Does Fund Size Affect Hedge Fund Performance?

Selina Sy analyzes the performance of hedge funds in 2013 by fund size and examines whether smaller hedge funds can offer investors more favourable returns than larger and more established hedge funds.

As our feature article *What Are Investors Looking For? Size and Track Record Requirements* revealed, investors are looking at a broad range of fund sizes when selecting fund managers for the year ahead. Fund size is related to a variety of characteristics such as fund strategy and scope, as well as the ability of the manager to grow capital and attract larger investors. Twenty-one percent of investors that seek to invest in smaller funds – specifically those with less than $1bn in assets – told Preqin that they target these funds in order to achieve better returns (see Preqin Investor Outlook: Alternative Assets H1 2014). With investors turning away from investing in just the largest funds this year, we examine the relationship between assets under management and returns posted by hedge funds both in 2013 and over the longer term.

Hedge Fund Returns vs. Fund Size

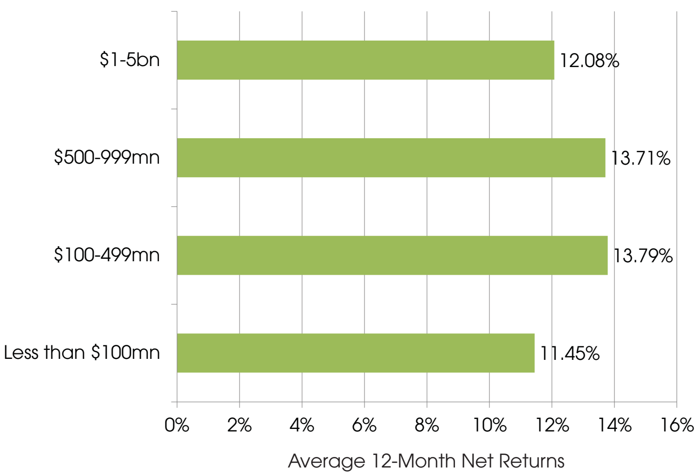
As our 2014 Preqin Global Hedge Fund Report revealed, 2013 was a good year for hedge fund performance in the eyes of investors, with 84% of investors interviewed by Preqin stating that hedge fund returns had met or exceeded expectations over the past year. Preqin's Hedge Fund Analyst shows that it was funds with assets under management in the range $100-999mn that posted the largest gains in 2013, with average returns of these funds in excess of 13.7% (Fig. 1). Funds with assets of less than $100mn posted lower average returns than their peers in larger size categories in 2013, with average returns of 11.45%. Larger funds with assets in the $1-5bn category posted returns in between the smallest funds and the mid-large sized funds at 12.08% on average. Funds with more than $5bn in assets under management represent a very small proportion of the industry, and thus these funds have been omitted from this analysis as there is insufficient data to form any meaningful conclusions.

Distribution of Returns in 2013

According to the Preqin Investor Outlook: Alternative Assets H1 2014, 29% of respondents cited high absolute returns as their main returns objective from their hedge fund investments, and performance remains one of the key factors when evaluating or exiting a fund. Fig. 2 shows performance over 2013 according to the 25th percentile, median and 75th percentile values among each of the fund size categories, and this data shows that the top three-quarters of all fund groups achieved positive returns in 2013. The top quarter of funds in the size range $100-499mn saw cumulative returns exceed 20.76%, and these funds were the main contributors to the impressive performance of this size category over the course of the year. Twenty-seven percent of funds in this size category posted returns in excess of 20% in 2013, and this is higher than the proportion of funds in the $500-999mn and $1-5bn categories that achieved this (19%).

Funds with assets of less than $100mn had the largest range between the 25th and 75th percentiles out of all the fund size categories, with the top quarter delivering returns surpassing 18.58%. Nearly a quarter (23%) of funds with less than $100mn in assets made a loss in 2013, which is notably higher than the proportion of funds in other size categories which were in the red for the year. As a result of this wide dispersion in returns, investment in small funds is a difficult task and it is usually just the most experienced investors, which can take on the risk of investing in a fund with a greater chance of failure, that are able to invest in these funds. Investors which are successful in picking top performing funds are likely to be rewarded when the fund grows, as funds in the $100-499mn size range have on average higher returns with less variation in performance. Funds with more than $500mn had the lowest range between the 25th and

