Performance of Emerging Equity Long/Short Hedge Fund Managers

2003-2012

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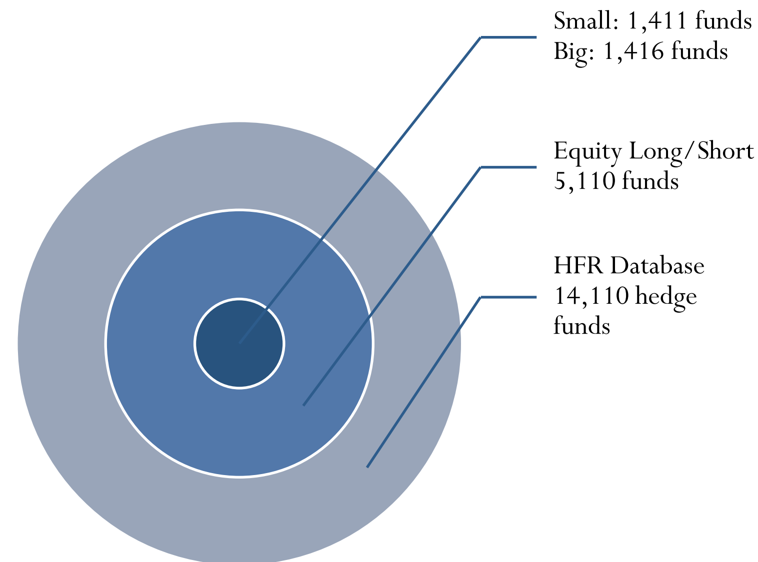
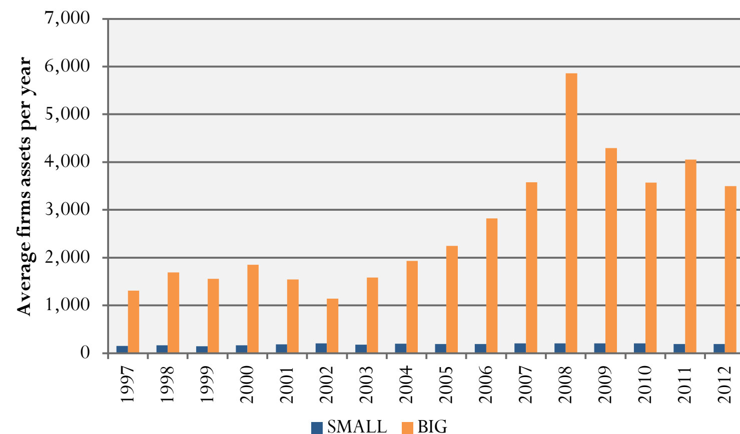
Summary

- Beachhead analyzed approximately three thousand equity long/short hedge funds in order to determine the impact of firm size on fund returns.
- Beachhead focused specifically on equity long/short funds in the Fundamental Value, Fundamental Growth, and three sector-specific categories.
- Firm size was chosen over fund size alone since many firms run multiple smaller funds and report multiple share classes for a given fund.
- Results demonstrate that hedge funds managed by firms with $50 million to $500 million in AUMs have outperformed those run by larger peers over almost any period.
  - Five and ten year outperformance was **254** bps and **220** bps per annum, respectively.
  - Outperformance was most pronounced preceding and following the crisis, especially during 2009.
  - Overall risk was in line, with a beta of approximately **1.09** relative to larger peers.
  - Smaller funds show a higher dispersion in returns, which suggests that potential outperformance is higher with careful manager selection.
- The conclusions are more robust and practical than prior studies due to several factors:
  - A narrower focus on a subset of similar strategies provides better insight into the impact of firm size and AUM growth since capacity constraints and other factors are likely to be comparable across the population of funds.
  - Sub-$50 million managers were eliminated due to the impracticality of investing for most investors.
  - Results include both live and dead funds but avoid the backfill bias inherent in the Pertrac study.

