Worthy Insights

Market Commentary from
Worth Venture Partners, LLC
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Accessing Emerging Hedge Fund Returns

Seeking Return Over Size

Executive Summary

- Emerging manager investors – early stage "angel" investors – can now access a growing menu of cost-effective options to secure an even larger emerging manager allocation customized to their risk appetite. New and expanding execution vehicles and platforms are easing the challenge of investing substantial amounts into smaller emerging funds
- Over various time periods, academics have documented emerging manager outperformance of 1.7-2.2% per year. This outperformance is especially notable as it is even greater during times of crisis, a trend which is garnering increased attention after a recent period of hedge fund underperformance. As a result, many hedge fund allocations are being re-evaluated and entire portfolios re-underwritten to place emerging manager allocations in greater focus
- Alpha becomes beta over time and this occurs at a faster pace with large capital inflows. Those seeking manager return over manager size must place themselves alongside advisors with strong sourcing capabilities
- Creating customized emerging manager portfolios is now possible given technology innovation in risk management oversight and reporting
- Among emerging manager solutions, alignment and efficient fee negotiation prowess are key differentiators that lead to stronger maintenance of an emerging manager return premium. In particular, alignment is found among separately managed account ("SMA") platforms that typically increase capacity by sourcing new offerings, rather than adding more capital to existing strategies which may erode the performance edge

Introduction | History of the tactical advantage

Historically, "angel" investing was associated with private equity allocations to niche opportunities offering outperformance. Investors in emerging hedge funds also fall into this category, committing funds to smaller more nimble management teams offering distinct skills in a niche segment. For most qualified investors, hedge fund investing entered this arena in the '90s. While those early investors were not called "angel" investors, they jumpstarted the industry and sparked a new investing methodology. Many successful firms that started in the '90s are today's behemoth hedge funds, and, until recently, many have rewarded their founding "angel" investors well. During the recent liquidity-fueled crisis the dynamics of size and capacity took center stage.

Over the last decade flows into the largest hedge funds resulted in another $1 trillion of institutional assets entering the space, setting the stage for the liquidity and performance challenges of 2015/2016. As a result, investors are now revisiting the overwhelming evidence supporting the rewards of "angel" emerging manager investing as the current risk-reward balance is even better than it was in the '90s.

> ***"…it seems that, on average, investors were better off investing with a small hedge fund instead of a large one in times of crisis – following the collapse of the high-tech bubble and again during the more recent global financial crisis."***
>
> Andrew Clare, Dirk Nitzsche and Nick Motson - The Sir John Cass Business School, City University, London, UK
> "Are investors better off with small hedge funds in times of crisis?" July 2015

Monitoring and risk management innovation, informed by decades of operational improvements, resulted in oversight methods that augment the lean operational infrastructure often found in emerging hedge funds. Thus, technology and best practices are now alleviating operational concerns that were once deal-stoppers. By adding independent checks and redundancies around accounting and trading practices through due diligence, independent administration, and separate account platforms, the rewards of emerging manager investing can now be successfully scaled and captured.

As venture investing is to private equity, emerging manager investing is to hedge funds. Given the drive to diversify portfolios across sizes and strategies, the challenge in today's alternative investment environment is *how* to execute this allocation. How can we best compare advisors who can source, perform diligence, and deliver access to the widest range of talented emerging managers?

Three popular vehicles for execution include fund of funds, seeders, and platforms, all with various methods of customization and consulting. Our comparison between execution methods highlights and contrasts the most important characteristics for investors.

One of the largest differences between these vehicles lies in building strong alignment and setting capacity limits. Recent research shows that asset flows strongly influence strategy returns, often negatively. To combat this effect, rebalancing ease and daily portfolio monitoring brings the flexibility required to maintain the outperformance expectation of a portfolio of emerging managers. As in all "angel" investing, monitoring success milestones and tactics

> ***"Institutional investors continue to favor large, institutional hedge fund managers,..A lot of money went into big multistrategy hedge funds and global macro/managed futures funds throughout the first half of 2015…***
>
> ***For example, according to survey data provided in both 2015 and 2014, multi-strategy manager Millennium Management LLC moved up to sixth place from 16th with growth of 31.3% to $30.4 billion, and managed futures specialist Winton Capital Management Ltd. was pushed up to the seventh spot from 13th with growth of 21.3% to $29.8 billion."***
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> Peter Laurelli, eVestment LLC, contributor to Pension and Investments
> "Hedge Fund Investments Rise, but Some Managers are Getting More", September 21, 2015

within the strategy are necessary to ensure the manager's continued ability to outperform.

