The Performance of Emerging Manager Funds

Does investing with emerging managers really offer the potential for greater returns? Joe Childs assesses the performance of hedge funds launched by emerging managers in comparison to those launched by established firms.

New and relatively inexperienced hedge fund managers can often find it a challenge to raise capital. The lack of an extensive track record can make it difficult to attract investors, despite regular indications that first-time funds can deliver significant percentage returns to investors. In this article, we look at funds launched since 2007 by firms managing their first fund and compare the performance of these with the performance of funds formed by established managers during the same period.

Performance in the Early Years

The first three years of operating a fund represent a crucial period for managers. Early performance forms the basis of a new track record and can determine whether or not investors add to the fund's seed capital. For managers that are launching their first fund, initial returns are likely to affect the growth and survival of that fund, the full implementation of their chosen strategy and the ability to launch further funds.

Fig. 1 shows that managers of first-time funds have generally posted superior returns during their first three years of operation compared to managers that have previously launched funds. The average emerging manager long/short fund launched since 2007 delivered annualized net returns of 8.80% in its first three years of trading, compared to a yearly rate of 5.38% among newly launched funds managed by established firms. Similarly, event driven, CTA/ managed futures and macro are all strategies in which newer managers typically posted noticeably higher returns than their more mature counterparts. Emerging and established managers of multi-strategy funds on average delivered similar levels of returns (approximately 7.5%) in their first three years of trading.

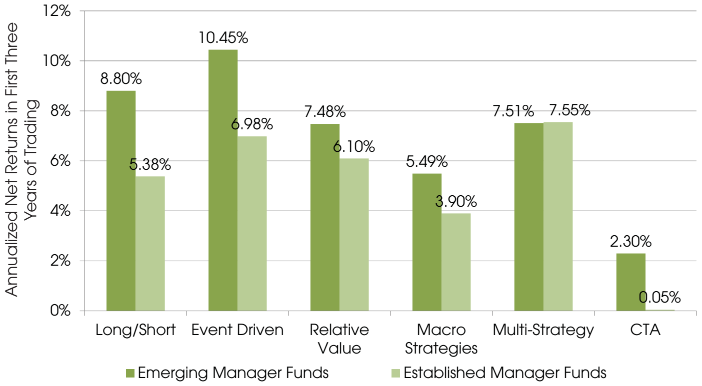
The volatility of returns posted by emerging and established managers during the initial years of operation tells the converse story, with investors in first-time funds typically subject to greater swings in the level of returns. For example, the average annualized volatility of returns during the three years following inception ranges from approximately 14.7% for established manager long/ short funds to 17.3% for emerging manager long/short funds. Similarly, first-time event driven and relative value funds are 2-3% more volatile during the early years, indicating that experienced managers are more adept at managing the risk level of their funds. Despite the difference in volatility levels, the Sharpe ratios posted by emerging and established manager funds are similar across all strategies.

Downside Returns

Investors are regularly reminded that past performance is no guarantee of future results, but track records continue to play an important role in manager selection. One reason for this is the evidence of survival and the ability to grow assets that a track record represents. Our analysis found that 22% of emerging manager funds made a loss in their first year of trading. This compares favourably with the 26% of established manager funds that incurred a loss and suggests that investors are no more likely to lose money by investing with first-time fund managers than they are by investing with firms that can demonstrate track records.

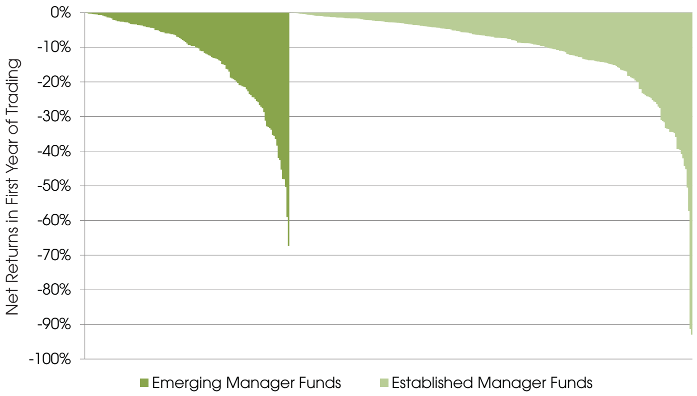
Although more than three-quarters of emerging manager funds made gains in the 12 months following inception, those that ended their first year in negative territory tended to experience larger declines than the first-year losses suffered by established manager funds. Fig. 2* depicts the distribution of returns posted by loss-

