

# The Case for Smaller Hedge Funds

NIAGARA INSTITUTIONAL DIALOGUE 2012

Presentation by:

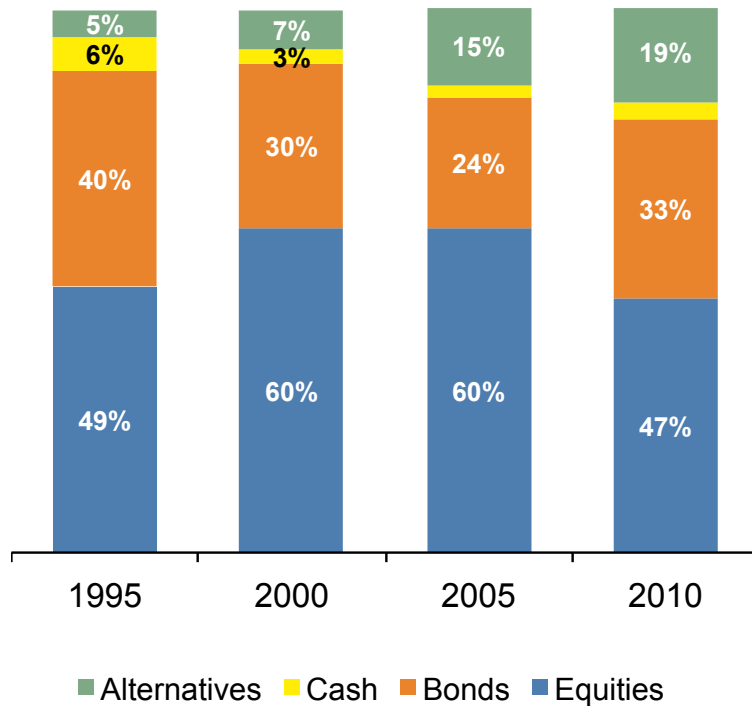
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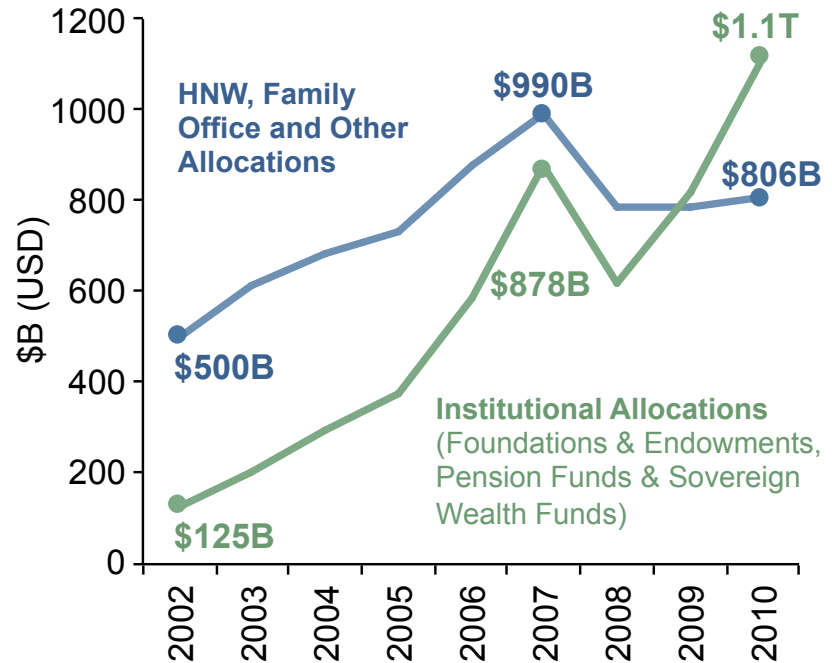
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## Growth of Alternative Industry and Hedge Fund Industry Assets