Easily accessible customization is creating an evolutionary leap in the way investors build their emerging manager exposures, and SMA platforms are leading providers in this area. Innovation in sourcing, evaluation, and monitoring has led to greater access for both institutional and family office-size allocations.

Evolution

"Angels" of yore. In the '90s, all hedge fund investors were generally considered "angel" emerging manager investors as the vast majority of hedge funds at that time would be considered emerging managers by today's standards.

> ***"…a number of estimates indicate that as of mid-1998 there were between 2,500 and 3,500 hedge funds managing between $200 billion and $300 billion in capital… with the vast majority controlling less than $100 million in invested capital."***
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> Presidents Working Group on Financial Markets
> "Hedge Funds, Leverage and the Lessons of Long-Term Capital Management ", April 1999

The modern hedge fund industry began with simple stock picking accompanied by hedges; hence, the nomenclature. In the '80s and '90s the industry was comprised of a small group of fund managers trading niche products in unique ways, and they generally outperformed traditional equity managers based on their "edge." Superior performance was due to being tactical, skilled and nimble. As it does today, expertise dictated the ability to raise capital. Early-stage "angel" investors were often prior co-workers and industry colleagues who helped raised awareness of a strategy through word-of-mouth.

Fast forward to the first half of 2015 when institutional flows were favoring larger firms, thereby driving growth at the largest hedge funds.

> ***"The marketplace is becoming increasingly fragmented with large funds receiving the bulk of investor capital, while new and emerging funds are simultaneously growing in number.***
>
> ***Oftentimes, institutional investors make allocations to more established hedge funds. Track records, a solid infrastructure, and established partners in compliance and risk control are increasingly important to these investors. For new funds, the biggest challenge is getting off the ground and raising capital."***
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> Darc Matter - "Challenges Hedge Funds Face When Raising Capital", May 12, 2015
> www.darcmatter.com/blog/challenges-hedge-funds-face-when-raising-capital/

Running in place. Despite persistent evidence of smaller funds' outperformance, until very recently data indicated that capital from "angels" is not growing apace with those seeking to allocate to larger funds. The largest hedge funds continue to take in vastly larger amounts of capital while the smallest hedge funds struggle to grow, and when the latter do grow it can be painstakingly slow. Thus, average hedge fund returns for institutional investors now approach the hedge fund index, which is dominated by the largest funds.

A new means to the end. Diversification is needed to drive alpha. Recent innovation should facilitate this aim. The imperative for even the largest investors is to differentiate returns through investing in niche, uncrowded strategies promising to beat benchmarks. To this end, research continues to support the hypothesis that smaller emerging managers are better positioned to outperform their larger peers. Evaluating and assessing these managers is more feasible thanks to new industry developments.

Differentiating Returns | Emerging manager results

Evidence abounds. The ability to improve returns by investing in niche and uncrowded strategies has only recently become available on a larger scale. Vehicles are now available for a diversity of investor sizes and risk appetites. Over the prior two decades, family offices and dedicated early-stage "angel" investors were typically the primary source of launch capital. The early alignment of the owner-manager-trader was due to a strong relationship between general and limited partners across the table, which motivated alignment during the formative years. Emerging managers provided the expertise, determination, and enterprising leadership style to propel a novel strategy and operation.

"Over the past ten years, Small equity long/short managers returned 7.56% per annum and outperformed their larger peers by 220 bps per annum (over the past five years, outperformance was 254 bps per annum).

Small managers showed a moderately higher annualized standard deviation, but drawdowns were in line and the Sharpe ratio was significantly higher."

Beachhead Capital Management
"Performance of Emerging Equity Long/Short Hedge Fund Managers", February 2013

Motivation is high. The widespread hedge fund index underperformance in 2015/2016 is motivating a re-underwriting of exposures. The heightened correlation of the decline has spawned industry wide frustration and a debate about optimal capacity. With so many blue-chip hedge funds hitting speed bumps during the past 12 months, the unwinding may be exacerbating the crowding fears. At the same time, this activity is motivating a re-examination of real diversification in the alternatives portfolio: size, team diversity, risk factor diversity, and capacity are all up for debate. This recent period has fueled a reassessment of firm risk by demonstrating that bigger managers miss expectations as spectacularly as small managers.