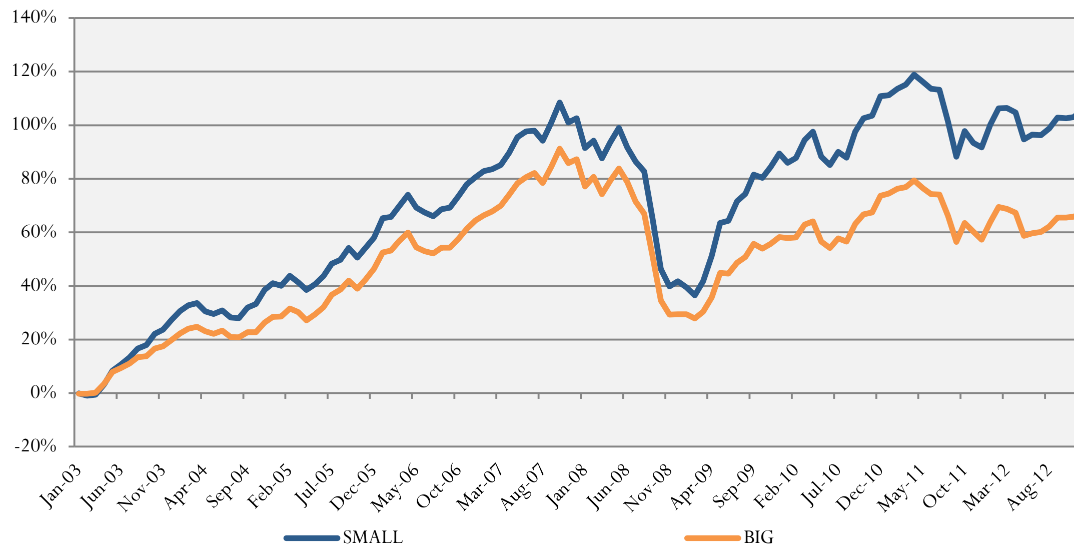
DATA CONSTRUCTION & FUND UNIVERSE

- 2,827 equity long/short hedge funds drawn from the HFR database of live and dead funds screened according to sector classifications (Fundamental Value, Fundamental Growth, Technology/Healthcare and Energy).
- Funds are grouped annually into Small and Big portfolios according to firm-wide equity long/short AUMs (based on funds that are reported to HFR). Portfolios are rebalanced monthly.
- Small is defined as funds managed by firms with $50 million to $500 million in AUMs as of the beginning of each calendar year; Big is defined as firms with greater than $500 million in equity long/short AUMs.
- Returns are included only from the date of joining the database to mitigate backfill bias.
- As of the beginning of 2012, the population consisted of approximately 700 funds, of which 63% qualified as Small. The percentage of Small funds in the universe has fluctuated between 51% and 74% over the past decade.
- Currently, a Big firm manages on average $3.7 billion in equity long/short AUMs vs. $193 million for a Small firm. Average Big firm assets have tripled over the past decade while Small firm assets have remained roughly constant.





Performance Statistics



	10 Years		5 Years		3 Years	
	SMALL	BIG	SMALL	BIG	SMALL	BIG
Compounded Annual Return	7.56%	5.36%	0.45%	-2.09%	3.04%	2.12%
Cumulative Compounded Return	107.24%	68.56%	2.28%	-10.00%	9.41%	6.49%
Largest Monthly Gain	8.03%	6.70%	8.03%	6.70%	5.16%	4.53%
Largest Monthly Loss	-11.47%	-10.94%	-11.47%	-10.94%	-6.48%	-5.83%
Percent Up Months	65.83%	66.67%	56.67%	55.00%	58.33%	58.33%
Max Drawdown	-34.53%	-33.17%	-32.66%	-31.75%	-14.00%	-12.78%
Annualized Standard Deviation	10.33%	9.31%	12.71%	11.42%	9.70%	8.88%
Sharpe Ratio	0.57	0.39	0.04	-0.19	0.34	0.26
Correlation	97.86%	-	98.19%	-	98.51%	-