Fig. 1: Performance of Hedge Funds Launched Since 2007 by Strategy: Emerging Managers vs. Established Managers



Source: Preqin Hedge Fund Analyst

Fig. 2: Distribution of Negative Returns Posted During the First Year of Trading for Hedge Funds Launched Since 2007: Emerging Managers vs. Established Managers*



Source: Preqin Hedge Fund Analyst

*Based on 141 emerging manager funds and 278 established manager funds making funds during the first year of trading. Despite the largest loss being posted by an established manager, a greater proportion of emerging managers suffered significant declines. Just over one quarter of loss making first-time funds posted returns of less than -20% in their first year compared to 14% of loss-making follow-on funds.

Monetary Value of Investor Gains

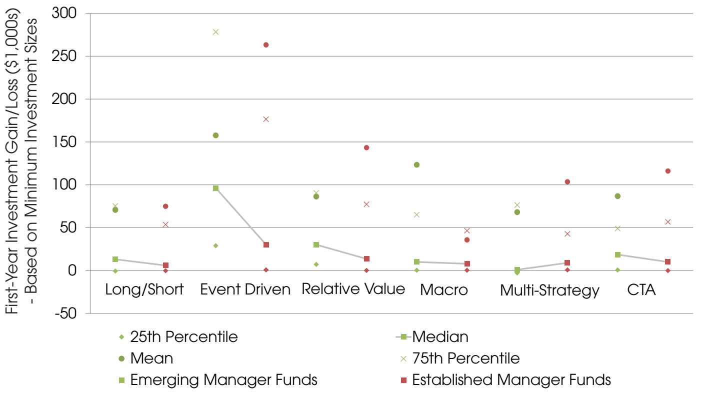
As well as posting more extreme returns on the downside, the dispersion of returns among first-time hedge funds tends to be greater on the upside when compared to similar funds managed by more experienced managers. This provides support to the notion that the performance of emerging manager funds is typically more volatile than that of established manager funds.

Fig. 3 illustrates the distribution of first-year returns among emerging and established manager funds employing various strategies. The data has been converted into monetary terms by using the minimum investment requirements of individual funds. The small size of many emerging manager funds relative to more established counterparts means that double- or triple-digit returns can amount to small increases in a fund's net asset value. It should be noted, however, that the emerging and established manager funds in our sample stipulate similar minimum investment sizes and, as Fig. 3 indicates, individual investor gains from a first-time fund can rival early investments with established managers.

Across most strategies the median fund provided a minimum investment return of $5k-$30k after 12 months of trading, with little variation between managers that had previously launched funds and those that were offering their maiden vehicle. An investor in the median first-time long/short fund, for example, gained $13k during the first year of trading while the equivalent investor with a new fund managed by an established firm gained $6k. Given that the median minimum investment requirements among emerging and established managers of long/short funds was $250k and $100k, the respective monetary gains amount to similar percentage gains (5.2% and 6.0%).