Research is pervasive. A re-underwriting of alternative portfolios is underway, and emerging manager portfolios offer one avenue to reposition and achieve much-needed diversity. Evidence in the form of decade-long studies clearly refute many of the old biases and resoundingly support outperformance among smaller emerging managers.

July 2015 Research: "*Are investors better off with small hedge funds in times of crisis?"* Researchers at City University London recently completed a study that found an annual return differential of 1.68% between the largest and smallest AUM decile hedge fund portfolios across more than 7,000 funds. They analyzed returns from January 1995 to December 2014 while correcting for survivorship bias. They also document that during periods of financial crisis, investors in smaller hedge funds generally fared better than those in larger funds. They found a stronger negative relationship between hedge fund size and returns than between hedge fund age and returns.

"Our results indicate that there is a strong, negative relationship between hedge fund performance and size."

Andrew Clare, Dirk Nitzsche and Nick Motson - The Sir John Cass Business School, City University, London, UK
"Are investors better off with small hedge funds in times of crisis?" July 2015

Within strategy groups, the study found the negative relationship statistically significant for Long/Short Equity but not for Emerging Markets and Event Driven strategies. For Managed Futures strategies, they found a significantly positive correlation between size and return.

February 2013 Research: "*Performance of Emerging Equity Long/Short Hedge Fund Managers".* The earlier Beachhead Capital 10-year study analyzed the relationship between firm size and fund returns within Long/Short Equity strategies by comparing the returns of 2,800+ equity long/short funds, 700 which qualified as small when segregating small funds ($50 million to $500 million AUM) and large funds (over $500 million AUM). The larger firms on average managed $3.7 billion while the smaller firms on average managed $193 million. To correct for backfill biases, they only included data as of the date a manager joined the database.

They noted outperformance on both return and risk among the smaller managers as they had a Sharpe ratio of 0.57 vs. 0.39 for the larger peers, resulting in higher alpha for the smaller managers. In addition, they noted strong outperformance in 2009 as contributing to the overall performance bump. Interestingly, they found a consistently high correlation of returns between big and small above 0.97. Outliers among the smaller group also outperformed. The study highlights that in almost every year, the top performing smaller funds materially outperformed the larger top performers.

The study contends that outperformance of smaller funds is in part due to their broader opportunity set, talent self-selection, and performance fees as a more meaningful percentage of overall compensation.

February 2013: Performance of Emerging Equity Long/Short Hedge Fund Managers
10 Years Ending December 2012

	Small	Big
Compound Annual Return	7.56%	5.36%
Cumulative Compound Return	107.24%	68.56%
Largest Monthly Gain	8.03%	6.70%
Largest Monthly Loss	-11.47%	-10.94%
Percentage Up Months	65.83%	66.67%
Max Drawdown	-34.53%	-33.17%
Annualized Standard Deviation	10.33%	9.31%
Correlation	97.86%	

Source: Beachhead Capital Management - "Performance of Emerging Equity Long/Short Hedge Fund Managers", February 2013

September/October 2014 Research: *Financial Analyst Journal - "Flows, Price Pressure and Hedge Fund Returns".* With the differential documented, the question remains why? A third study documented the effect of asset flows on alpha. The Financial Analyst Journal in Sept/Oct 2014 featured Assistant Professors Ahoniemi and Jylha at Imperial College Business School in London, who contended that for funds experiencing large inflows, the flow results in declining alpha over time. Their findings point out that hedge fund returns have significant flow-induced price pressure resulting in relative outperformance of funds receiving high inflows. Over subsequent months, reversal of the initial impact occurs relatively slowly. They conclude that flows have implications for performance attribution since hedge fund alphas fell by 33% over a 24 month period when controlling for flow impacts.

Size can be the enemy of return. Most explanations come back to two key themes that lead to managers' alpha becoming beta and performance declining with size – namely, (1) capacity to execute a limited number of best ideas and (2) the decline in differentiated returns.

The economic picture today is a difficult one, with equity markets hovering tentatively vs. the last five years where they were headed straight up. As interest rates trend to zero or lower with no end in sight, investors are looking for better ideas and re-analyzing the path to capturing alpha.

Based on the Ahoniemi and Jylha study and others like it, the path to differentiated and improved returns leads straight to dedicated emerging manager programs as the next evolution in hedge fund investing. However, the question remains on the tools and methods being implemented to execute the plan.

