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The Nimble Advantage: Unlocking the Potential of Small Hedge Funds for Institutional Investors in a Dynamic Market Landscape

Executive Summary: This paper explores the advantages of small hedge fund managers over their larger counterparts, emphasizing their ability to outperform during periods of market stress and capitalize on unique market inefficiencies. Small managers have historically demonstrated a wider dispersion of returns and a capacity to invest in less-covered markets, such as micro and mid-cap stocks, where they can achieve higher returns through nimble and innovative investment strategies. Despite these advantages, institutional investors often face challenges in evaluating and accessing smaller funds due to resource constraints. However, integrating small hedge funds into an investment portfolio offers enhanced diversification benefits by reducing overall portfolio risk and potentially improving returns. A strategic allocation to small managers, complementing investments in larger funds, can optimize portfolio efficiency while capturing the alpha generated by these dynamic managers. Institutions can leverage specialized solutions providers to navigate the complexities of selecting and monitoring small managers effectively, thereby enhancing their investment outcomes.

Introduction

In our first paper, titled “Unmasking Superstar Fund Managers: Beyond the Glitz, Glamour, and Greed,”¹ we explored how the allure of extraordinary returns and relentless media coverage can overshadow the underlying risks and potential downfalls of superstar fund managers. We proposed that, rather than being swayed solely by the captivating narratives surrounding established stars, investors should consider exploring a curated index of ambitious emerging managers, akin to the “Peter Lynches of the future.” **Emerging managers possess the agility to capitalize on overlooked opportunities and access high-return small-cap stocks, providing them with a competitive edge.**

Instead, we advocated for a more prudent approach: investing in a curated index of emerging managers. Emerging managers consistently outperform their more established counterparts due to their nimbleness and willingness to invest in overlooked opportunities, particularly small-cap stocks with historically higher returns. Staying small is crucial for maintaining high performance, making it essential for investors to engage with emerging funds before they close to new investors.

What distinguishes emerging managers is their innovation and responsiveness to market conditions. Their ability to start with new, profitable ideas has enabled them to outperform larger funds, as evidenced during the 2008 financial crisis. Their commitment and lack of conflicts of interest drive their success.

Notably, emerging managers have a strong track record of outperforming larger, blue-chip funds. Data from Hedgeweek shows that from 2019 to 2022, emerging managers outperformed hedge funds by an average of 4.8%, highlighting their potential to deliver superior returns. Please see our first paper for details of the results.

In this paper, we aimed to further explore the reasons and significance of selecting smaller fund managers. We detail how smaller funds consistently outperform larger ones, the benefits of diversification, and the practical steps institutions can take to leverage these advantages.

¹ Singular Research Special Situations Report: Unmasking Superstar Fund Managers: Beyond the Glitz, Glamour, and Greed

More importantly, we emphasize that during a crisis or market downturn, having exposure to small managers is advantageous. Our findings indicate that, rather than losing their edge during the two recent financial crises, smaller hedge funds outperformed larger ones. Investors would have been better off with smaller hedge funds during these periods of financial turmoil.

Summary of studies to support our claims

A study by BeachHead² highlighted that smaller hedge funds consistently outperform larger ones. Over a five-year period, small firms outperformed large firms by 254 basis points annually and by 220 basis points over ten years. This outperformance was most notable around the financial crisis period, driven by alpha (manager skill) rather than beta (market conditions).

Chart 1: Performance of global Hedge Funds by size 2020-2023

Performance of global hedge funds by size 2023 v 2022



Source: With Intelligence

Source: With Intelligence

The study analyzed nearly 3,000 equity long/short funds to investigate this issue further. The study categorized hedge funds into two groups: small firms with \$50 million to \$500 million in assets under management (AUM) and large firms with AUM exceeding this range. The findings were quite revealing.

