Enhancing Portfolio Returns with Emerging Managers

Mark T. Finn
Vantage Consulting Group
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EXECUTIVE SUMMARY

Emerging hedge fund managers are often overlooked by the institutional investor community. They are deemed too small to make an impact on the bottom line and too risky in terms of institutional mandate and consultant reputation. In a recent Preqin survey[i], the data provider noted that 71% of institutional investors will not invest in a hedge fund without at least a two-year track record. This reluctance to invest in young funds provides opportunities for investors to capture excess returns from Emerging Managers. In this paper, we outline the case for investing in funds managed by emerging managers.

While there is no fixed definition of what makes an “Emerging Manager”, in general, managers are thought to be ‘emerging’ if they are small or young (or both). Of course, ‘small’ and ‘young’ refer to the fund and not the manager; Emerging Managers are often experienced managers in new vehicles. Most research classifies managers as emerging or young if they have less than one billion in capital and less than a three-year track record.

Emerging Managers are often more motivated, nimble, creative, and have less organizational bureaucracy than their established hedge fund manager counterparts. Furthermore, opportunity sets for smaller managers are often far less constrained than those of larger managers. For these reasons, several studies by academics and hedge fund data providers have shown that, as a group, Emerging Managers outperform more established funds in the same discipline.

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EMERGING vs ESTABLISHED MANAGERS

As noted, institutional investors often avoid Emerging Managers, despite the growing body of research that confirms Emerging Managers can deliver superior returns. However, the idea of seeding Emerging Managers has gained traction among a few large institutions, which have created Emerging Manager Platforms including CalSTRS, CalPERS, and the Teachers Retirement System of Texas. Some institutions with well-established Emerging Manager programs stipulate age and size thresholds as well as apply a qualitative view to determine if a manager qualifies. For example, New York City Retirement requires its Emerging Managers to have less than $1 billion in AUM, less than a 3-year track record, and enough AUM that New York City Retirement does not account for more than 10% of the fund[ii]. While a strict cutoff on manager assets or track record may not be necessary, a program to invest in Emerging Managers can benefit from a disciplined approach.

Emerging Managers often share similar characteristics besides their size and age. These characteristics set them apart from their larger more established counterparts and perhaps offer some insights into the historically higher alpha generated by Emerging Managers. While each Emerging Manager has a distinct strategy and investment style, the managers often share some similar characteristics:

- Investment opportunities and strategies from innovative new asset classes
- Investment opportunities in new and emerging markets
- Generating returns from unique niche opportunities
- Lower AUM means only best investment ideas survive
- Potentially smaller investments with more concentrated portfolios
- Rapid decision-making structures
- Highly motivated team
- High employee ownership
- Strategy focus (fewer strategies)
- Fewer constraints from liquidity, fast trade execution
- Small teams and greater accountability
- Lower fees for ‘founder class’ investors

High employee ownership creates a strong alignment effect for new managers. Furthermore, with little in the way of a track record, it is imperative that a new fund outperform its peers for reputational reasons as well as future marketability. With only a limited amount of funds to manage, Emerging Managers tend to be highly focused on their specific strategy and underlying positions. This reduces the potential distraction of having a multitude of nuanced funds or separately managed accounts.

The higher degree of success by many small managers may lie in their ability to exploit less efficient or niche markets without sacrificing liquidity, thus enabling smaller funds to take larger active positions. This is especially evident in the long/short space. In addition, in a small organization, there is direct accountability for actions and greater ownership of trade ideas and little ability to hide behind an expansive structure.

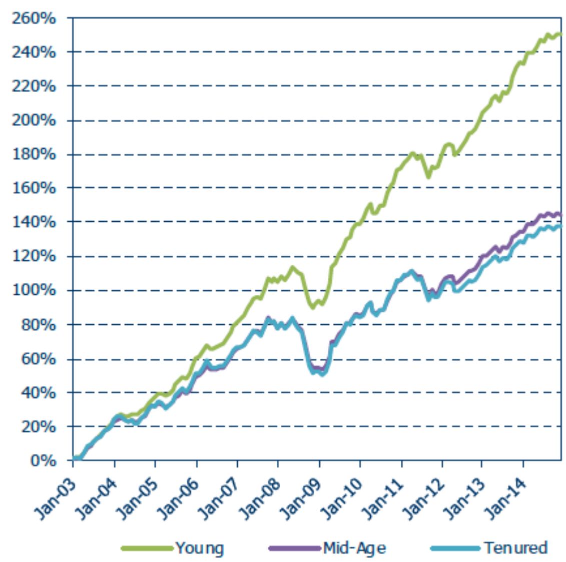
Finally, early stage investors are usually charged lower fees than those charged by more established funds.

