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Study: For Hedge Funds, Smaller Is Better

The smaller the hedge fund, the more likely it is to outperform, a new study shows.

By Alicia McElhaney May 11, 2018

The smaller the hedge fund is, the better its performance is likely to be, according to a new study.

The study — "Size, Age, and the Performance Life Cycle of Hedge Funds," released April 26 — sought to determine whether a hedge fund's size and age had any effect on its performance. Researchers Chao Gao and Chengdong Yin from Purdue University's Krannert School of Management, and Tim Haight of Loyola Marymount University, used data from the Lipper TASS and the HFR databases to answer these questions.

According to the researchers, the information revealed by the study is especially important now, as many hedge funds have had "lackluster" performance since the last recession.

"Small funds outperform large funds and are more likely to maintain good performance," Gao, Haight, and Yin wrote. "In addition, the contribution of the management fee to managers' total compensation grows with fund size, suggesting decreasing incentives to improve performance."

To determine what size funds best performed, the researchers separated hedge funds into three size groups at the beginning of each year, and assessed monthly performance in each group: less than $10 million under management (small), $10 million to $100 million (medium), and more than $100 million (large). Their sample included performance data from January 1994 to December 2016.

Though the study found that younger funds tended to outperform their older peers, age didn't matter as much for smaller hedge funds.

"Our analysis suggests that investors are more likely to earn higher returns by investing in small hedge funds," the authors wrote.

Other studies have shown that hedge funds' compensation structures are often not effective in aligning managers' incentives with investors' interests. Management fees tend to comprise a larger portion of total compensation for fund managers as their company grows.

"In other words, when funds grow large, fund managers may have less incentive to improve fund performance because most of their compensation comes from the asset-based management fee," according to Gao, Haight, and Yin.

The researchers also explored whether young funds took on more risk to achieve better performance, but found that was not a factor.