Changes in Pension Asset Allocation: 1995 to 2010<sup>1</sup>



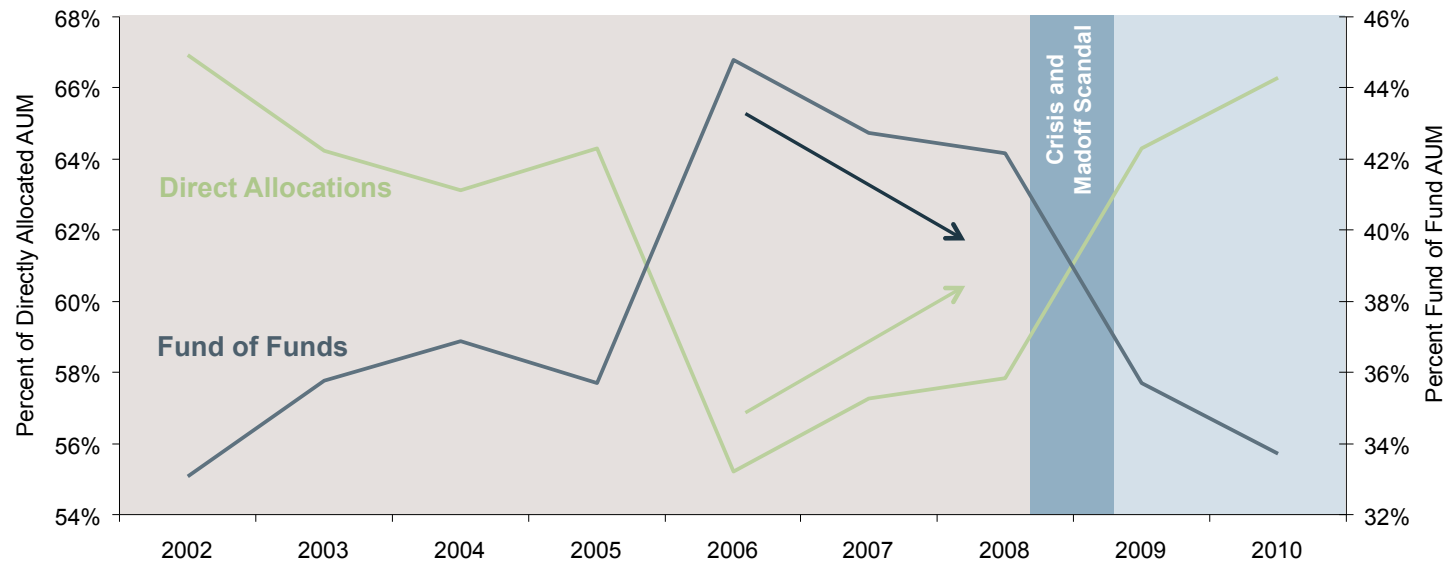
Hedge Fund Assets by Type<sup>2</sup>



1 Citi Prime Finance, "Global Pension and Sovereign Wealth Fund Investment in Hedge Funds: The Growth and Impact of Direct Investing," June 2011 referencing Towers Watson Global Pension Asset Study 2011

2 Citi Prime Finance, "Global Pension and Sovereign Wealth Fund Investment in Hedge Funds: The Growth and Impact of Direct Investing," June 2011 referencing HFR Q4 2010 Global Data, McKinsey & Company, Prequin & Greenwich Associates Data

## Approaches to Hedge Fund Allocations

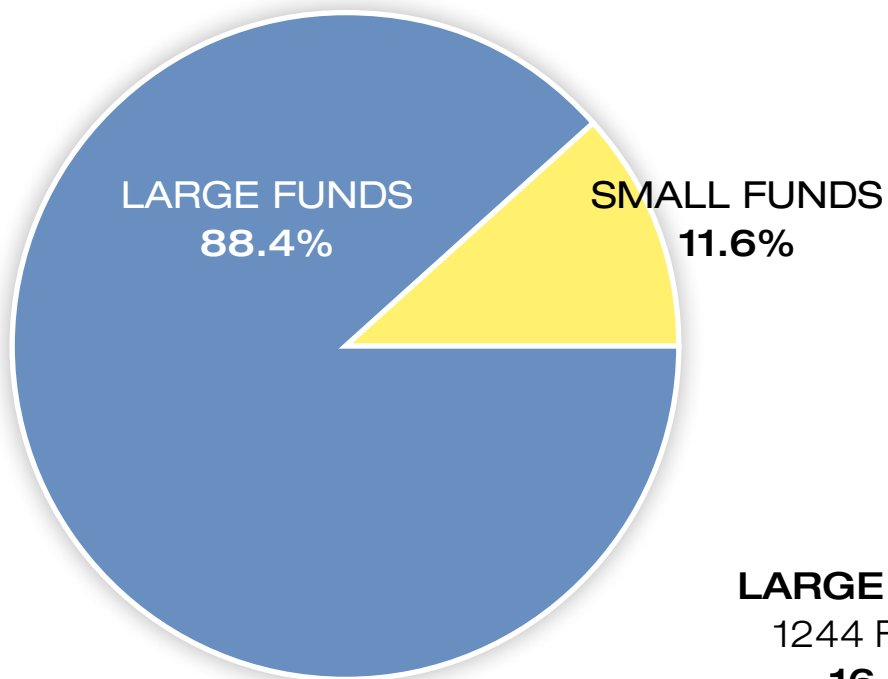


- Desire to control portfolio selection
- Fund of fund fees and the incentive to achieve high returns