EMERGING MANAGERS CONSISTENTLY OUTPERFORM ESTABLISHED MANAGERS

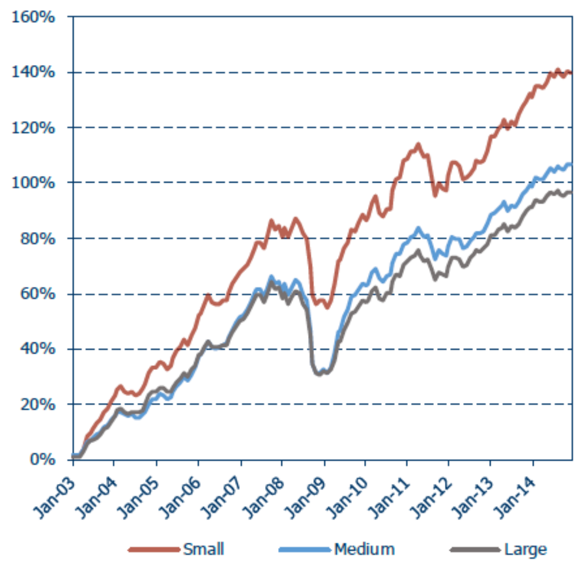
Several research papers have shown that, on average, Emerging Managers outperform more established hedge funds. According to a study by Preqin, since 2007, the average Emerging Manager long/short fund returned 8.8% net of fees in its first three years of trading while established managers returned 5.38%[iii]. The study was comprised of 2,191 Emerging Managers, which Preqin classified as funds with less than a three-year track record, and 8,647 total funds.

The Preqin results were corroborated by eVestment Alliance[iv] in a longer and more recent analysis between 2003 and 2014. The study grouped funds into age groups consisting of Young (<2 years), Mid-Age (2-5 years), and Tenured (>5 years) as well as by AUM consisting of Small (<$250M), Medium ($250M-$999M), and Large (>$1B). Among the portfolios of funds grouped by age, the youngest funds had the highest cumulative return from January 2003 to December 2014, at 250.25%. The Mid-Age index came in second at 144.04%, followed by the Tenured index at 137.24%. Among the indices organized by size, the Small index had the highest cumulative return from January 2003 to December 2014, at 139.86%. The Medium index came in second at 106.49% and the large index third at 96.30%.

Performance of Young, Mid-Age, and Tenured Funds



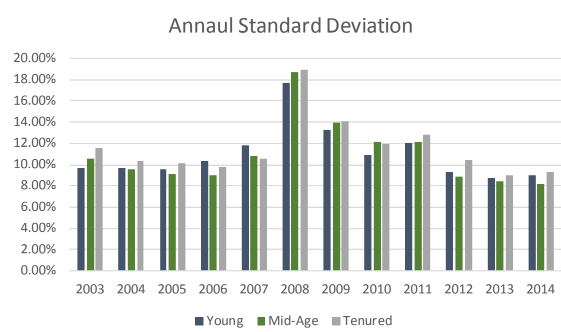
Performance of Small, Medium, and Large Funds



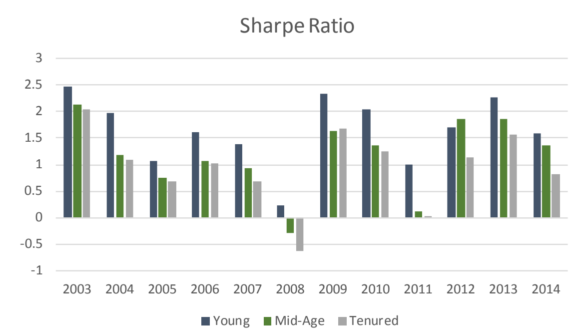
Source: eVestment Alliance, LLC

The eVestment report shows that Emerging Managers were also less volatile than Tenured managers, as Younger managers had lower standard deviations in 10 of the 12 years of the study. Moreover, Younger Emerging Managers produced a higher Sharpe Ratio in all 12 years of the study relative to the Tenured managers.

