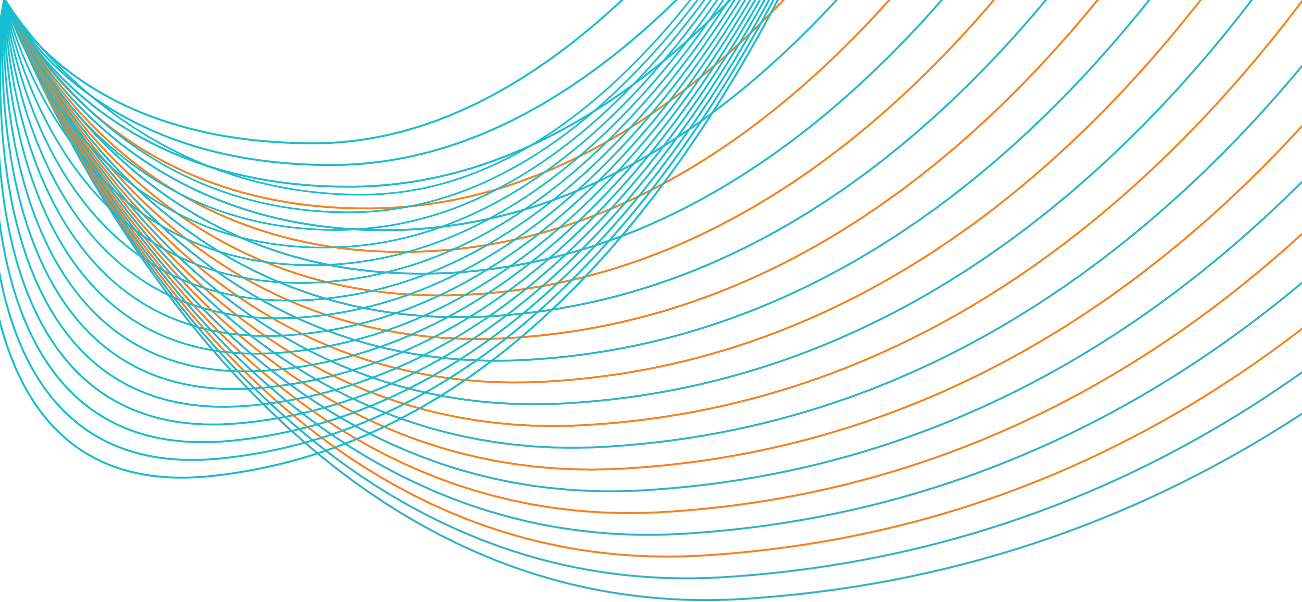

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The Fundana series discusses investments in Emerging Managers, derived from the real world experience of the Fundana team. Fundana is the investment advisor to several Funds of Hedge Funds and directs around half of its new investments to Emerging Managers. The investment process typically involves allocating a small amount Day 1 or Early Stage (within the first 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.

How do seed deals impact on the performance of new hedge fund managers?

This article (*from Nick Morrell – Head of Operational Due Diligence at Fundana*) is a follow-up of the June article How do seed deals impact on fund raising for new hedge fund managers?), and takes a deeper look at the use of seed deals by new hedge fund managers to pose the question:

"Does accepting a seed deal impact on performance?"

In essence, this article aims to help investors to decide if they are better off looking at funds with seed deals or those without.

As discussed in the previous article, the seed deal landscape has changed significantly over recent years. Seeding of emerging managers has become more institutionalized since the 2008 credit crisis, at a time when asset raising for newly launched hedge funds has become significantly more difficult.

Reading the data

This article will therefore look at the relationship between performance over the first couple of years of a new fund's life and whether or not the fund manager accepted a seed deal. As in previous articles, we will also analyze the same data split between two time 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.

All data discussed below will show the outperformance of the emerging hedge funds compared to the performance of our flagship FoHF (gross of fees) over the same time period.

Prima Capital Fund is Fundana's flagship FoHF offering with a 19-year track record.

As for previous articles in this series, for this article we will focus on 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. The dataset has been compiled from all the new investments made in our Funds of Hedge Funds since January 2006, encompassing 59 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 September 2012. Of these, 40 have more than 2 year's track record.

Finally it is important to bear in mind that there is some degree of bias in these results, as a number of the funds (5 pre-crisis and 3 post-crisis) with one year

of performance did not reach their second year anniversary.

Q1. How does a seed deal impact on performance in the first couple of years?

Here we will analyze all funds in our database to determine whether managers who use seed deals are able to outperform both the overall portfolio of our flagship FoHF, and also their competitors who do not use a seed deal. For this we will look at outperformance over 1 and 2 year periods after launch.

Table 1 looks at all funds in the database (from 2006 to today), and compares outperformance over the first year and the first two years of our funds' existences. So for example, the 29% figure indicates that 29% of the funds had an outperformance between 0% and 10% in the first year when compared to the FoHF portfolio. The 7.7% average indicates that the average outperformance of all funds in the first year was 7.7%.

