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Smaller hedge funds outperform during a crisis

Madison Marriage

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Pensions funds should think twice before investing in large hedge funds, according to new research from London's Cass Business School that shows smaller hedge funds perform better during a time of crisis.

The research, which analysed the performance of 7,261 hedge funds from 1994 to 2014, showed that a hedge fund with £200m of assets would on average outperform a £5bn hedge fund by 125 basis points a year.

A £200m hedge fund was also found to outperform a £1bn equivalent by 61bp, according to the research commissioned by Gatemore, the investment advisory firm.

These trends were more pronounced during the financial crisis and just after the technology bubble burst in the early 2000s.

Andrew Clare, professor of asset management at Cass Business School, said the results were "surprising". Many investors would expect large hedge funds with bigger risk management and research teams to outperform when markets are choppy.

Prof Clare, who is also a trustee of the £2bn Magnox Electric Group pension scheme, and serves on the investment committee of the £4bn GEC Marconi pension plan, said the findings would encourage him to reassess allocations to large hedge funds.

"As a pension trustee, I would look at hedge funds between the £200m-500m mark because [their] performance [is likely to be] very good compared with the mega funds," he said.

However, David Walker, a director at Cerulli Associates, the research company, doubted whether the findings would push institutional investors to ditch large funds.

He said: "Small funds may lack a recognisable name that would make pension trustees comfortable investing in what is already a complex and often 'politically difficult' investment strategy.

"Even if institutions wanted to avoid the industry's 'big names', taking early steps into hedge funds will probably be more palatable to investment committees if the allocation is to a large, well-known management firm."

But Mr Walker agreed that small hedge funds are more likely to cope in stressed market conditions.

He said: "Smaller hedge fund managers are often hungrier for returns, and have portfolios that are not yet so large that their trading of instruments moves market prices, disadvantageously, in front of them. "As liquidity in some asset classes has decreased since the financial crisis — and many practitioners fear may fall sharply further come the next crisis — [the] advantage of nimbleness may become more apparent for smaller managers."

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