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newmanagers
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Is the performance in the first year of a new hedge fund a leading indicator for a good investment?

The Fundana series of articles discusses Investments in Emerging Managers; it derives from the real world experience of the Fundana team. Fundana is the investment advisor to several Funds of Hedge Funds and directs at least half of its new investments to Emerging Managers. The investment process typically involves allocating a small amount Day 1 or Early Stage (defined as less than one year after the fund's launch) to new managers who have strong pedigrees.

The objective of this series of articles is to share thoughts around our key observations. It does not aim to be "statistically significant" but to create a dialogue around those observations.

The Emerging Managers space is currently in vogue. Following the 2008 credit crisis, allocators focused first on the opportunity to invest with previously hard-closed Blue Chip hedge fund managers. Now that most of those funds are hard-closed again, investors are taking another look at Emerging Managers.

This article looks at the **performance of hedge funds in their first year of operations, how it has evolved over time, and whether it can give a good insight into the future success of a fund.**

We will focus on the small and mid-sized launches (typical Day 1 assets under management ("AUM") of between $20m and $500m), as Fundana does not invest in the very large new launches (>$1bn at launch). The dataset has been compiled from all the new investments made in our Funds of Hedge Funds since January 2006, encompassing 58 Day 1 / Early Stage investments in the Long/Short Equity, Global Macro and Event Driven strategies which have been operating for more than 1 year as of the end of April 2012.

How has the first year's performance of hedge funds evolved before and after the crisis?

For the purpose of this article, we consider two separate periods: the first period runs from January 2006 to July 2008, hence before the industry crisis; and the second period runs from August 2008 to date. The database contains 25 Day 1 / Early Stage investments in the first period and 33 in the second period (funds with at least one year of returns, hence which started on or before May 2011).

Rather than comparing first year absolute returns between the new funds over time, which is difficult to analyze considering the volatility of the last few years, we analyze the over- or under-performance of the new hedge funds against a portfolio of hedge funds.

For the purposes of this study, we look at the relative performance of the new hedge funds vs. our flagship Fund of Hedge Funds (Prima Capital Fund, or "the proxy") as this is a good proxy for a blended mix of existing and older hedge funds.

Table 1 presents the overall relative performance of the new hedge funds vs. the proxy after one year.

Day 1 / Early Stage	Pre July 2008	Post July 2008	Total funds
Number of hedge funds	**25**	**33**	**58**
Positive performance vs. the proxy after 1Y	18	22	40
Negative performance vs. the proxy after 1Y	7	11	18
Ratio of positive funds vs. the proxy after 1Y	**72%**	**66%**	**69%**

Table 1: Relative performance of the new hedge funds vs. a proxy after 1Y

It confirms our overall observations that current new launches are as successful now as they were before the crisis at delivering a positive relative performance, as 72% of pre-crisis launches were positive and so were 66% of the post-crisis funds. However, we are mindful of the problems of drawing conclusions from these statistics (firstly, because of the low number of observations and secondly, due to the inherent selection bias implied by an investment with a successful fund made 6-12 months after it launched).

In contrast, looking at the details of the relative performance of the new launches after one year, we do see a change in the relative performance of the new managers as shown in Figure 1 below. The horizontal axis shows the launch date of the Day 1 / Early Stage investments in which we invested, and the vertical axis represents the relative performance of the hedge funds vs. the proxy after one year. Since the crisis, we have observed that the relative outperformance of the new funds after one year has been much less impressive than those launched pre-crisis.