The most notable difference in performance between newly launched emerging and established manager funds can be seen in the event driven category. Investors in the median first-time event driven fund gained $96k compared to the $30k return delivered

Fig. 3: Distribution of Investor Gains/Losses in First Year of Trading for Hedge Funds Launched Since 2007: Emerging Managers vs. Established Managers



Source: Preqin Hedge Fund Analyst

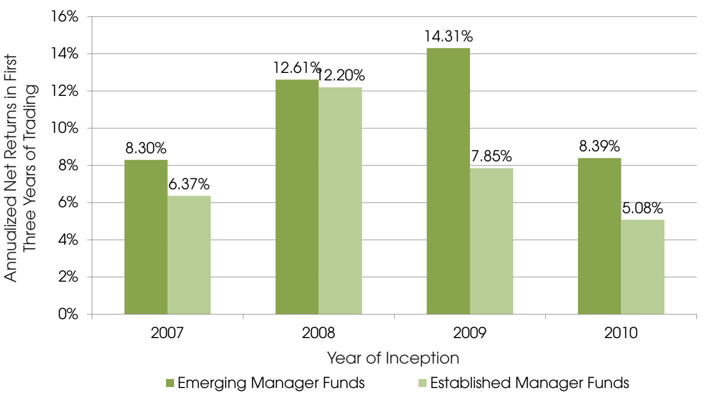
to investors with established managers, which also typically faced higher minimum investment requirements (a median of $835k compared to $500k among emerging managers). Event driven funds also demonstrated the greatest dispersion of returns, with 75% of first-time funds delivering at least $30k and 25% of funds posting more than $278k in the first year.

Performance under Different Market Conditions

The typically larger returns posted by emerging manager funds in the early years of operation (see Fig. 1), compared to funds newly launched by established managers, remain evident when accounting for varying market conditions in which funds launched. As Fig. 4 illustrates, first-time long/short funds outperformed established manager vehicles during the first three years of operation regardless of the year of launch. A similar pattern is seen across other strategies, including relative value and event driven strategies, and it is notable that emerging managers have had a particular edge over experienced firms since equities began to rally in 2009.

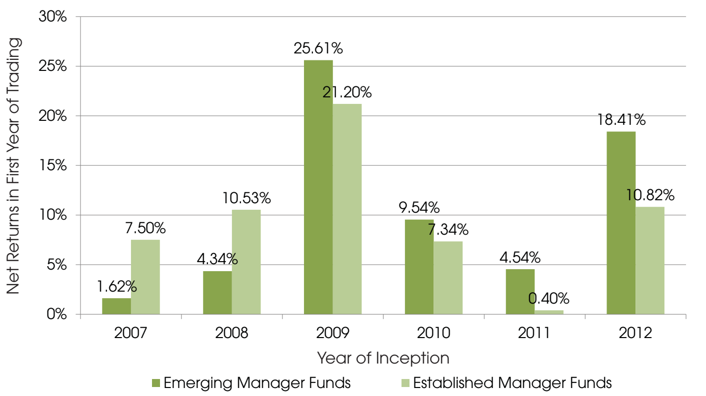
There is some evidence, however, that under difficult and volatile market conditions, the experience of managers with a previous

Fig. 4: Performance of Long/Short Funds in First Three Years of Trading by Year of Inception: Emerging Managers vs. Established Managers



Source: Preqin Hedge Fund Analyst

Fig. 5: Performance of Long/Short Funds in First Year of Trading by Year of Inception: Emerging Managers vs. Established Managers



Source: Preqin Hedge Fund Analyst

track record can offer value. Fig. 5 plots a shorter time frame than Fig. 4, taking account of average fund returns in the first 12 months following launch. Although first-time funds have continued to outperform follow-on funds since 2009, it shows that funds launched in 2007 and 2008, when developed economies and public markets began to decline, were more successfully handled in the medium term by established managers than new managers.

Summary

Our analysis indicates that investors participating in an emerging manager's first offering tend to be rewarded with better returns than if they had allocated capital to a newly launched fund managed by an established firm. A more volatile level of returns means that first-time funds offer the potential for significant losses but also for significant gains. Therefore, the selection of the right vehicle is key to tap into the potential of these emerging funds. Combined with the performance of some first-time funds during unstable markets, this suggests that long term investors are likely to benefit most from investing with emerging managers.

Data Source:

Subscribers to Preqin's Hedge Fund Analyst can click here to use the Advanced Search and view detailed performance data for emerging managers tracked by Preqin.

Search for funds based on inception date or track record, fund size, fund type, strategy, geographic focus and much more.

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