional Investors in Small Funds over the Next 12 Months



Source: Strategic Consulting Analysis

When looking at types of investors that tend to be interested in emerging managers, the survey respondents indicated high net worth investors comprise the majority of the interest in their funds, at 49.5%. Family offices are also emerging fund benefactors, with 24.3% of the respondents stating that family offices had shown the most interest in their fund. Funds of funds round out the top three, with 11.9% of respondents stating FOFs show the most interest in their funds. (See Figure 21.) However, at least according to one manager, not all FOFs and family offices are created equal. One manager stated that "The family offices and funds of funds willing to seriously consider a fund like ours ($20 mn AUM; terminal capacity well under $100 mn) tend to be innovative, perform better than their peers, and be low career-risk environments for those individuals responsible for fund selection."

Figure 21: Investor Types Showing the Most Interest in Emerging Managers' HFs



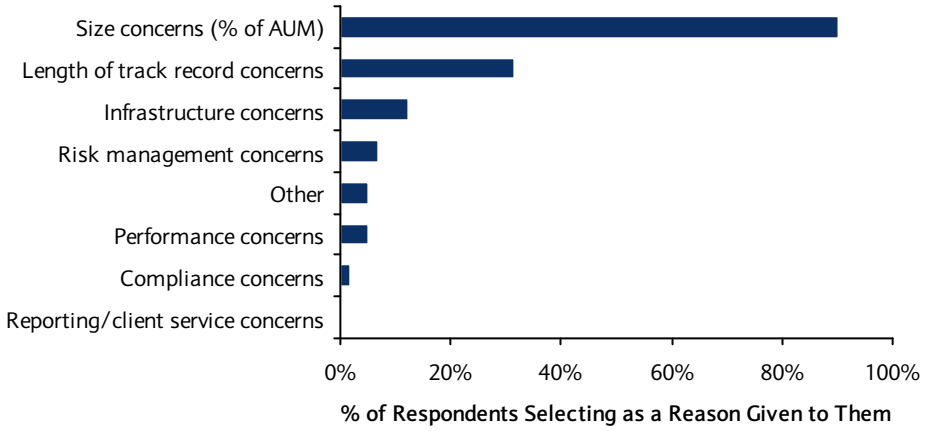
Source: Strategic Consulting Analysis

Another manager lamented that "Many institutional investors are talking about investing in 'emerging managers' but they are talking about funds with $200-500m v[ersus] $1b+, not the very small start-ups, which is a misleading headline regarding interest in actual emerging managers. As long as big funds remain open, no money will

filter to small funds." In fact, of those funds polled, very few stated they had interest from institutional investors at this time. Only 2.0% of respondents indicated they get the most interest from endowments, foundations, pensions or sovereign wealth funds.

Finally, we asked the emerging fund managers what reasons institutional investors had given for not making an investment with them. (Respondents were asked to select all reasons that applied.) In Figure 22, you can see that size concerns, or the percentage the investor would control of total AUM, was the runaway winner, accounting for nearly 60% of the responses. In second and third places were length of track record and infrastructure concerns.

Figure 22: Reasons Given by Institutional Investors for Not Investing with Emerging Managers



Source: Strategic Consulting Analysis

Survival Rates Within Size and Age Categories

The wide-spread perception in the industry is that new or small funds fail more often than old or large funds, and the research supports that theory.

Of course, many investors have shied away from small or young funds over the years due to concerns about the long-term viability of these funds. The wide-spread perception in the industry is that new or small funds fail more often than old or large funds. While it is exceptionally difficult to calculate survival rates in the hedge fund industry due to a lack of mandatory reporting requirements, we have attempted to create a proxy by looking at how many funds reported to the age-based or size-based indexes as of December 2008 versus how many in each category continued to report in December 2010. To mitigate survivor bias, defunct or otherwise no-longer-reporting HFs from the BarclayHedge Graveyard Database were included in the data sample from which all of the size- and age-based indexes were calculated.

For the size-based indexes, there appears to be a definite slant in favor of the large funds. Of the small funds known to be in existence in December 2008, only 69.1% of them were still known to be in existence in December 2010. In comparison, 80.3% of the large funds known to be in existence in December 2008 could still be verified as operating two years later.

The age-based indexes do not show such a difference in survival rates of underlying funds. 75.6% of the young funds known to be in existence in December 2008 were still known to be in existence in December 2010, while the corresponding figure for old funds is 75.0%.

It is important to remember, however, that just because a fund is not known to be in existence does not mean that the fund is defunct. Funds stop reporting to commercial data sources of any number of reasons, including that the fund closed to new investment, the fund closed down, the fund ceased marketing, the fund forgot to report, etc. Again, these numbers should be taken as a rough proxy for survival rates only.

Conclusions

Quantitative, academic analysis of data shows that, on average, smaller, younger funds tend to outperform their larger, older peers, although the higher returns of small funds may be offset by the greater level of risk they pose. Each group in the age and size stratification indexes has its own set of risks and rewards that bear examination. From our emerging manager survey, it is clear that attracting investor capital remains a challenge for these funds, possibly due to the more conservative risk/return preferences of institutional investors. Whether this environment will improve for emerging managers in the future remains to be seen.

Further Reading and Inquiry

We invite you to review our earlier pieces to get further information on some of the topics addressed in this edition of HF Pulse. Please see our 4th Quarterly HF Intelligence piece entitled "Look Both Ways" for more information on recent allocations to new and small managers.

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