Outperformance vs. FoHF portfolio	After 1st year	Annualized over 2 years
< -10%	6.6	5%
-10% to 0%	24%	23%
0% to 10%	29%	30%
10% to 20%	25%	33%
>20%	15%	10%
Average	**7.7%**	**7.5%**
Median	5.8%	7.8%

Table 1: Outperformance vs. FoHF portfolio – comparison after 1 and 2 years

This shows that there is no significant difference between the two time periods, but it also indicates that our emerging managers have significantly outperformed the overall portfolio, indicating that this strategy of looking to emerging managers has been a successful one. Around 70% of the managers have outperformed the overall portfolio over time.

Table 2 goes on to look at the differences between managers who used seed deals and those who did not.

Outperformance vs. FoHF portfolio	After 1st year		Annualized over 2 years	
	with seed	No seed	with seed	No seed
< -10%	13%	0%	5%	5%
-10% to 0%	23%	25%	19%	18%
0% to 10%	19%	39%	29%	21%
10% to 20%	26%	25%	29%	25%
>20%	19%	11%	19%	0%
Average	**7.9%**	**7.4%**	**9.7%**	**5.1%**
Median	8.8%	5.6%	9.3%	4.9%

Table 2: Outperformance vs. FoHF portfolio – comparison between funds with and without seed deals

Here we can see that after the first year, there is no significant difference between funds with and without seed funding. However, after two years of operations, there is a significant difference, with annualized outperformance for funds with seeds increasing from 7.9% to 9.7% on average, whilst for funds without seeds the outperformance fell from 7.4% to 5.1%.

Q2. What differences in outperformance can be seen before and after the 2008 credit crisis?

Looking at the same data, but split into pre-crisis and post-crisis periods, Table 3 shows data for all funds split across the two time periods.

This split highlights that since 2008, whilst the emerging managers have continued to outperform the overall FoHF portfolio, there has been a significant decrease in the level of outperformance over both the first year and the first two years.

Also of note is that whilst the first year and first two year figures are in-line for the pre-crisis period, when it comes to post-crisis there has been a fall from 4.9% to 3.0%, indicating an underperformance in the second year post-launch.

Finally, Tables 4 and 5 split the data further to analyze the impact of seed deals between the pre- and post-crisis periods, again looking at the first year (Table 4) and the first two years (Table 5) after launch.

Table 4 does not add anything significant to the data in Table 3, simply highlighting again that the outperformance in the first year is significantly less for post-crisis new manager launches.

Outperformance vs. FoHF portfolio	After 1st year		Annualized over 2 years	
	Pre-crisis	Post-crisis	Pre-crisis	Post-crisis
< -10%	12%	3%	10%	0%
-10% to 0%	16%	29%	5%	40%
0% to 10%	12%	41%	10%	50%
10% to 20%	28%	24%	55%	10%
>20%	32%	3%	20%	0%
Average	**11.5%**	**4.9%**	**12.0%**	**3.0%**
Median	15.6%	2.9%	13.0%	3.9%

Table 3: Outperformance split between pre- and post-crisis time periods

Outperformance vs. FoHF portfolio	With seed		No seed	
	Pre-crisis	Post-crisis	Pre-crisis	Post-crisis
< -10%	20%	3%	0%	0%
-10% to 0%	13%	16%	20%	18%
0% to 10%	13%	13%	10%	36%
10% to 20%	13%	19%	50%	7%
>20%	40%	0%	20%	4%
Average	**11.0%**	**5.0%**	**12.3%**	**4.7%**
Median	15.6%	2.8%	15.6%	4%

Table 4: Outperformance (first year) with and without seed deals, split between pre- and post-crisis time periods

However, Table 5 shows that the pre-crisis outperformance was largely driven by those funds with a seed deal, with an average annualized outperformance of 14.2% against 8.8% for funds without a seed.

Annualized out-performance over two years vs. FoHF portfolio	With seed		No seed	
	Pre-crisis	**Post-crisis**	**Pre-crisis**	**Post-crisis**
< -10%	8%	0%	13%	0%
-10% to 0%	8%	33%	0%	45%
0% to 10%	8%	56%	13%	45%
10% to 20%	42%	11%	75%	9%
>20%	33%	0%	0%	0%
Average	**14.2%**	**3.6%**	**8.8%**	**2.5%**
Median	14.7%	7.1%	12.9%	1.4%

Table 5: Outperformance (first two years) with and without seed deals, split between pre- and post-crisis time periods

Post-crisis, the level of outperformance is significantly lower for all funds, but again those funds with a seed deal did slightly better than there un-seeded counterparts.

What conclusions can we draw from these results?

The first conclusion is that investing in emerging managers has been a good investment decision for us, and continues to be so – all the aggregated data are positive, indicating that these investments have outperformed the overall portfolio in our flagship FoHF.

Secondly, emerging managers were able to generate significantly more outperformance prior to the 2008 credit crisis. This could indicate that on average the quality of managers was greater prior to 2008, or, more likely in our opinion, that the ability of any manager to generate significant outperformance since 2008 has been hampered by the very difficult market conditions.

Finally, the data indicate that for investors looking at emerging managers as a longer-term investment (2 or more years) they could be better off focusing on those who have received seed deals. However, whilst this distinction was clear-cut prior to 2008, there is much less in it today.

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