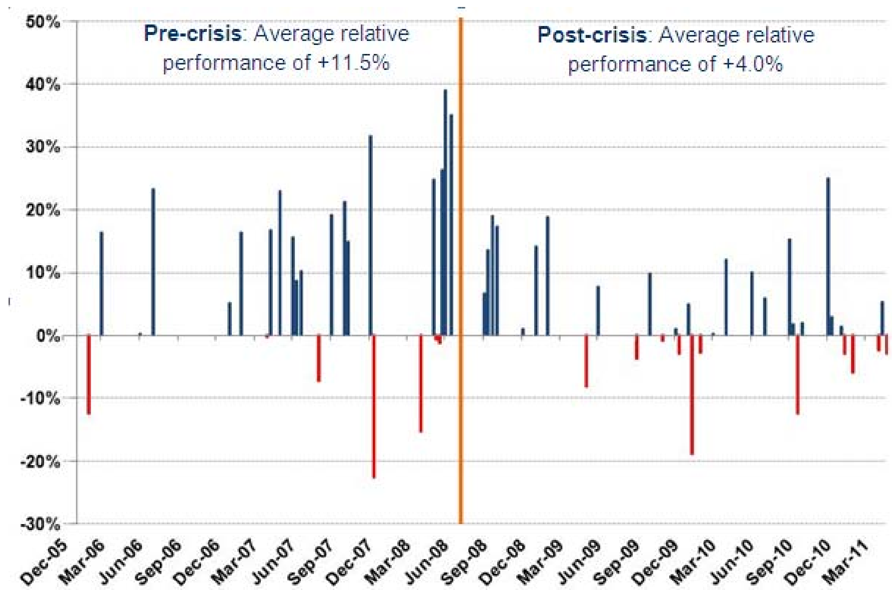

Figure 1: Details of the relative performance of the new hedge funds vs. the proxy, one year after they launched.

Aggregating those relative performances in Table 2 below, we see that 8 out of 33 of the post-crisis new launches (approx. 25%) have been successful (defined as >+10% relative performance) after one year, compared to 15 out of 25 of the pre-crisis new launches (approx. 60%).

Day 1 / Early Stage	Pre July 2008	Post July 2008	Total funds
Number of investments	**25**	**33**	**58**
>10% relative performance after 1Y	15	8	23
< -10% relative performance after 1Y	3	2	5
Average relative performance after 1Y	**+11.5%**	**+4.0%**	**+7.3%**

Table 2: Relative performance of the new hedge funds vs the proxy before and after the crisis

Consequently, the average relative performance pre-crisis was +11.5%, compared to +4.0% post-crisis. This is the main difference we have observed thus far with the recent new launches.

What are the possible explanations for this pattern of results and what conclusions can we draw based on these results?

Several explanations exist for the change of this return pattern, all of which we have experienced over the last three years. Some are more objective, others are more subjective, but we do think they have played a role in the recent behavior of less outstanding performances from new launches:

1. A more volatile environment has pushed new managers to take longer to build the portfolio to avoid setting off on the wrong foot from the start of their new fund. Post-crisis, we often see new managers taking 2-3 months to build up their portfolio, compared to 2-3 weeks pre-crisis.

2. The increase of start-up costs (mostly linked to the institutionalization of the industry and the increasing compliance and regulatory burden) is discouraging new managers from taking more risk at the start.

3. The increase of backing by large institutional seeders and large institutions is creating a sense of “less short term business risk” mentality for the new managers (through the use of investor level gates for instance).

4. Few hedge funds have been strong performers over the last few years, and new hedge funds were not immune to the more difficult trading environment.

We have drawn **a few conclusions** from our experience thus far are:

1. Most successful new launches (>+10% relative performance in the first year) have been good or great investments, meaning they have been large positive contributors for our funds of hedge funds. For instance, out of the four successful new launches since January 2010, three managers are already significant holdings as of today, of which two were Day 1 investments.

2. However, this early outperformance does not give any indication as to the long term success of the managers. Some of them were good / great for just a couple of years; others generated strong outperformance for five years and more.

3. None of these successful new launches were bad investments (i.e. no large negative contributors to our funds).

4. Very few flat / negative relative performers during the first year were subsequently strong performers and contributors to our funds of hedge funds.

5. Although we took “increase or out” decisions with our new investments after 12 months of performance before the crisis, we are now typically waiting longer as we understand that the change of the industry with its related costs, as well as current market volatility, have changed the way some managers operate during their first year.

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