Annual Standard Deviation of Young, Mid-Age, and Tenured Funds



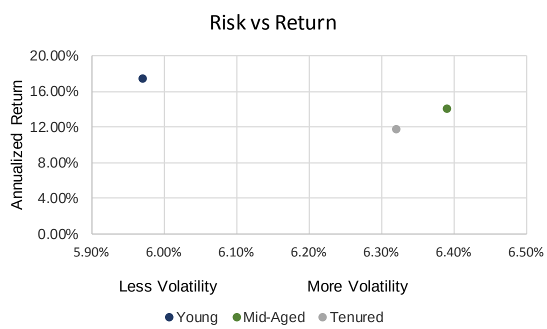
Sharpe Ratio of Young, Mid-Age, and Tenured Funds



Source: eVestment Alliance, LLC

An older study published by PerTrac Financial Solutions[v] found that Emerging Managers had both higher absolute returns and better risk-adjusted returns relative to more established funds over a ten-year period between 1996-2006. The report grouped funds by age – Emerging (<2 years), Maturing (2-4 years), and Established (>4 years) and found that Emerging Managers substantially outperformed their more established counterparts over the ten-year period. Young hedge funds had an annualized return of 17.5% relative to 14.1% for Mid-Aged, and 11.8% for Established funds. The study also showed that Young hedge funds were able to achieve these returns with a lower standard deviation and higher Sharpe Ratio than both of their more tenured counterparts.

Risk vs Return of Young, Mid-Age and Tenured Funds



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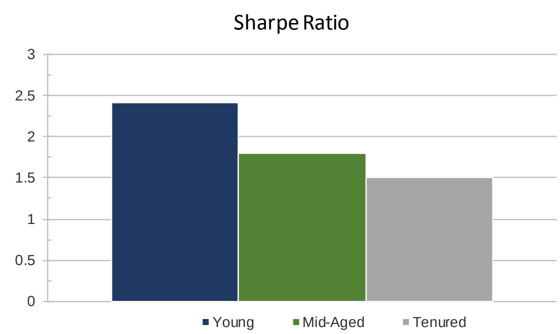
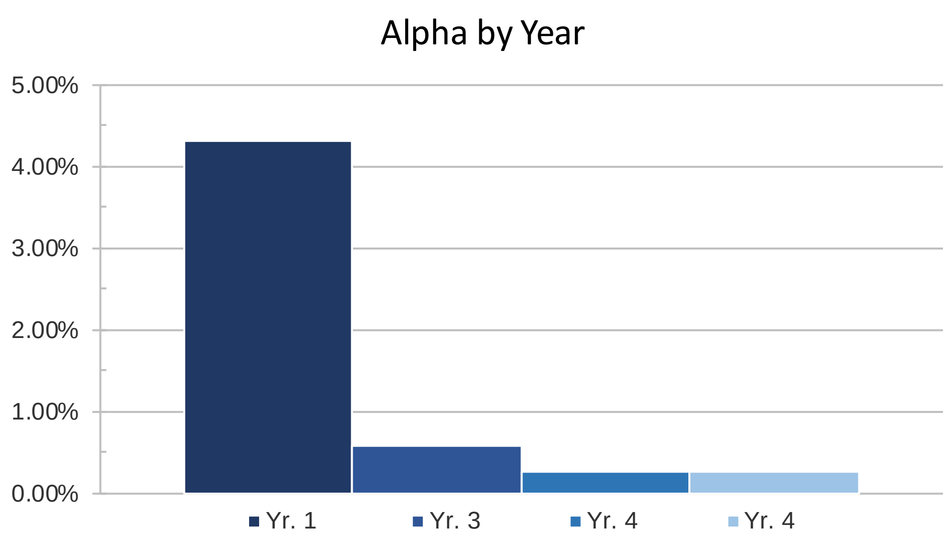


Source: PerTrac Financial

Research by The University of California Irvine in conjunction with The University of Minnesota found that Emerging Managers actually perform best in their first year[vi]. The study then shows that returns subsequently drop each year after the initial launch. Researchers found that Emerging Managers were able to produce 4.31% in alpha in their first year and excess returns then drop to 1.10% and 0.59% in years two and three. The 1996 study followed 931 Emerging Managers for 10 years.