The sample included a roughly equal number of small and large firms. In 2012, the average assets under management (AUM) for small firms were \$193 million, compared to \$3.7 billion for large firms. **Over the past decade, the average AUM for large firms has tripled, while the AUM for small firms has remained relatively constant, indicating that large firms have had an easier time attracting capital.**

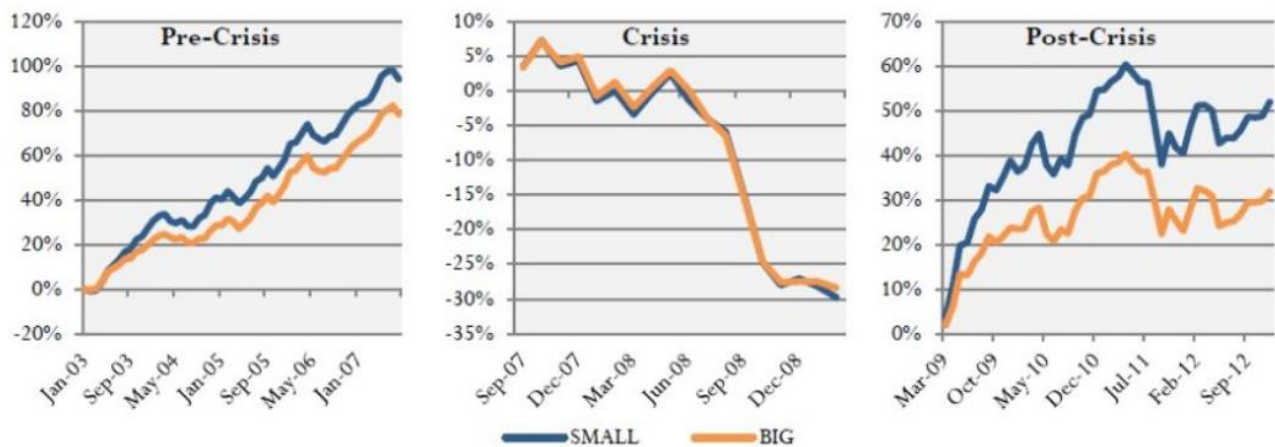
² Smaller Hedge Fund Managers Outperform: A Study of Nearly 3,000 Equity Long/Short Hedge Funds by Beachhead Capital

Weathering the Storm: The Resilience and Superior Alpha Generation of Small Hedge Funds Amidst Financial Crises:

The trend of smaller funds outperforming their larger counterparts was most notable in the years surrounding the financial crisis, particularly in 2009. This outperformance was driven primarily by alpha rather than beta, and there was a greater dispersion of returns among smaller funds compared to larger ones.

As illustrated in the charts below, the outperformance by small managers was significantly more evident before and after the financial crisis, particularly during the post-crisis recovery period. Interestingly, despite having a somewhat higher beta, smaller firms did not underperform larger ones during the crisis. This outcome may be attributed to better risk management or greater agility stemming from a smaller capital base.

Chart 2: Performance of Small vs. Big Before, During and After a crisis



Source: Hedgethink and Beachhead

According to the study "The Time-Varying Nature of the Relationship Between Hedge Fund Performance and Size"³ by Andrew Clare, Dirk Nitzsche, and Nick Motson (2015), there is a strong, negative relationship between hedge fund performance and size. Interestingly, this relationship did not dissipate during the two recent financial crises. In fact, during these periods, investors would have been better off investing in smaller hedge funds than larger ones.

The study also documents significant cross-sectional variation in this relationship by broad hedge fund strategy. **Notably, the analysis reveals that investors were generally better off with small hedge funds during crisis periods, such as after the collapse of the high-tech bubble and during the recent global financial crisis. Several factors may explain this phenomenon.**

First, larger hedge funds tend to include more fund-of-fund investments, which are prone to rapid withdrawals, potentially hampering performance as these funds manage large redemptions. Second, smaller hedge funds may have more stringent gating arrangements, mitigating the adverse effects of

³ Are investors better off with small hedge funds in times of crisis? Andrew Clare, Dirk Nitzsche and Nick Motson Centre for Asset Management Research, The Sir John Cass Business School, City University, London, UK

redemptions on performance. Third, smaller hedge funds typically have less market risk, or 'beta,' embedded in their portfolios.

The study's findings indicate that the outperformance of smaller hedge funds is primarily due to alpha rather than beta, suggesting that the differential in performance cannot be attributed to greater risk-taking.