Fig. 1: 12-Month Average Returns over 2013 by Fund Size



Source: Preqin Hedge Fund Analyst

Fig. 2: 2013 12-Month Cumulative Return Quartiles by Fund Size

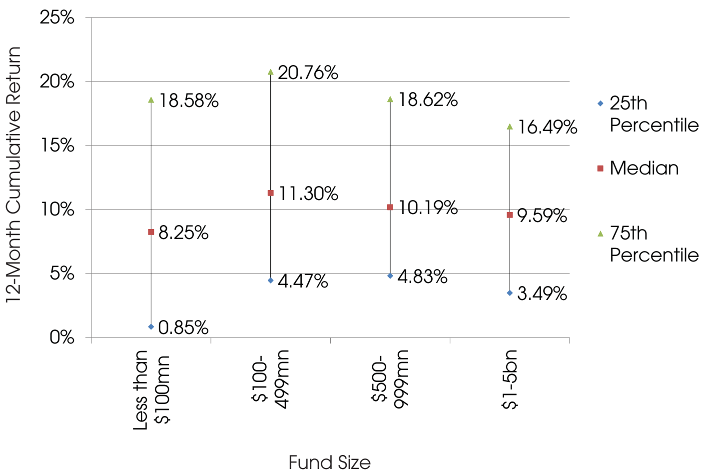


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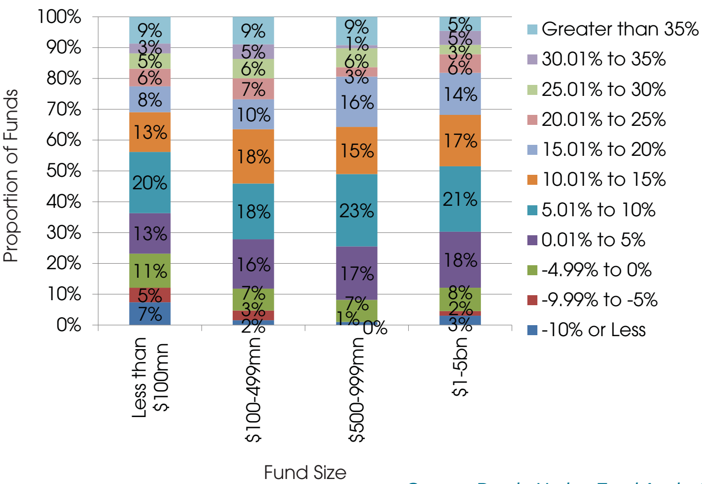
Fig. 3: Distribution of 2013 12-Month Cumulative Returns by Fund Size



Source: Preqin Hedge Fund Analyst

Fig. 4: Top Performing Funds by 3-Year Annualized Return and Volatility

Source: Preqin Hedge Fund Analyst

75th percentiles, with 70% of these funds posting returns of between 0% and 20% in 2013.

Fund Size and Volatility

While the majority of investors were happy with the performance of hedge funds in 2013, it is still vital that fund managers demonstrate strong risk-adjusted returns. According to the Investor Outlook, 28% of hedge fund investor respondents cited consistency or low volatility of returns as their top returns objective from their hedge fund investments, while 25% named high risk-adjusted returns as the key factor. The case for the top 50 performing funds over the last three years by volatility from each size category is displayed in Fig. 4, with funds grouped according to their most recently reported AUM figure. It illustrates that the largest funds have tended towards lower returns with the lowest volatility over the three-year period, and as a result, these funds are more concentrated towards the bottom left of the chart. For many investors, long-term low volatility of hedge fund performance is attractive and these funds with $1-5bn in assets are generally able to provide this. Larger top performing funds have clearly demonstrated a tendency towards lower risk, albeit with lower returns, over the three-year period, which has no doubt satisfied the more risk-averse investors that are looking towards established track records with minimum volatility.

Top performing funds with assets of less than $100mn have shown the largest variation in risk-return profile over the three-year period, with these funds exhibiting higher returns and higher volatility than their larger counterparts. This again indicates that although smaller funds can provide attractive returns to investors, a high degree of investor skill is required to select the best funds due to the variation in returns. This combined with the higher volatility of these funds means that they may not be attractive to most investors, and it is likely to be the more established investors that are willing to take on the risk associated with investing in smaller funds.

Outlook

Our feature article shows that investors are looking at a variety of fund sizes for investment in 2014 and different investors have different return objectives from their hedge fund investments. Although investors look at a variety of features when assessing potential investment opportunities, performance remains the key factor in the selection process. Forty-eight percent of investors stated that returns are a key factor when looking at a fund manager and 21% of investors also stated the potential for better returns from smaller managers as a reason for preferring funds with less than $1bn in assets. Many investors lack the skill and risk appetite to make meaningful allocations to these smaller funds and instead look to invest in more established funds. However, there are opportunities for the smallest fund managers to grow from investors which are looking to gain access to niche opportunities and markets, or indeed to gain other benefits through seeding arrangements.

As funds become larger, the distribution of returns among the best performing funds moves towards the lower end of the return spectrum, in line with lower volatility. Fund managers in the mid-sized groups, i.e. those from $100-499mn or from $500-999mn, have shown the highest mean and median returns in 2013. The size range $500-999mn had the lowest proportion of funds suffering a loss in 2013, and the longer term return and volatility characteristics of these funds are similar to funds with assets of more than $1bn. Therefore, those investors which are looking to move away from investing in just largest funds, but without taking on too much volatility, may choose to look towards investing in those funds with more than $500mn in assets.

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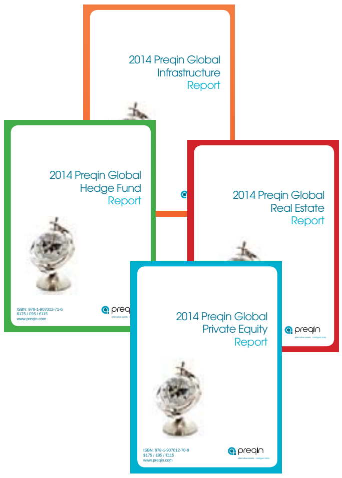

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