Risk vs Return of Young, Mid-Age, and Tenured Funds

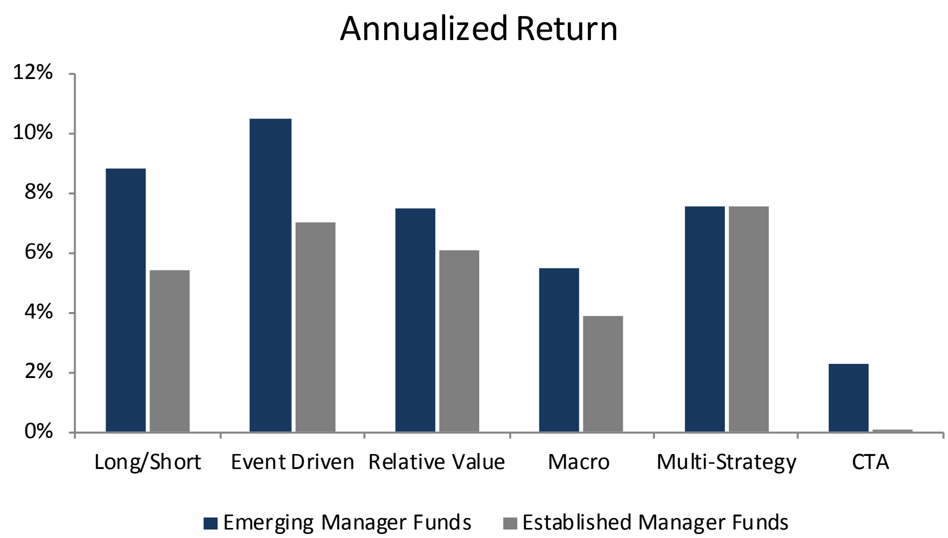


Source: "The Performance of Emerging Hedge Fund Managers" (2009)

EMERGING MANAGERS OUTPERFORM IN MOST STRATEGIES

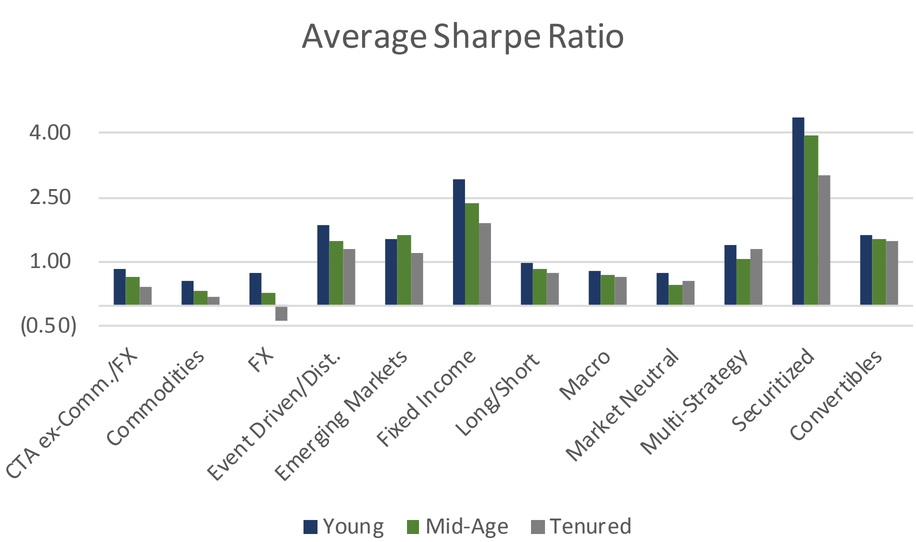
Emerging Managers tend to outperform across a wide range of strategies. The Preqin study focused on Long/Short equity funds launched since 2007 and less than 3 years old. These funds delivered more than 3% higher returns than the comparable established fund in the same category. The same phenomenon of outperformance can be seen in Event Driven, Relative Value, Macro and CTA strategies as shown on the following chart. eVestment also segmented out various funds by strategy and found similar results with Emerging Managers outperforming older managers in all strategies except emerging markets.