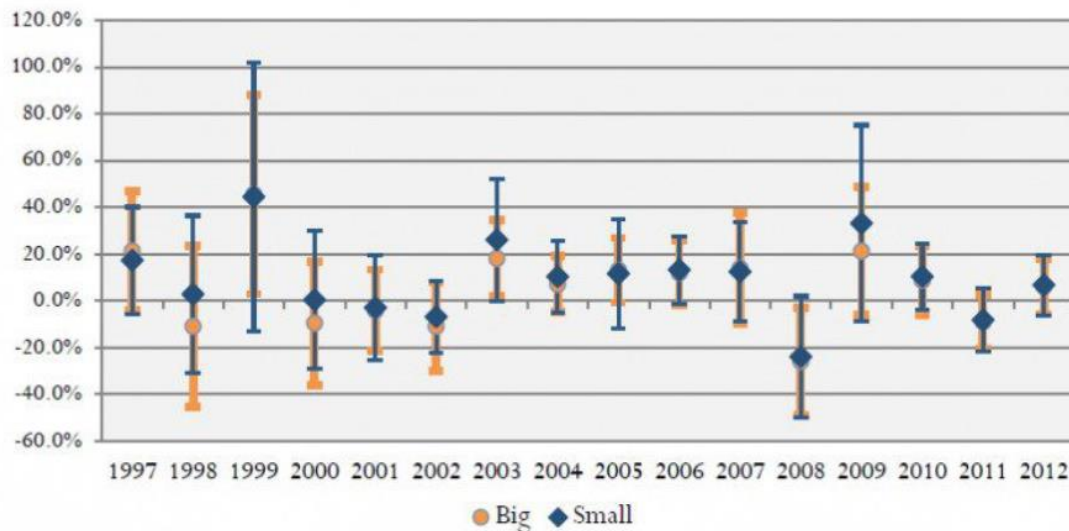
Niche Dominance: How Smaller Hedge Funds Exploit Market Inefficiencies

Smaller hedge funds exhibit a wider dispersion of returns compared to their larger counterparts, which enhances their value proposition. These funds have a broader opportunity set and can capitalize on inefficiencies in less-covered markets, thereby achieving higher returns. This advantage is particularly pronounced in niche strategies and sectors that larger funds cannot efficiently target due to their size and regulatory constraints.

Since the late 1990s, the top-performing small funds have consistently outperformed their larger counterparts. Interestingly, even the worst-performing small funds have matched or outperformed comparable large funds in most years. This result underscores the argument that the outperformance of small funds is not solely driven by taking on higher symmetric risk.

This phenomenon serves to validate the hypothesis that smaller managers are motivated to achieve superior performance, while larger firms tend to exhibit more risk aversion in their investment approaches.

Chart 3: Wider Dispersion of Small Hedge Funds



Source: HedgeThink and Beachhead

Resource Crunch and Visibility Gap: The Challenge of Evaluating Small Hedge Funds

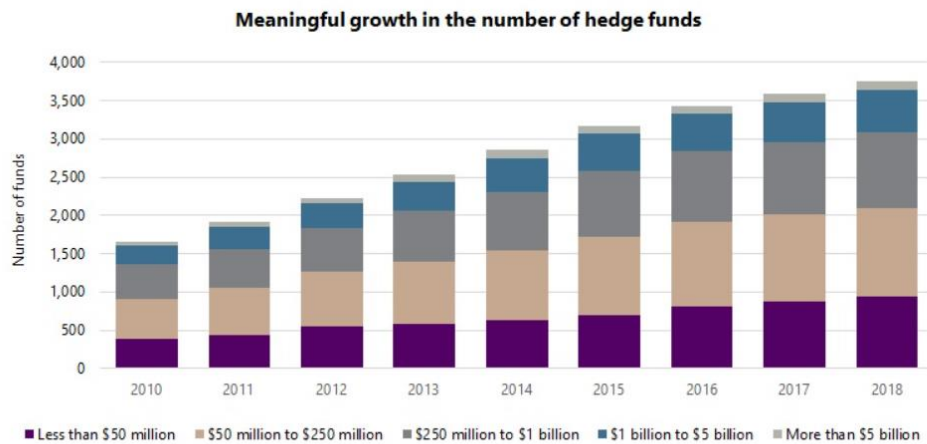
The reluctance of investors to prioritize small fund managers can be attributed to resource constraints. Evaluating the expansive landscape of smaller hedge funds demands significant resources that many institutional investors lack. Despite the potential for higher returns, institutions often

gravitate towards the largest hedge funds, which are more accessible and perceived as safer bets.

