



Hedge Fund Lifecycle

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“Keep it real simple. Do one thing and do it the best you can.”

-Harry Snyder, co-founder of In-N-Out Burger

1. Introduction

Last year, our hedge fund research team traveled extensively, researching and meeting with over 500 managers. Our travels took us around the world from the subways of New York and London to the streets of Shanghai and Hong Kong. One of my favorite destinations, however, remains California. Not only does it have a unique culture and hedge fund base, but it is also well-known for its technological innovation and fine cuisine. One required dining stop during each of my research trips is at the famed In-N-Out Burger. Not only are the cheeseburgers legendary, but the company also reminds me of the way a business can use small size to produce high quality results and thrive in a world of much larger competitors.

As a company, In-N-Out Burger exemplifies many of the qualities we look for when recommending hedge funds. The company chooses quality, sustainability, and respect for clients over unbridled growth. In-N-Out exhibits extreme focus and simplicity, which in turn enables great execution. The product does the talking - the brand is quiet and not press-seeking. The company chooses to concentrate its portfolio and instead of having small revenue stakes on a huge franchise portfolio, it owns 100% of a smaller number of carefully chosen stores. Finally, the company maintained its independent family ownership, never giving in to temptations to go public or take on outside investors. As In-N-Out approaches its 65th anniversary this year, its life cycle and evolution as a business is a model worth studying.

The life cycle of a business refers to the various stages of development of a company – from start-up to hiring its first employees to expanding into new markets. Each stage has its own unique characteristics and the focus of its managers will reflect the current point in its life cycle. Hedge funds experience a similar life cycle. Incentives, opportunities, and risks evolve as a hedge fund progresses through its natural evolution as a business. Understanding where a hedge fund manager is in its life cycle has important implications for investors, including when to hire, or terminate a manager, and establishing proper expectations for return, volatility, and correlation.

Alpha, or manager skill, should be the primary driver

of returns for hedge funds and, therefore, a wide dispersion of returns separates the best from the rest of the pack. So how does one differentiate ex-ante? Trailing returns? Every investment presentation includes the all-too-familiar disclosure - past performance is not indicative of future results. By incorporating a life cycle analysis into the manager selection process, we believe investors can substantially improve the likelihood of superior performance over a selection process based solely on historical performance. Determining where a manager lies in its life cycle, however, is a combination of an art (qualitative) and a science (quantitative).

While each manager is unique and will have a distinct life cycle, our research indicates that hedge funds generally exhibit similar patterns of progression. We broadly classify the life cycle of a hedge fund into four stages: Emerging, Growth, Maturity, and Decline (leading to Closure or Revitalization). Each underlying stage exhibits similar characteristics including size, age, infrastructure, process, uniqueness, and investor base. As an emerging hedge fund grows assets and generates more consistent returns, the growth and early maturity stages of a hedge fund represent a “sweet spot” for investing. We believe this sweet spot is when a manager is most likely to generate solid, consistent excess returns and has developed a sustainable business and stable operational infrastructure.

Smaller funds are not without risk. They generally operate leaner business teams, which can result in greater operational risk relative to their larger brethren. Additionally, the universe of smaller managers is generally less efficient, which may increase due diligence costs and manager turnover; it will also require a more robust network to source managers and conduct reference checks.

It is worth noting that the length of each stage is not fixed in duration and does not necessarily follow in sequence. For example, some funds move directly from the emerging to the maturity/decline stage and hardly experience a growth stage. It is also important to consider the hedge fund’s sub-strategy, as different opportunities have different optimal characteristics. For example, the benefits of size are more pronounced for distressed debt strategies than for a small-cap hedged equity manager. For simplicity, we focus our comments on long/short equity strategies, where the life cycle can be more influential.