CFA Institute's Enterprising Investor contributor Michael Weinberg recently contended:

1. *Institutional investors who have successfully allocated to large established managers now need small managers to achieve true diversification.*

2. *The optimal way to achieve this small manager diversification is through small manager–focused solutions providers in order to complement institutional investors' large manager direct allocations.*

"Small Hedge Funds Complement Large Ones", May 19, 2015

"Undoubtedly one of the biggest challenges facing emerging managers is to create institutionally attractive infrastructure cost effectively. Without this, emerging managers will face an uphill struggle convincing institutional investors that they merit attention and allocations."

Sean Scott, Partner, Harneys - COOConnect
"Emerging Hedge Fund Managers: Survival of the Fittest", August 19, 2015

Sourcing | Challenges and alternatives

Emerging solutions. Technology innovation broadens and levels the playing field, and both typical "angel" investors and institutional investors are finding the reach to improve and differentiate returns. Small managers may lack 'large firm' infrastructure and resources, which has historically resulted in avoidance by trustees at institutions. But recent developments have opened up new options on the investment menu for even the most discerning fiduciary.

Both institutions and family offices alike often require a partner to navigate the universe of small managers. Access points have now emerged to provide a slate of options to choose from making allocations easier and offering enhanced returns. Technology and innovation have helped smooth the sourcing, evaluation and monitoring process to deliver targeted and customized emerging manager solutions that address a number of investors' deepest concerns in the manager selection process.

Considerations for Selecting an Emerging Manager Solution

Alignment

- Emerging manager providers differentiate greatly on their degree of co-investment
- "Skin in the Game" is more widely observed in privately owned platforms

Fees

- Expertise in negotiating favorable terms
- Fees charged efficiently at one level

Customization Ready

- Bespoke portfolios can target the appropriate risk-adjusted weightings
- Real time risk-testing and transparency

Rebalancing Ease

- Rebalancing and termination ease is often provided with customization
- Subscription/redemption process can be more efficient on some platforms

Vetting Expertise

- 7,500 "small" hedge fund firms as compared to the less than 500 "large" hedge funds
- Screens focus on those that are believed to have a sustainable investment strategy

Operational Rigor Added

- Third-party treasury and valuation oversight is now easier with technology
- Position and leverage monitors at managed account platforms can add outsourced risk management

Investment Process Analysis

- War stories provide a rich set of standards around investment and operational practices
- Investment analysis at the position level is easier than ever

Daily Portfolio Oversight

- Separately managed accounts monitored daily are using top-tier risk systems
- Transparency allows for efficient monitoring of activity

Execution | Making smaller more accessible

Strengths and weaknesses are often manifested by the motivations and conflicts in the structured investment options outlined in the table on the following page. These points of comparison are useful to contrast the various methods that have evolved to access emerging managers.

Seeders can help a start-up hedge fund attract outside capital, perhaps serving as a "stamp of approval" and validating a firm's viability. When an emerging manager has critical mass from a seeder, others may be more willing to invest because they no longer represent too large a share of the manager's assets. Most hedge fund seeding vehicles require capital to be invested for an extended period, typically two to four years. This time frame is necessary because the seeding vehicle, in turn, commits capital to seeded managers for multiple years.

Working with a consultant or advisor, some investors have chosen to hire emerging managers directly. More institutional investors are coming to their consultants and asking for advice around smaller managers. In these situations, the consultant faces a cost/benefit analysis. Consultants are inclined to perform diligence on funds that they can scale across multiple clients, thus reducing cost for all parties. Emerging managers do not easily fit into this equation. Consultants have relaxed some of the historical screening criteria to ferret out managers who complement their clients' portfolios. The challenge for consultants is scale — an extensive search for a viable emerging manager may only benefit one client due to the manager's limited capacity and thus increase consulting fees as this search is not their primary focus.

Large fund of funds, >$1 billion, have made a substantial investment in their due diligence operations. This scale and depth have not usually made emerging managers a focus segment until recently. Many rely on a combination of traditional strategies, restricted to those that are scalable to match the FOF's liquidity needs. Even with strong resources at their disposal, $1+ billion fund of funds may not find it efficient to allocate their time investing in emerging managers where single manager allocation sizes may be limited.

