Understanding the value of an emerging manager

Nell Sloane, a principal at Capital Trading Group, looks at the benefits of choosing youth over experience

One of the most fascinating debates in the financial services industry focuses on the never ending tug of war between emerging and established managers.

In fact, youth over experience is actually a deliberation that transcends global finance and can assume philosophical characteristics.

In the alpha-driven world of alternative investments, there is a plethora of studies that validates the outperformance of 'youth', or emerging managers, versus 'experience', or established outfits.

However, the majority of invested capital seems to flow into the very top funds with billions and billions in AuM.

What causes this distortion and how can a progressive allocator find her or his way to this emerging alpha in a systematic fashion?

Depending on the study, the excess return produced by emerging managers ranges from 200 to 400 basis points per annum with only a small increase in standard deviation by the younger funds.

Such outperformance also seems to come from pure alpha rather than timing beta, or rebalance of risk exposure.

Indeed, the studies suggest beta seems generally consistent and stable across small and big funds, indicating that positive alpha should be the driver of higher returns.

Most studies concentrate on hedge fund indices and define emerging managers as funds less than 36 months old with sub-$300m AuM.

In others the AuM is lowered to less than $50m to better reflect initial conditions of most new funds.

New studies are also careful in mitigating potential backfill and survivorship biases that often stain statistics on alternative products; although the sector outperformance gets reduced by these corrections, the substance of the results does not change.

Based on such striking outperformance, an allocator should ask two questions: What causes the excess alpha and why is it not pursued more aggressively at the institutional level?

The first reason for excess alpha is quite sensible: new managers are more highly motivated to succeed in their role as new entrepreneurs and tend to have their interests more directly aligned with the investors. This occurs in terms of fee structure and often because of a higher percentage of the founder's personal wealth being tied up in the new outfit.

Conversely, an established manager has already a structure in place generating lucrative revenues and the potential upside from a large deviation from his/her benchmark and peers is more than offset by the damages of a possible failure.

Therefore the manager will be more reluctant to place investment bets that significantly diverge from accepted themes.

More technically, emerging funds have a flexibility that goes lost as assets increase.

The ability to find arbitrage opportunities that will move the needle in terms of performance are generally more plentiful for small traders than large funds.

Such opportunities come with liquidity issues that are generally not a problem for emerging managers.

Indeed, capacity constraints are one of the biggest issues in money management and one that needs to be addressed carefully at an early stage by any allocator.

To this point, a study by Beachhead Capital finds that based on trading volume, the number of potential long and short opportunities decreases by up to 80% between $100m and $1bn in AuM.

As far as institutional preference for large outfits, the main reason is the heightened business and operational risk associated with a start-up fund.

From an allocator perspective, the career risk associated with having chosen a failed emerging manager is much higher than the risk of suffering underperformance.

Or as John Maynard Keynes famously put it: "Wisdom teaches that it is better for the reputation to fail conventionally than to succeed unconventionally."

In addition, there are other benefits in investing early with a new manager; one major point is certainly the ability of an allocator to negotiate better terms.

Fees will probably be lower than they would be for a successful and established fund and naturally capacity will not be an issue.

A small fund should also be willing to provide much more transparency to the investors.

Additionally, a new manager will be significantly more proactive in explaining his or her strategy, market developments and potential dislocations.

In conclusion, it is clear that there is value in identifying talented emerging managers in their first three years of operation.

The operational risk that is associated with this strategy must be mitigated by structuring a detailed and systematic process of due diligence based on quantitative, qualitative and operational reviews.

Such process can be expensive and time consuming but the reward may well be worth the effort. ◻