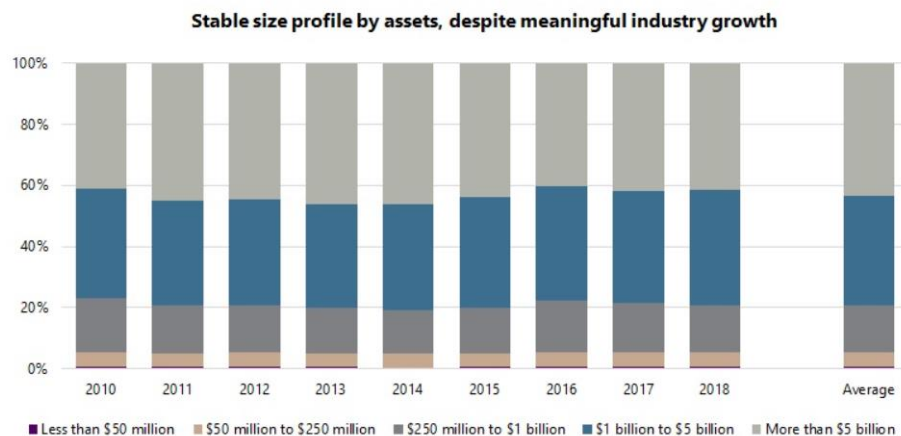
According to Aurum's exclusive database, comprising approximately 8,000 active and closed hedge funds, the active hedge fund count experienced a significant increase between 2010 and 2018, growing from roughly 1,700 to 3,800.

For instance, while it is relatively straightforward for institutional investors to engage with the 500 largest hedge funds, each with assets exceeding \$1 billion, the challenge lies in assessing the remaining 3,000 smaller hedge funds with assets under \$1 billion. These smaller funds collectively manage only 20% of the total hedge fund assets, underscoring the disparity in visibility and accessibility compared to their larger counterparts.

Chart 4: Small Active Hedge Funds – Number and Size profile



Source: Aurum Research Limited



Source: Aurum Research Limited

Source: Aurum Research

Leveraging Agility and Niche Expertise: How Small Hedge Funds Unlock Value

Small hedge funds possess distinct advantages over their larger counterparts:

1. **Expanded Opportunity Sets:** Unlike larger funds constrained by their size, small hedge funds can invest in micro-cap, small-cap, and mid-cap stocks. These stocks are often less efficient and receive less analyst coverage, creating opportunities for higher returns. Small managers can capitalize on these inefficiencies by executing trades without significantly impacting market prices. Academic studies historically correlate market capitalization, analyst coverage, and market efficiency, supporting the potential benefits of investing in less-followed securities.

2. **Capacity-Constrained Strategies:** Smaller managers excel in executing capacity-constrained strategies, such as arbitrage or regional specializations. These strategies require flexibility and agility, qualities that are often compromised in larger fund structures. By focusing on niche opportunities, small managers can potentially generate superior returns that larger funds cannot effectively pursue.

Optimizing the Portfolio Frontier: Integrating Small Hedge Funds for Enhanced Diversification and Superior Risk-Adjusted Returns

Incorporating small hedge funds into an investment portfolio enhances diversification. These funds typically exhibit lower correlations with larger funds and traditional asset classes, thereby reducing overall portfolio risk while potentially improving returns. This enhanced diversification can optimize the efficient frontier, offering higher returns for the same level of risk or similar returns with reduced risk.

A strategic approach involves allocating a portion of the portfolio to small hedge funds in addition to investments in large managers. This balanced strategy capitalizes on the stability of large funds while harnessing the potential for high returns and diversification benefits from small managers. Institutions can gradually increase their exposure to small managers as they gain confidence in the strategy.

Expert Allies: Leveraging Specialized Solutions Providers

To effectively integrate small hedge funds into their portfolios, institutional investors can collaborate with specialized solutions providers focused on small managers. These providers possess the necessary resources and expertise to identify and assess promising small managers. Partnering with such specialists enables institutions to capture the alpha generated by small managers while navigating resource limitations effectively.

To conduct thorough hedge fund research and execute successful marketing strategies, investors can benefit from various insightful resources. Some prominent platforms include BarclayHedge, HedgeFundDirectories.net, Standard and Poor's Hedge Fund Evaluator, EurekaHedge, and EuroHedge Database. Among these, eVestment stands out as a crucial tool for discovering up-and-coming managers and connecting with industry consultants. Furthermore, the quarterly Emerging Manager Monitor report offers current and relevant data, enabling investors to remain informed about the latest emerging manager prospects and industry trends.

For more information on a trial offer, please call us at 818-222-6234, e-mail us at Research@SingularResearch.com, or sign up by [Clicking Here](#).

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BUY-Venture, initial stages with little to no revenue and the potential for outsized returns with higher amounts of risk.

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