Worthy Insights

Market Commentary from
Worth Venture Partners, LLC
June 2013

Emerging Hedge Fund Managers

Are Institutional Investors Fishing In The Right Pond?

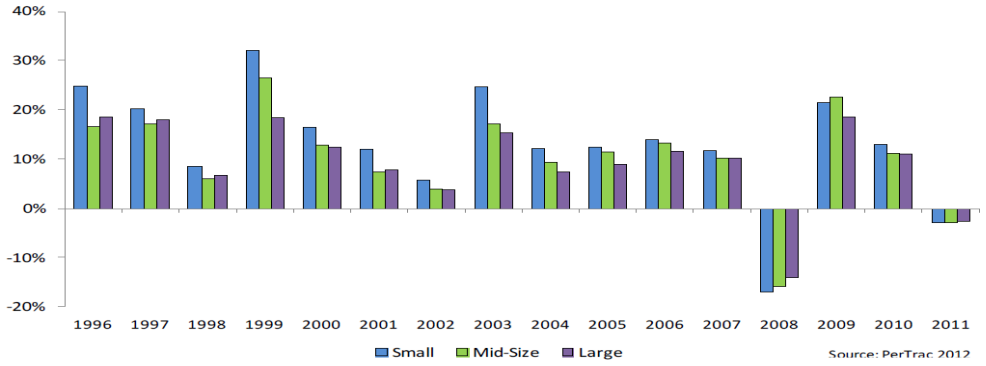
There has been a lot of buzz in recent years in the alternative space about 'emerging' hedge fund managers. Programs are being launched throughout the institutional investor community to dedicate funds to this "asset class."

- Credit Suisse points out that "research of returns from January 1996 through December 2010 indicates that smaller hedge funds (less than $100M in AUM) have historically outperformed larger hedge funds (greater than $500M AUM) by 3.95% annually." [1]

- Pertrac notes that "the average small fund has outperformed the average mid-size fund and average large fund in 13 out of the last 16 years." [2]

- Barclay's Capital notes that "quantitative, academic analysis of data shows that, on average, smaller, younger funds tend to outperform their larger, older peers, although the higher returns of small funds may be offset by the greater level of risk they pose. " [3]

Annual Performance by Fund Size from January 1996 to December 2011



[1] "2010 Hedge Fund Industry Review". Credit Suisse Asset Management. February 2011. Web. 3 June 2013. <https://www.credit-suisse.com/asset_management/global_includes/alternativeinvestments/doc/2010_hedge_fund_industry_review.pdf>.

[2] "Impact of Size and Age on Hedge Fund Performance: 1996-2011". Pertrac. October 2012. Web. 3 June 2013. <http://www.pertrac.com/resources/pertrac-research/impact-of-size-and-age-on-hedge-fund-performance-1996-2011/>.

[3] "Emerging Managers: Good buy or goodbye", Barclays Capital. April 2012. Web. 3 June 2013. <http://www.managedfunds.org/wp-content/uploads/2011/08/HF-Pulse-Emerging-Mgrs-Apr-2011-A41.pdf>.

Introduction | Emerging managers

The data clearly indicates that smaller funds deliver higher returns. This phenomenon can be attributed to a number of factors: the ability to take advantage of smaller opportunities, greater motivation due to an increased reliance on performance for income, and the ability to be nimble due to smaller position sizes.

What exactly is an emerging manager, and why do investors think that investing with them will help their portfolio? We decided to take a look various definitions of emerging managers to figure out where value is being created.

