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In Chaos, Small Hedge Funds Do Better

A study finds that size can hurt when ‘flighty’ investors flee

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By SIMON CONSTABLE

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The moment a crisis breaks out, hedge-fund investors should pray they're in a large fund, which has the capital and market influence to survive, right?

Just the opposite, it appears.

Researchers at City University London found that smaller funds hold up better when the world is going haywire, perhaps because of having fewer “flighty” investors who pull their money out at the first sign of trouble.

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On Wall Street, bigger is often synonymous with better—bigger bonus, bigger office, bigger job. However, "on average, investors were better off investing with a small hedge fund instead of a large one in times of crisis," concludes the July-dated working paper from the university's Center for Asset Management Research.

For instance, in 2008, during the global financial crisis, the smallest 10% of funds returned negative 0.48% a month while the largest returned negative 1.28%, for a difference of 0.8 percentage point a month, or 9.6 points for the full year, according to data provided to The Wall Street Journal by the authors. In 2000, amid the bursting of the tech-stock bubble, the smaller funds again performed better, with a monthly return of 1.09% vs. 0.65% for the bigger funds, a difference of 0.44 point a month or 5.2 for the full year.

Professors Andrew Clare, Dirk Nitzsche and Nick Motson, all from City University's Cass Business School, looked at data on almost 7,300 hedge funds drawn from Thomson Reuters's Lipper Hedge Fund Database from January 1995 to December 2014.

The authors offer three possible explanations for the difference in performance. Assessing each will take further research, says Prof. Clare.

First, the report says that stakes in larger funds are more likely to be held by those flighty investors, often in a so-called fund of funds—an investment that holds stakes in other funds. "My experience of working in the hedge-fund industry is [that] as soon as the proverbial hits the fan, there is no obvious commitment to the hedge-fund industry by fund-of-funds investors," says Prof. Clare.

Big hedge funds' performance may have been hampered by those investors cashing out of their fund-of-funds positions, the report suggests. Those redemptions would force fund-of-funds managers to sell stakes in the big hedge funds, whose managers in turn might have been forced into sales of securities at a loss or at a smaller profit than a later sale would have brought.

Second, the authors suggest that smaller hedge funds may have had "more stringent gating arrangements," or limits on withdrawals, that would have stemmed the flow of redemptions. For instance, they may have allowed redemptions only during certain periods each year or had minimum holding periods. "Clearly, small funds tend to be youngish funds," says Prof. Clare. Such funds may have still had investor covenants in place that restricted cash-outs during the market's crises, he adds.

Third, smaller hedge funds may have been less exposed to market risk than larger ones. By definition, small funds have less capital to invest, and that means they can put fewer investing ideas to work, explains Prof. Clare.

"The more ideas you apply, the more exposure to the general market you have," he says.

Steven Brown, a professor of finance at New York University's Stern School of Business, urges caution in acting on the paper's findings. "I think there needs to be a lot more work done on this," he says. "I would be careful about giving inexperienced funds large contributions."

The biggest 10% of funds that were studied had an average of close to $900 million under management over the analysis period, while those in the smallest 10% averaged $1.2 million.

Despite the differences in performance, the average fund size of both large and small funds grew significantly over the period. Assets managed by the biggest 10% of funds nearly quintupled over the two decades, while the assets of the smallest 10% doubled.

When it comes to hedge funds, says the study, both big and small are "bigger than they used to be."

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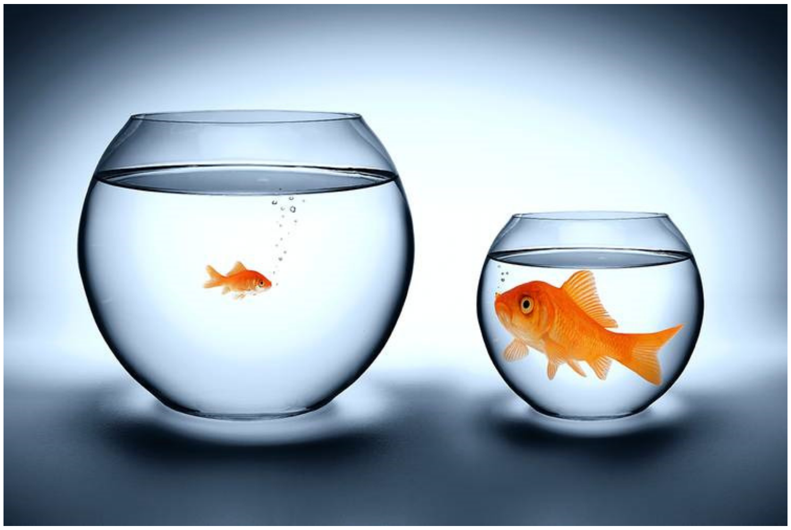

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