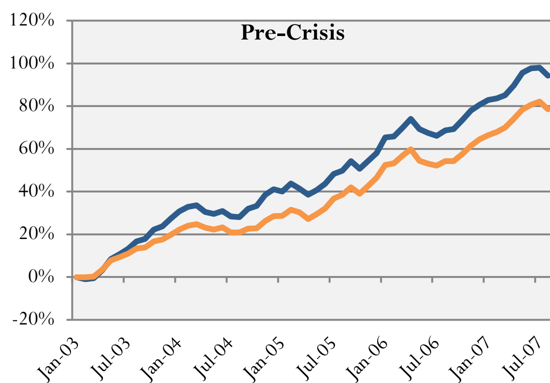
- Over the past ten years, Small managers returned 7.56% per annum and outperformed larger peers by 220 bps per annum.
- Small managers had a Sharpe ratio of 0.57 vs. 0.39 for larger peers over the past decade.
- Five year outperformance was 254 bps per annum, in part due to substantial outperformance during 2009.
- Drawdowns have been comparable across all periods, although Small managers tend to have a slightly higher standard deviation of returns.
- Correlation between Small and Big is very high through all periods (consistently above 0.97).

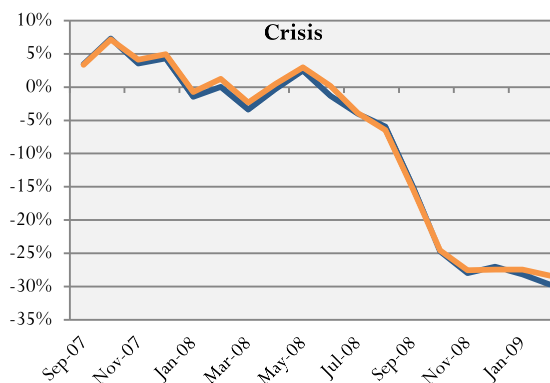
Outperformance by Period

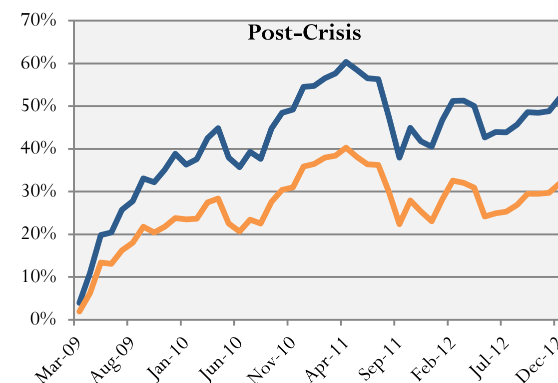
- The outperformance of Small managers is very stable over time.
- The chart on the right shows the compound annual outperformance of Small vs. Big firms over the past ten years (the uppermost left box shows 220 bps of outperformance from 2003 to 2012).
- As shown below, Small firms materially outperformed pre- and post-crisis. Despite a slightly higher beta, Small firms matched the performance of larger peers during the crisis.

From →

To ↑	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
2012	2.20%	1.69%	1.48%	1.92%	1.90%	2.54%	3.15%	0.92%	0.63%	0.93%
2011	2.34%	1.78%	1.55%	2.08%	2.08%	2.90%	3.90%	0.92%	0.37%	
2010	2.63%	2.02%	1.78%	2.47%	2.56%	3.82%	6.15%	1.59%		
2009	2.77%	2.08%	1.82%	2.67%	2.85%	4.76%	11.41%			
2008	1.58%	0.59%	-0.07%	0.46%	-0.17%	0.82%				
2007	1.80%	0.48%	-0.54%	0.14%	-1.75%					
2006	2.70%	1.22%	0.06%	2.03%						
2005	2.92%	0.82%	-1.90%							
2004	5.40%	3.45%								
2003	7.58%									