Annualized Returns by Hedge Fund Strategy



Source: Preqin

Average of Annual Sharpe Ratio for 10 years by Hedge Fund Strategy



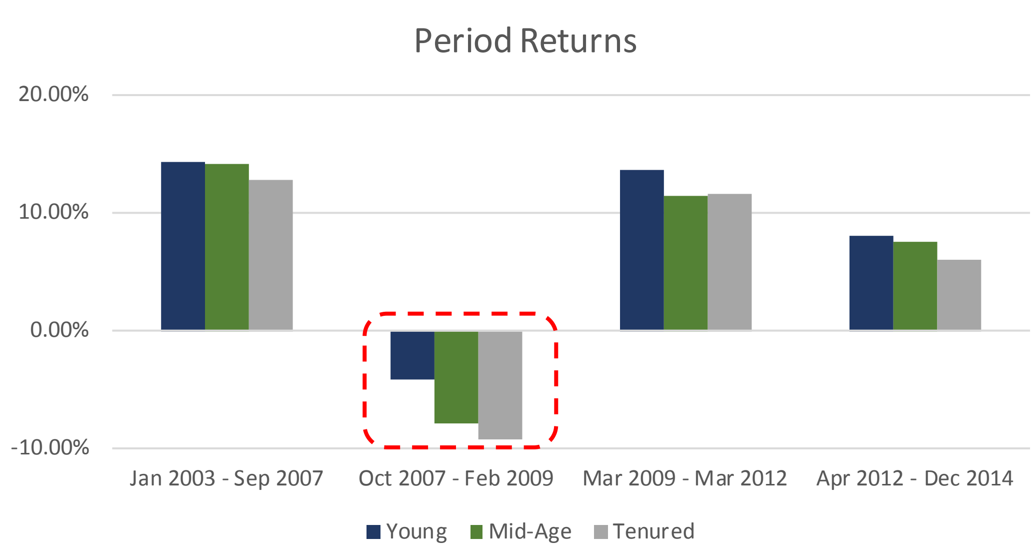
Source: eVestment Alliance, LLC

EMERGING MANAGER PERFORMANCE DURING THE FINANCIAL CRISIS

While the previously mentioned studies have concluded that Emerging Managers are on average less risky than traditional managers, a recent study by London City University[vii], using Thomson Reuters' Lipper Hedge Funds Database, found that smaller hedge funds outperform larger ones. In turn, investors would have been better off with smaller hedge funds than with large ones during two recent crisis periods (South East Asian Crisis, 1997 and Global Financial Crisis, 2008).

eVestment was able to show that during the financial crisis Emerging Managers were able to perform better than their more established counterparts. Not only were they able to perform better during that crisis, they were also able to outperform traditional managers before the financial crisis, during the rebound, and during the period after the rebound.

Average Returns by Hedge Funds Durring Various Economic Periods



Source: eVestment Alliance, LLC

EXPLAINING THE ANOMALY

There are several ways to explain the outperformance achieved by newer and smaller funds. In order to survive, Emerging Managers need to outperform their peer group to attract assets and build their businesses; consequently, they work harder and take more significant positions in their high conviction ideas. Additionally, Emerging Managers tend to be more nimble, making investment decisions faster by avoiding the more complicated and bureaucratic approval processes inherent in most larger firms.

As a function of smaller asset size, Emerging Managers can more easily invest in securities that are not feasible for multi-billion dollar managers, providing a larger universe of potential investments. These smaller securities are often less well followed or well researched by typical sell-side analysts. In turn, this also allows small managers to achieve a higher active share and thus higher active risk. Finn, Thaler and Kling[viii] show that when funds control for size risk, they are in danger of becoming closet index funds.

