SMALLER AND EMERGING MANAGERS
SMALL AND NIMBLE versus LARGE AND BUREAUCRATIC

The Facts

Smaller and emerging managers are a commonly overlooked source of Alpha. A PerTrac 2010 study re-confirmed the previous findings of studies from 1996 through 2008. Hedge funds with less than $100 million in assets (small funds) outperformed mid-sized ($100-500 million) and the largest funds by over 300 bps per year. Similarly, emerging funds with less than 2 year track records (young funds) outperformed mid-aged funds (2 to 4 years old) and older funds by over 400 bps annually, on average. This significant outperformance was achieved with comparable volatility. See Table 1.

Table 1

<table>
<thead>
<tr>
<th>Performance by Size of Fund</th>
<th>Small Funds</th>
<th>Mid-Sized Funds</th>
<th>Large Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compound ROR</td>
<td>13.05%</td>
<td>9.99%</td>
<td>9.28%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>6.96%</td>
<td>5.92%</td>
<td>6.05%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Performance by Age of Fund</th>
<th>Young Funds</th>
<th>Mid-Aged Funds</th>
<th>Older Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compound ROR</td>
<td>15.74%</td>
<td>11.48%</td>
<td>10.12%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>6.47%</td>
<td>7.11%</td>
<td>6.72%</td>
</tr>
</tbody>
</table>

In 2008, the most difficult year in recent memory, young emerging managers continued to outperform returning -11.31% while mid-aged funds returned -19.46% and older funds returned -17.58%. However, small managers underperformed the mid and large funds returning -17.03% in 2008 versus -16.04% for mid-sized funds and -14.10% for large funds. While both smaller and young emerging managers took a significant hit in 2008, by 2010 they had more than returned to the consistent record of outperformance.

But why did larger funds outperform smaller funds in 2008 and is this likely to be repeated? We speculate that large funds had more cash on hand and more access to financing sources than small funds so they were better able to handle redemptions and margin calls without compromising portfolio performance. Additionally, they had many prime brokerage accounts which gave them greater flexibility. Small and emerging managers now address these issues when evaluating their operational
risks. Finally, there was a flight to perceived “quality” among investors; allocators were more interested in moving monies into larger, more institutional funds.

Studies by Northern Trust, Neuberger Berman, and Hymans Robertson have reconfirmed these findings. Year after year (again, 2008 the exception for small managers), study after study definitively validates the premise that investors should not ignore the differentiating factors of size and age of funds as they go about the process of allocating their portfolios prudently. The most recent Neuberger Berman study showed emerging managers annualizing from 2003 to 2011 at 9.49% versus established managers at 7.61%.iv

Hurdles to Raising Assets

So in the face of such irrefutable evidence, why is there such investor reluctance to embrace smaller and emerging managers? We believe there are a variety of reasons that prevent allocators from investing in these managers.

The most compelling constraint is the inability of the allocator to assess the investment skill of the smaller and emerging manager without a concrete audited track record of sufficient length. Also, the allocator may be too understaffed, may not have an understanding of the strategy, and may not feel comfortable in evaluating the investment risk of the manager. The response is not to allocate.

The second constraint is the allocator’s lack of ability or staff to assess the operational risks of investing in smaller or emerging managers. If the strategy or asset class is new, the allocator may not feel competent to measure the risk attribution or confirm the appropriateness of the financing terms, administrator, or prime broker. All of these factors are important in evaluating and assessing smaller and emerging managers’ operational risk. Again, the response is not to allocate.

Finally, the allocator may be reluctant to take on the headline risk of a small or emerging manager. With a well known, larger hedge fund with a solid reputation, the allocator may believe (mistakenly as we have seen with Galleon, Bayou, and Amaranth) that this will provide insulation from headline risk. However, the bigger the fund, the bigger the headline.

All of these concerns are valid but with appropriate analysis and responsible oversight, the rigorous investment and operational review necessary for this group of managers can be accomplished and rewards can be realized. Investors can capture the Alpha that would be forgone by only investing in larger and more established managers.
The Rewards for Early Investment

The benefits of investing in small and emerging managers are numerous. Aside from the improved risk and reward characteristics, other benefits include achieving deeper strategy and market insight and securing hedge fund capacity. Finding these “diamonds-in-the-rough” requires an understanding of the strategy being implemented and their sources of Alpha. We highlight reasons why these managers generate higher Alpha with examples from the past three years.