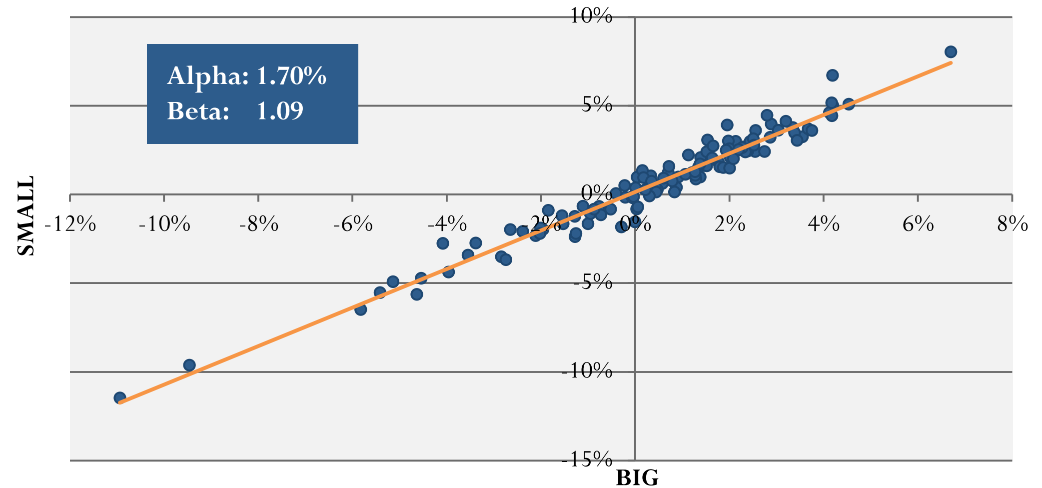


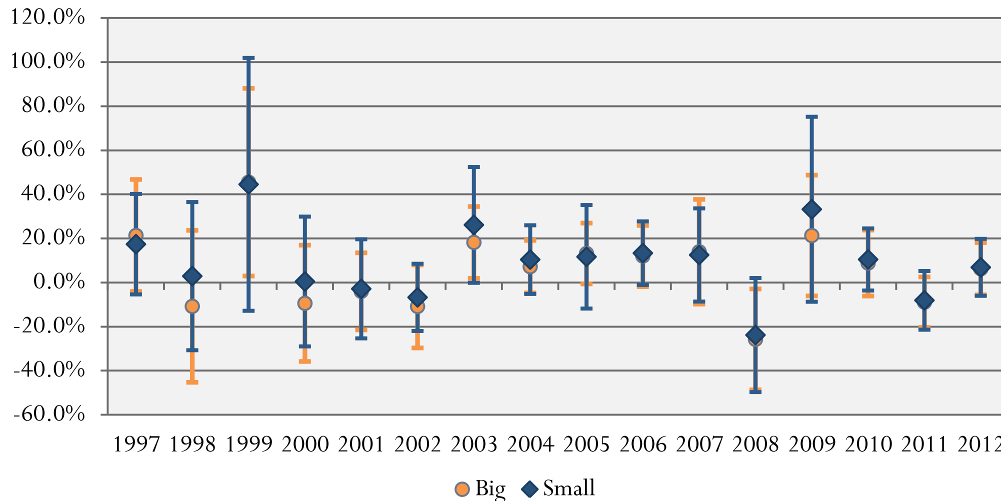




ALPHA AND DISPERSION OF RETURNS

- The outperformance of Small over Big during the past ten years is primarily due to alpha, which was 1.70% per annum, not higher beta.
- Correlations between Small and Big is consistently close to 1.0 as shown by the tight cluster of monthly returns.