> NAIC states that, *"generally, the industry definition of an 'emerging manager' is a money manager that manages assets below a given threshold—for example, no more than $2 billion of assets."*[4] NAIC then broadens the definition from one strictly determined by size, adding that, *"emerging managers are defined as any private equity/alternative asset class investment firms/ funds that are majority owned or managed by people who have traditionally been underserved or excluded from the industry, namely people of color and women."*
>
> Progress Investment Management Company, a $7 billion manager of emerging managers, defines "emerging manager" on their website as *"a registered investment advisor that has at least 51% employee ownership and $2 billion or less in assets under management."*[5] It is also important to note that these definitions of "emerging manager" encompass many asset classes, and that $2 billion in AUM for a long only equity or fixed-income manager (where the average large manager probably manages close to $100 billion) is approximately the equivalent of $400 million for a hedge fund manager (where the average large manager probably manages around $20 billion).
>
> The Financial Times Lexicon defines emerging managers as *"investment managers that are newly created and have a small asset base. They are typically specialized and run by managers that believe they can attain higher returns by being focused and nimble."* [6]

It is clear that there is no uniform definition of emerging managers. For our purposes, we will focus on the overriding theme that emerging managers should be defined by size, and will thus focus on managers that are small. The goal of emerging manager programs, for the most part, is to increase returns while maintaining an optimal risk/reward profile. As a result, we think that the size of the fund should be the most important determinant as to whether a manager is "emerging." If fund maturity were the basis of determining whether a manager was "emerging," then an investor would not have the benefit of proven performance.

Our data indicates that the first few years of returns are important in determining whether a manager is able to survive, and that investing in early launches to gain "emerging manager" exposure robs the investor of this important window to gauge sustainability. If ethnicity and gender were the basis of determining whether a manager is "emerging," then how would women or minority owned multi-billion dollar funds fit in to the picture? Although we agree that age, gender and ethnicity have a place in the emerging manager asset class, we believe that if one defines "emerging" as small, then better performing funds can be discovered. The return benefits of size, age, and diversity remain, while the unintended recipients of emerging manager mandates can be eliminated.

---

[4] "Emerging Manager Programs: A Best Practices Overview". National Association of Investment Companies. June 2011. Web. 3 June 2013. < http://www.naicpe.com/publications/NAIC-EmergingManagerPrograms.pdf>.

[5] Progress Investment Management. n.d. Web. 3 June 2013. <http://www.progressinvestment.com/faq_investors.php#emerging_manager>.

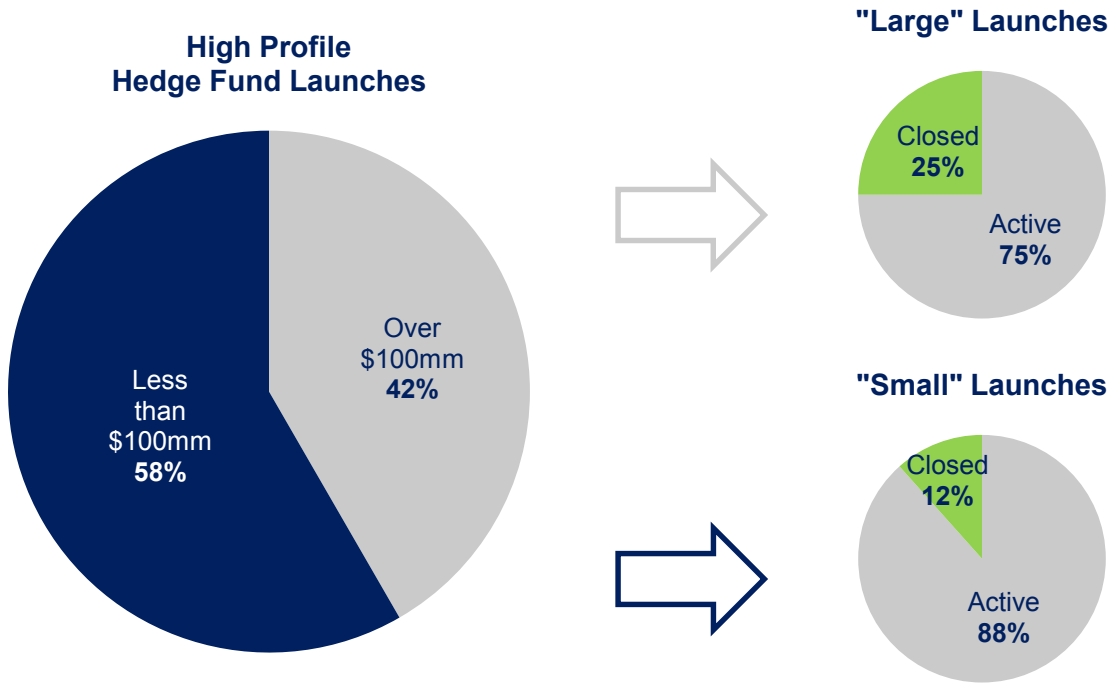
[6] "Financial Times Lexicon". Financial Times. n.d. Web. 3 June 2013. <http://lexicon.ft.com/Term?term=emerging-managers>.