Emerging manager fund of funds merge together a number of emerging managers under one investment offering, but likely provide limited transparency and a full additional level of fees. They can offer diversification benefits, due diligence and full tactical management, yet may lack desired customization. Investing in an emerging manager fund of funds can reduce execution times or concern about becoming too large a percentage of any one manager's asset base, but can also provide broader and more timely and efficient exposure than an investor might achieve through investing directly.

A bespoke, custom-tailored "fund-of-one" — that is, an emerging manager hedge fund program designed specifically for one investor — can be a key part of the solution for hedge fund investing when added transparency is needed. However, there aren't many firms that have the experience and resources to manage many different customized portfolios.

Emerging manager SMA platforms vary greatly in the number of managers on their platform, the scope of oversight services and their outreach efforts to the emerging manager investor community. Emerging manager platforms by design specialize in sourcing and monitoring smaller hedge fund managers. The potential return premium also comes from a combination of their additional operational oversight and ability to collapse fees by negotiating favorable terms. As a result, many are able to avoid the double fee of a traditional fund of funds.

Direct Comparison | Debating the entry point

Strengths indicated by one or two check marks

	Seeders Private Equity	Consultants or Advisors	>$1 Billion Fund of Funds	Emerging Manager FOF	Bespoke FOF	Emerging Manager Platform
Structural Advantages						
Alignment	✓		✓	✓✓	✓	✓✓
Fees	✓	✓			✓	✓✓
Customization		✓			✓	✓✓
Rebalancing Ease				✓	✓	✓✓
Liquidity		✓	✓	✓	✓✓	✓✓
Process to Support Allocations						
Vetting Expertise	✓✓			✓✓	✓✓	✓✓
Access to Best Talent	✓			✓	✓	✓✓
Adds Rigor to Operations	✓	✓	✓	✓	✓	✓✓
Investment Process Analysis	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓
Daily Portfolio Oversight						✓✓

Conclusion

Return over size. Outperformance remains the objective, but finding alpha in today's environment has presented hedge fund investors with a new challenge. The key themes: diversification, niche strategies, experience, and the ability to be nimble. As large hedge funds have eroded some of their alpha, capital is moving towards outperformance among emerging managers. Studies indicate that smaller can have its advantages when it comes to performance, and experience has shown that the added diversification can avoid certain liquidity issues in addition to capital at risk.

Larger menu of options. Emerging manager solutions range from customized managed accounts, designed to meet highly specific objectives and requirements, to turnkey commingled solutions that provide access to robust portfolios of talented investment managers. We have seen the emergence of efficient, dedicated emerging manager platforms, fund of funds, seeders and consultants scrambling to fill this need each with its own strengths and weaknesses. With the right partner, larger allocators can obtain exposure to an aggregated group of smaller managers that are suitable for their investment goals.

Harnessing technology. Platforms often harness technology to offer unique transparency and daily operational oversight. Technological innovation has helped address these concerns and facilitate diversification by creating rigorous risk management and enabling single-client customization.

Capacity in check. The largest contrast between entry points is in motivations of the provider. Alignment towards maximizing return and the ability to manage risk appropriately is strongest for emerging manager fund of funds and separately managed account platforms. They are often among the most motivated to source new ideas rather than cannibalize performance in the pursuit of alpha. This has become critical as it is clear that too much capital injected into too small a fund can result in undesired outcomes – namely, impacting the performance needle such that alpha becomes beta. This essentially causes the undoing of the premium associated with emerging manager investing.

Innovation opens the way. Investing in emerging firms requires early and ongoing due diligence that can command a sizeable time commitment. Allocators are aware of this challenge – namely, the vetting process to identify the right manager from among seemingly innumerable small hedge funds. Managers, meanwhile, must prove they can meet the needs of investors accustomed to the large-scale services of seasoned funds and managers. Structural evolution of platforms has helped address challenges on both sides.

About Worth Venture Partners

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Worth Venture Partners is a SEC-registered investment adviser, formed in October 2012 by Abby Flamholz and David Wertentheil to capture returns of emerging alternative managers. As of May 2016, approximately $245 million is invested on behalf of investors. Our core principles remain consistent:

(1) Maintain what we believe to be our high-quality risk management practices;
(2) Ensure we are collaborating with our investors and their other financial advisors to be a part of the ecosystem of service in an effort to achieve tax-efficient and structural goals; and
(3) Strive for our clients to receive opportunistic and/or low correlated returns with the best liquidity and oversight we can provide.

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