This phenomenon is also evident in mutual funds. An analysis by Vantage Consulting Group on mutual fund data shows that small funds take roughly 1% more active risk.

Smaller funds take more active risk

	Median AUM ($mn)	Median Market Cap ($bn)	Tracking Error (1Y-d)	Tracking Error (3Y-m)
Small funds (< $250mn)	65.8	**12.4**	**6.6**	**5.4**
Medium-sized funds (< $1bn)	500.9	13.4	5.7	4.8
Large funds (> $1bn)	2517.1	22.9	5.4	4.4

Source: Vantage Consulting Group, Bloomberg. *based on data from 2729 US mutual funds

Furthermore, new businesses are generally able to start off with the latest technology and best practices and are unburdened by legacy operational inefficiencies. Smaller and newer asset management firms can enjoy many of the same benefits that startups enjoy in other industries. Managers of new funds can learn from past mistakes and can use their industry knowledge along with research and innovation to establish a firm with best practices. Many young firms were launched in part with the motivation of escaping an unhealthy firm culture, old operational and technological systems, and underqualified co-workers. Typically, building an operation from scratch today will result in more efficiency than building off of legacy systems and technology.

IN LIGHT OF THIS ALPHA, WHY ARE EMERGING MANAGERS OVERLOOKED?

There are two types of challenges which may explain why institutions have been reluctant to tap into Emerging Manager alpha. Firstly, there are the perceived risks associated with investing in small managers with short or no track records:

- Unproven risk, i.e. insufficient performance track record and/or firm history
- Reputational risk, e.g. investors cannot hide with the herd (hence they feel too exposed)
- Capacity constraints, i.e. "they can't invest enough to impact our P&L"
- Asset allocation constraints (e.g. the 20% rule)

These perceived risks are often more a function of comfort level or concerns about judgments after the fact. They can be significantly mitigated when investors undertake a deliberate program to invest in Emerging Managers. In addition, these 'risks' may, as mentioned above, help explain the enhanced investment opportunities inherent in the Emerging Manager space. Empirical evidence demonstrates that a track record has little value in predicting future results. An Emerging Manager's lack of a track record can often be overcome by a demonstrable history with a previous fund and additional diligence of the strategy, including simulation and stress testing. Committees, consultants, and CIOs can mitigate concerns about reputational risk when trying new strategies by designing a well thought out program to incubate new strategies. These Emerging Manager programs have often led to excess returns, improved future strategy capacity, and can ultimately improve the overall risk adjusted return of a portfolio. While there can be capacity constraints when dealing with a single Emerging Manager, a portfolio of Emerging Managers can move the needle on an overall portfolio. As managers grow, they can graduate from the emerging program allowing additional capital to be deployed as the strategy proves out. Allocation limits serve a valid purpose but they need not prevent an allocation in an Emerging Manager program.

The second set of challenges relate to the business side and the manager's specific strategy and the challenges presented by a smaller capital base and less revenue. The following risks are more impactful to the suitability of the fund and must be well understood before any investment is contemplated:

- Investment risks: Emerging Manager performance has a large spread.
- Operational risks: Small managers may not have the resources to properly resource important functions like accounting and compliance.
- Business risk: Small managers may not have a strong enough balance sheet to sustain the fund through poor performance or irrational markets.
- Complexity: Significant resources are needed for potential investors to adequately research and vet new funds with novel or innovative strategies.

Many of these concerns can be mitigated with separate accounts, side letters and additional oversight and transparency, such as access to positions directly through the prime broker. Together, these risks may explain why the spread between the best and worst performing funds is wider for the Emerging Manager complex and provide an argument for why a team with specialized knowledge in the Emerging Manager space is preferred.

CONCLUSION

Despite considerable evidence that Emerging Managers improve both returns and correlations, they remain largely unexploited in intuitional portfolios. While some notable institutional investors have developed Emerging Manager programs, this significant underrepresentation behavior by intuitional investors creates a meaningful opportunity for thoughtful investors to garner excess returns.

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