Launching Funds | Pedigree debate

Many investors, as well as their consultants and advisors, believe that in order to be successful, an emerging hedge fund manager must come out of a large hedge fund, launch with a significant amount of his /her own capital, and immediately build out an institutional grade infrastructure. BHA, a network of qualified investors and managers, points out on their website that *"more than ever, it seems that investors are interested in managers with a quality pedigree. Managers who can show that they've spun off from reputable firms have an edge in this type of marketplace….. it shows that investors are eager to invest in new funds provided they are run by blue-chip talent."*[7]

Fin Alternatives echoes this sentiment, stating, *"this year saw a real validation of this mandate in the flow of new investment activity towards managers in the emerging category. If you are an emerging manager with a strong performance pedigree from your past, an infrastructure that supports the growth new investment means for your business and a management game plan that addresses the personnel requirements to scale, it is game on for your chances to garner serious interest."*[8]

One needs to look no farther than traditional "seeders," who fund early stage managers in exchange for economic interest in the new fund's future growth, to prove that this attitude is prevalent. These seeding funds favor the exact profile of manager described above, and they will not consider anyone who is not perceived to have stellar business building capabilities regardless of their ability to generate outperformance. The reigning wisdom is that if a manager is raised in a large, high profile institution then he/she is a likely candidate for success, even if they had no prior exposure or contribution to the business side of the firm they are leaving. As a result of this bias, we believe a whole segment of the "emerging manager" community is being overlooked by investors. We examined the data to determine whether or not our belief is justified.



[7] Kelsey, Ben. "Emerging Manager Pedigree More Important Than Ever". Brighton House Associates. September 2011. Web. 3 June 2013. <http://www.brightonhouseassociates.com/web/emerging-manager-pedigree-more-important-than-ever/>.

[8] Harrison, Diane. "Ten Reasons Emerging Managers Should Market Hard in 2012". FINalternatives. December, 2011. Web. 3 June 2013. <http://www.finalternatives.com/node/18907>.

We researched 192 high profile hedge fund launches over a three year period from 2009 through 2011 and came to several conclusions. We defined "high profile" as a manager or managers leaving a fund or financial institution managing more than $1 billion. Of the 192 launches, 80 launched with $100 million or more in AUM and the remaining 112 launched with under $100 million. We discovered that 20 out of the 80 "large" launches have subsequently closed down or returned outside investor capital, and that 13 of the 112 "smaller" launches have closed down. Interestingly, while 25% of the better attended launches failed, only 12% of the lower profile launches closed their doors.

Through additional examination of limited return data, we discovered that in both the "large" launch and "small " launch groups there are plenty of lackluster returns and situations where AUM has shrunk to a fraction of the launch size due to excessive redemptions. Furthermore, one of the "large" launches had the head of one of its divisions arrested for insider trading, another had its CEO resign after it settled a market manipulation case with the SEC, and a third had a partnership break-up only one year after launch. Although managers launching with larger asset bases are perceived to be safer due to their ability to implement more institutional infrastructure, the data does not support this hypothesis. In fact, there appears to be a higher sustainability rate in funds that launch with smaller asset bases and grow at a measured pace over time.