Flexibility

First, a smaller manager has the flexibility to invest in positions where an excellent risk-reward potential exists but the result would not have a significant impact on a larger manager’s portfolio. An example of flexibility: Southpaw Asset Management – The liquidation of a mining company

“With respect to the investment, we made our initial investment in late 2008 and it totaled approximately $3 million (AUM at the time was approximately $500 million). We subsequently added to the position to the tune of another $4 million (total cost was approximately $7 million). The dynamic of the investment was such that we were able to purchase our claims below the actual cash in the estate with additional upside optionality related to litigation against Directors & Officers (their insurance carrier really) and PWC (their auditor) due to fraud. By virtue of buying below cash in the estate, we had a profit locked-in (time value of money being the only real cost). Both cases settled and our P&L was approximately $31 million on the investment. At the risk of some immodesty, not a bad return given the risk involved.”

Liquidity

Second, the ability to be nimble and move in and out of positions can enable a smaller manager to capture opportunities that larger managers cannot. For example, in long/short equity the ability to put on a short is frequently limited by the availability of stock that can be borrowed. For a smaller manager, shorts can be put in place more readily and with confidence that the borrow will remain in place. Size also keeps them true to their strategy; the need to style drift as a result of an attempt to allocate from an over-sized asset base in a crowded strategy is non-existent.

Over the last five years we have invested with a long/short technology fund with AUM of $150 million on average. The fund has compounded at over 15%, with a volatility of 4%. The fund’s ability to maintain a diversified base and keep its shorts in place through market gyrations has been essential to its success.

Insights

Additional benefits come from having direct access to the investment decision makers. Investing early and in support of smaller and emerging managers gives the allocator greater access to the portfolio manager and thus the potential for further insight into their strategy, market developments, disruptions, and opportunities. This understanding and transparency, in turn, allows the allocator to be more responsive with their own allocation decisions and to be better equipped in evaluating managers with whom they invest.
Capacity and Fees

Finally, investing early gives an allocator access to capacity and to potentially reduce fees. By the time most superior managers are widely recognized, their funds are either closed or about to be closed. There is enormous value in discovering talented managers before they become well recognized.

Further Considerations with Smaller and Emerging Managers

Investing in smaller and emerging managers is not without risk. “The attrition rate for hedge funds is about 15% per year and...the ‘half-life’ for hedge funds is about 2.5 years,” for various reasons; the attrition rate is even higher for smaller funds.” More than half of these failures are over operational issues. The remainder is due to misrepresented performance or wrongfully allocated capital (trading mistakes). We believe that with the proper oversight and process, the odds of success can be dramatically improved.

There is an alignment of risk between smaller and emerging hedge fund managers and their investors. Hedge fund compensation is based on profits, not assets, as is the case with mutual funds. As such, hedge fund managers are more committed to seeing their funds succeed. They invest from day one with their own capital and sacrifice alternative income. New hedge fund managers always put a significant portion of their net worth in the fund, and thus, they have more “skin-in-the-game”. On the other hand, experienced managers can develop complacency as a result of accumulated incentive fees and wealth.

Additionally, failed hedge fund managers rarely start new funds, in contrast with terminated mutual fund managers who remain in the industry about 67% of the time. Hence, the probability that an emerging manager in the hedge fund industry is counting on another start-up as an alternative to success in his or her current venture is remote, thus increasing the incentive to succeed.

Hedge fund managers do not increase risk when they underperform. Experienced and larger managers tend to reduce the risk they take over time. They take on less risk as they seek to avoid loss of personal wealth, current income, and reputation.

In summary, we believe that investing in smaller and emerging managers reap great rewards over time for the astute investor. They perform better, maintain flexible and open businesses, remain fully committed to their firms, and keep their money in their funds. Because of these factors and others, the additional Alpha provided is compelling and well substantiated. Equally important, the market insight from access and open dialogue with managers is irreplaceable.

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