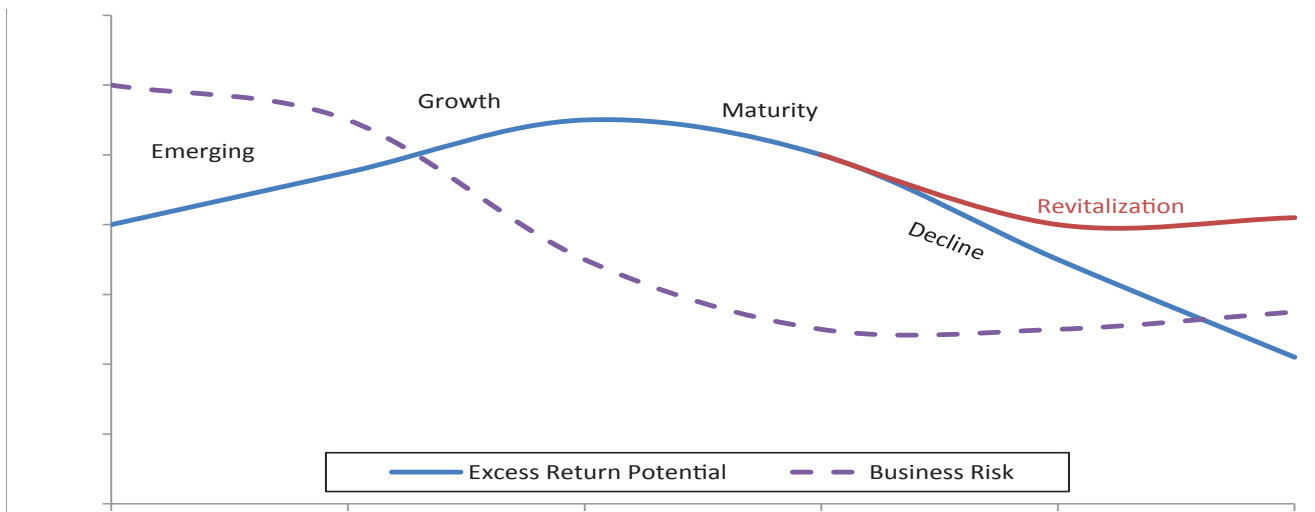
2. Bigger is not always better

Academic and industry research has suggested that size is relevant in predicting hedge fund performance and performance persistence. According to a recent study by analytics firm, PerTrac, smaller funds have outperformed much larger funds in 13 out of the last 16 years. Several academic studies have also reached similar conclusions. Getmansky (2005) noted a “positive and concave relationship between fund size and performance, which suggests funds have an optimal size and that exceeding that size has a negative impact on performance.” Similar conclusions were reached regarding the persistence of performance. Boyson (2008) noted that “performance persistence is strongest among small, young funds. A portfolio of these funds with prior good performance outperformed a portfolio of large mature funds with poor performance by 9.6 percentage points per year”. The study also noted this persistence was strongest among directional (hedged equity) funds. Berk and

Green (2004) reached a similar conclusion. Hence, it is not surprising that many high-profile hedge funds have recently returned capital to investors citing their massive size as the enemy of performance.

Despite the research, however, super-sized funds continue to garner a disproportionate share of industry assets and institutional investor attention. As of September 30, 2012, the largest 5% of all hedge funds accounted for over 62% of industry assets. The trend continued in 2012, as the largest funds (>\$5 billion) attracted the vast majority of hedge fund capital flows. One could easily hypothesize the reasons for this trend – The entrance of larger pension investors? The perceived safety in larger, less volatile funds? Lower monitoring and due diligence costs? Herding? Career risk?

While size is often the most widely cited characteristics impacting success, our research has identified a number



	Emerging	Growth	Maturity	Decline
Size	Small	→	→	Mega
Age	New	→	→	Mature
Infrastructure	Simple	→	→	Complex
Process	Entrepreneurial	→	→	Bureaucratic
Uniqueness	Distinctive	→	→	Groupthink
Investor Base	Early Adopters	→	→	Laggards

Exhibit 1: Illustrative Hedge Fund Life Cycle

Source: Fund Evaluation Group, LLC

of other qualities which we believe significantly impacts performance. Most notable were the size of the investment team, the number of key decision makers, and the number of funds. As such, we developed a consistent framework (“LIFE”) to guide the evaluation process. Broadly classified across six categories, we score 21 variables to systematically evaluate each hedge fund’s location in their life cycle. In conjunction with quantitative analysis, we utilize the LIFE score to guide hire and fire decisions and to identify red flags or areas of follow-up.

