FINANCIAL POST

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When it comes to picking a hedge fund, bigger isn't always better

By David Kaufman

David Kaufman: A few legendary funds are able to manage billions of dollars and consistently deliver outsized returns, but smaller can be better

For many years the question of whether the size of a hedge fund affects its returns has been hotly debated. Although there is ample evidence that a few legendary funds are able to manage billions of dollars and consistently deliver outsized returns to investors over the long term (especially on a risk-adjusted basis), there is mounting evidence that, at least in the world of hedge funds, smaller can be better.

The reasons for this are varied, but boil down to three key elements: managers of small funds are hungrier; managers of smaller funds depend on performance fees to live on; and very small investments can "move the needle" for smaller funds.

The first element - that managers of smaller funds are hungrier - is intuitive. When anyone starts a business, they often pour everything they have into it, including all of their time and money, to increase the likelihood of success. Once success arrives, they do not give up on doing a great job, but may be less likely to work the extra hours that being exceptional can require.

So while there is nothing necessarily lacking in the motivations of a seasoned manager with years of experience under his belt, it is likely that a manager with only a few years of experience with a given fund will be very highly motivated to do a great job.

The second element - that managers of younger funds rely on performance fees to live on - is closely tied to the first. Since a manager with, say, $75 million in assets under management (AUM) is not making any significant profits on the management fees associated with her fund (taking into account the high costs of compliance, rent, and staffing), she must have positive performance in order to make any profit at all.

With most performance fees in the hedge fund world in the 10-20 per cent of positive performance range, managers of smaller funds become hyper-focused on making trades that will increase performance, while managers of much larger funds could live quite nicely on management fees alone (since management fees increase with each marginal dollar invested and costs are generally fixed).

Of course, a manager who is solely reliant on performance fees to make a living could be motivated to take imprudent risks with investors' capital in order to create gains in tough markets. The antidote to this (remembering that everyone is *always* motivated by incentives) is to ensure that the manager has enough of his or her own money in the fund to act as a disincentive to take unreasonable risks at the wrong time.

The final element - that smaller funds can move the needle with smaller investments - is, on its own, enough of an argument to at least consider a fund with only 3-4 years of track record and less than $100M under management.

Say that a truly "can't miss" trade presents itself, but that no more than $5M can be allocated to it. And say that the return on that trade is 10 per cent. If a $100M fund were to allocate $5M to that trade (assuming it were to work out), it would increase the value of the entire fund by $500,000, or 0.5 per cent. This is a material amount over the course of a year. Now say that a $1B fund were to make the same trade but also capped at the $5M available. That fund would also net $500,000 from the trade but the marginal return to that fund would be 0.05 per cent - so small that it is almost a rounding error.

Since some of the best investments in any given investment strategy come in small amounts (suggesting, as is likely, that the markets are more efficient when larger numbers are at stake as compared to smaller ones), and since there are a limited number of "great" trades that present themselves of any size over the course of a year, it is clear that a smaller fund will benefit from these trades to a much greater degree than a larger counterpart.

Note that, from a due diligence perspective, while it may be advisable to consider smaller funds to add to one's asset mix, being small and/or young does *not* give a fund a free pass from an operational or structural point of view. The same checklist that one would use to conduct due diligence on a larger fund should be used with a smaller fund, allowing for the fact that a smaller fund could have more key-person risk and fewer redundancies in back office operations. This may be an acceptable trade-off for better risk-adjusted performance.

What would not be acceptable, for example, would be the use of a second-rate auditor, legal structure, or compliance model. These are the ante for playing in the game, and if a manager is unable to meet important minimal standards, one must conclude that they may be small for a reason other than that they are relatively new.

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