Launches | Seeking an "edge"

All that said, there are plenty of high profile launches that have been mildly to wildly successful; however, the above statistics are sobering as they demonstrate that high profile launches do not have a greater guarantee of success than less publicized launches of lesser-known managers who may or may not have the business savvy assumed of well-known large fund defectors. These lesser-known managers tend to launch more modestly with their own capital and the support of friends and family. They typically do not have the personal funds or expertise to build out a comprehensive institutional infrastructure, yet our analysis indicates that they do not have a disadvantage when it comes to performance and sustainability.

In fact, we believe that more modest launches and growth plans encourage managers to maintain motivation to grow their capital, and focus intensely on returns balanced by preservation of capital. Rather than launching with significant AUM and growing quickly into a new/unproven business infrastructure due to large inflows of institutional funds, these emerging managers can focus on investment management, and ease into their growth at a measured pace. By contrast, a manager leaving a large fund with the goal of replicating the business model of his prior fund will be more likely to have a similar return profile to the fund he left and not of an "emerging manager."

If the odds of a manager's success is not correlated to the size of their launch or the size and caliber of the institution that groomed them, then what should institutional investors look for in order to capitalize on the supposed outperformance of emerging managers? We believe that success is not tied to a manager's ability to build a business, but instead to his/her investment acumen and ability to maintain an "edge" in whatever area of the market they choose as their focus. There are many managers overseeing small pools of capital who have built up impressive performance track records. As long as the managers implement both strong investment and risk management processes, we believe that they must be considered as far as emerging manager mandates are concerned.

We believe that these lesser known managers are being overlooked because it is extremely hard to comb the universe for "hidden" talent. These managers are launching all over the world, many outside of the larger cities where hedge funds tend to congregate. Investment allocators may not be sending analysts to the central United States, Africa, or the Middle East. Additionally, and most importantly, there is a business risk in investing with a small manager who has not built out an institutional-grade infrastructure. There can also be discomfort with an infrastructure that does not adhere to institutional standards and does not look familiar to an allocator. Therefore, it is extremely difficult to discover many of

these managers, and once they are found, it is an even more complicated process to gain confidence in their business plans.

While it may be difficult to gauge a "small" launch's ability to grow a successful business, it seems like the institutional investor community has become very comfortable with the "large" launch's business building ability. Larger launches come with the promise of high priced talent, and they can typically afford to hire more experienced personnel. On the flip side, the principal of the firm, who may have been making money-making decisions at his prior firm, will move further away from day to day trading decisions. Larger launches appeal to administrators, custodians, prime brokers, and other top end service providers that smaller firms cannot always afford, intrigue, or access. Furthermore, larger launches can pay for marketing talent which often includes a marketing and investor relations team to open global distribution pipelines.

The struggle for many emerging managers is often their inability to raise assets and scale. In recent years, there has been a proliferation of groups that allow smaller managers to outsource a lot of their infrastructure, including groups focused on marketing and investor relations. When paired with the right outsourced infrastructure package, we strongly believe that a small manager with an excellent and sustainable investment process can outperform a manager launching with a larger asset base who has lost most of their emerging manager edge.

Conclusion

In conclusion, we believe that investors would benefit tremendously by finding a way to harness the investment talent of the best small managers where there is proof of concept, without concern for the size of the launch or pending growth of the business. Quality infrastructure and business development can be acquired, but the ability to consistently outperform in a risk controlled manner and maintain an "edge" in an ever-evolving competitive market are rare and valuable skills. Instead of looking for the next launch with the highest probability of becoming the large multi-strategy hedge fund that investors are trying to diversify away from, why not partner with a guide who can lead you to pools of undiscovered managers who embody the true essence of emerging managers: consistent outperformance.

About Worth Venture Partners

Investor Relations: David Wertentheil, Partner, dwertentheil@worthventure.com
212.558.9017 | www.worthventure.com

Worth Venture Partners is a woman-owned asset management company, founded by Abby Flamholz and David Wertentheil, built to provide global institutional and private client investors with the opportunity to invest in industry leading emerging hedge fund managers.