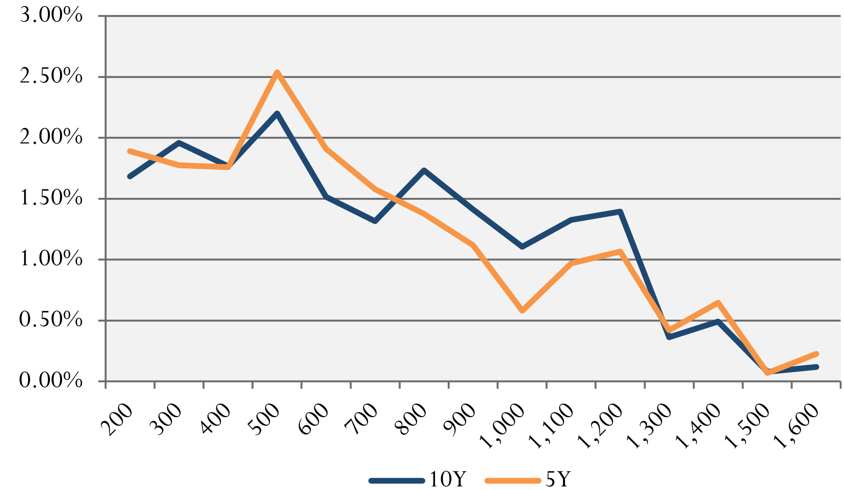




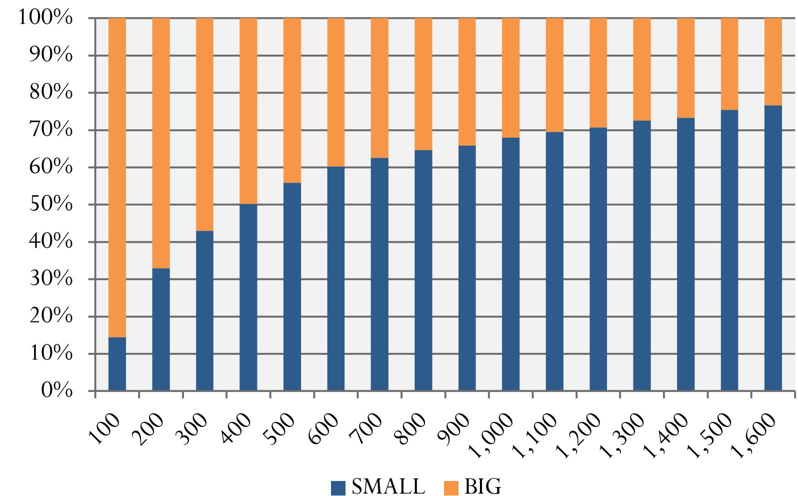
- The dispersion of annual returns is higher with smaller firms, although this is less pronounced over the past few years.
- In almost every year since the late 1990s, the top performing Small funds materially outperformed the top performing Big funds.

SENSITIVITY TO AUM THRESHOLDS

- The chart on the upper right shows the effect of raising the threshold that defines Small vs Big firms over ten and five years: as the threshold is raised, outperformance of "small" vs. "big" firms declines.
- For instance, funds managed by firms with $50 million to $1 billion in AUMs outperformed funds managed by larger firms by 1.1% and 0.6% per annum over ten and five years, respectively.



- The chart on the lower right shows how the percentage of "small" vs. "big" funds varies depending on the AUM threshold.
- For instance, at a threshold of $400 million, the number of "small" and "big" funds in the population would have been roughly equal over the past ten years.



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Why Small Firms Outperform

Reason	Rationale	Beachhead Analysis
Opportunity Set is Broader	• Smaller funds can invest in a broader array of inefficiently priced stocks, including small and midcap equities • Off the run ideas can have a more meaningful impact on returns	• An analysis of US equity trading volume demonstrates that the opportunity set shrinks by 80% between $100 mm and $1 bn in AUMs • Fund specific analysis shows little overlap between small fund holdings and crowded names
Talent and Self-Selection	• The most talented managers are more inclined to start their own firms rather than create a small fund at an established firm	• Managers often evolve from managing capital within larger firms to starting their own firms
Performance Fees Matter More	• For smaller firms, performance fees are a more meaningful percentage of overall compensation and therefore smaller firms have a greater incentive to try to materially outperform	• Up to 80% of larger firm value is tied to management, not incentive, fees due to higher enterprise value multiples on management fee EBITDA
Strategy Focus	• Small managers can concentrate capital in sectors/regions/strategies where competitive advantage is strongest	• Firms often add peripheral strategies as AUMs increase, often at the expense of returns
Portfolio Decision Making	• Key portfolio managers manage portfolios, not people	• As firms grow, key portfolio managers spend more time managing teams of analysts
Alignment of Incentives	• Outperformance matters more due to higher co-investment and the impact of performance on capital raising	• PM co-investment tends to be a materially higher percentage of AUMs at smaller firms
Short-side Alpha	• Large managers have trouble generating short-side alpha	• Capacity constraints are more acute on short positions due to position volatility and structural changes in stock lending