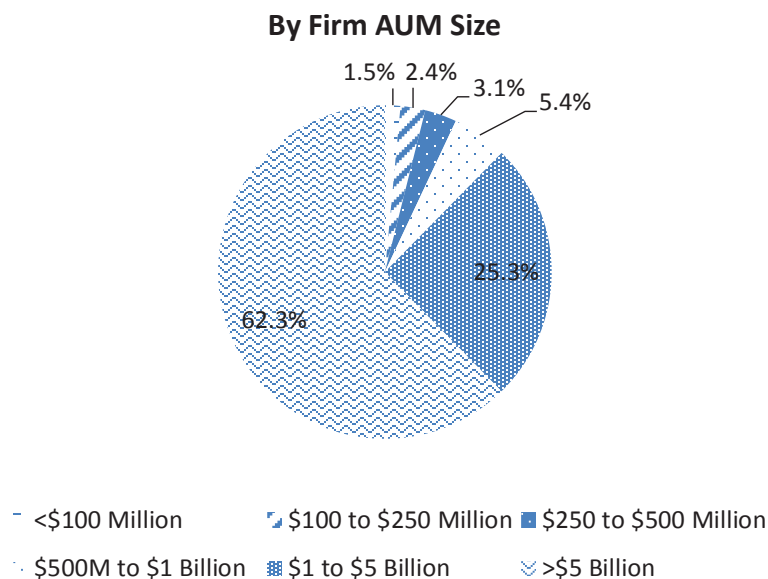
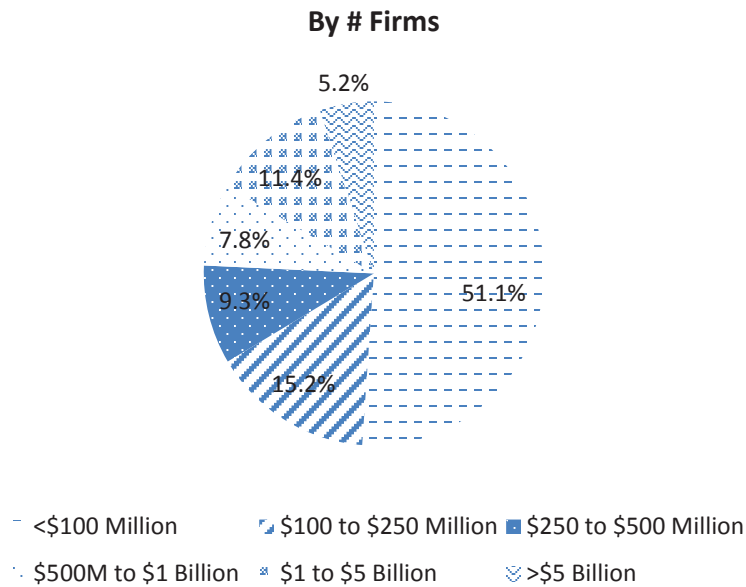


Exhibit 2: Hedge Fund Industry Assets by Firm AUM and AUM Grouping, September 2012
 Source: Hedge Fund Research, Bank of America Merrill Lynch

Firm Size	Process
Assets Under Management	Number of Key Decision Makers
Total Number of Employees	Number of Direct Reports to PM
Number of Investment Professionals	Compensation Structure
Rate of Growth	Change in volatility profile
Strategy Drift	
Age	Uniqueness
Fund Age	Correlation Score
Age of Key Decision Makers	Holdings Overlap
Aspirations	Concentration
Infrastructure	Investor Base
Number of Funds / Products	Investor Base Stability
Number of Distribution Channels	Internal Capital Alignment
Number of Offices	
Ownership Structure	
	Total LIFE Score

Exhibit 3: Hedge Fund LIFE Analysis - Long/Short Equity

Source: Fund Evaluation Group, LLC

3. Conclusion

Hedge funds naturally evolve through a business life cycle. Incorporating additional analysis on identifying the stage of where a manager lies in their life cycle can improve manager selection. The LIFE analysis provides a systematic methodology to guide the process and provide insights into the expected risk and return profile of a fund. Larger hedge fund managers tend to seek to generate steadier returns with a concurrent focus on controlling volatility, even if it diminishes return potential. The trend towards big funds getting even bigger provides a compelling opportunity for investors to gain access to smaller, capacity-constrained managers. Many of these highly motivated, unique funds are in the sweet spot of their life cycle and offer more upside return potential than their monolithic peers.

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Author Bio



Jeffrey Furst is a Senior Research Analyst on the Hedged Strategies team at Fund Evaluation Group. Jeff is primarily focused on conducting investment manager due diligence, client education and support, and the analysis of equity-related hedge fund strategies. Jeff also serves as senior member of the Global Equity research team. Fund Evaluation Group is a recognized leader in the field of institutional investment consulting advising on over \$51 billion in client assets. Prior to joining Fund Evaluation Group in 2011, Jeff served as a Senior Investment Analyst at Summer Hill Capital Partners. Jeff received his MBA from the Williams College of Business at Xavier University and his B.S. from Miami University. Jeff also holds the Chartered Financial Analyst (CFA) and Chartered Alternative Investment Analyst (CAIA) designations.