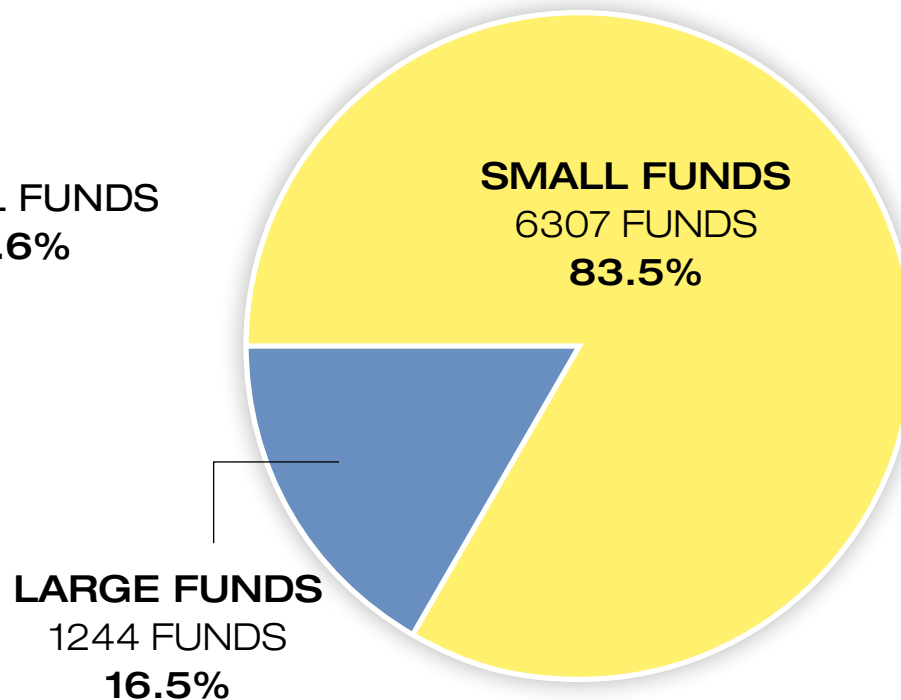
Source: Citi Prime Finance, "Global Pension and Sovereign Wealth Fund Investment in Hedge Funds: The Growth and Impact of Direct Investing," June 2011 referencing HFR Q4 2010 Global Data

# Landscape of the Hedge Fund Industry in 2012: Industry assets are concentrated with Larger Hedge Fund Managers

### Hedge Funds by Assets



### Hedge Funds by Number



**Goal:** Find 50-60 great smaller managers among the group of 6,300

"Small" defined as managers with less than \$1 billion in assets under management, while "large" is defined as managers with greater than \$1 billion in assets under management.  
Source: Hedge Fund Research. "HFR Global Hedge Fund Industry Report." Data as of December 31, 2011.

## Structural inefficiency makes investing in smaller managers attractive

- Broader universe of managers and investment opportunities
- Potential long-term outperformance
- Greater dispersion of returns

Variance of Small vs. Large Manager Returns*	
Top Quartile HF Manager	80% greater returns for small managers
Bottom Quartile HF Manager	40% lower returns for small managers

- Diversified and complimentary exposures
- Potentially better terms such as lower fees, transparency, capacity constraints among others



**Opportunity to generate higher  
risk-adjusted returns and differentiated alpha**

\* Source: Barclays Capital, *Hedge Fund Pulse*, "Emerging Managers: Good Buy or Good Bye?", April 2011.

A very recent study:

Smaller managers outperform their larger peers  
over the last decade by 131 bps.

Barclays Capital  
*Hedge Fund Pulse*

**“Emerging Managers: Good Buy or Good Bye?”**

April 2011.

This is just one study of many...

\* Period ended December 31, 2010. Source: Barclays Capital, *Hedge Fund Pulse*, “Emerging Managers: Good Buy or Good Bye?”, April 2011. Data collected from commercially available hedge fund databases, Hedge Fund Research (HFR), and HedgeFund.net databases. Small funds were defined as AUM less than \$100 million. Mid-size funds have AUM of \$100 - \$500 million and large funds have AUM over \$500 million.

## Smaller Manager Studies

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James Xiong, Ph. D., CFA, Thomas Idzorek, CFA, Peng Chen, Ph. D., CFA, and Roger G. Ibbotson, Ph. D., **“Dynamics of Fund of Hedge Funds: Flow, Size, and Performance”** *Ibbotson Associates Research Paper*, October 2007.

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Chris Argyrople, CFA. **“Large vs. Small Hedge Funds: Where Should You Invest?”** Concentric Investment Management, LLC. June 2008.

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Rajesh K. Aggarwal and Philippe Jorion. **“The Performance of Emerging Hedge Fund Managers”** August 7, 2009.

## Commentary on Smaller Manager Thesis

David F. Swensen. **Pioneering Portfolio Management**.  
New York: Free Press, 2000.

Byron Wien. **“The Inherent Instability of Hedge Funds”**  
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Jenny Anderson. **“The Triumphs, and Obsession of New Hedge Fund Managers”**, *The New York Times*, May 12, 2006.

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Stanley Druckenmiller. Duquesne Capital Management, **“Druckenmiller Quits Hedge Fund Trading to Manage Own Family Office”**, Infovest21, August 18, 2010.

Stan Luxenberg. **“Younger Hungrier Hedge Funds Generate Bigger Returns”**, Institutional Investor, May 29, 2012.

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## Limited Position Overlap Across Underlying Managers

	Fund of Funds of Smaller Managers	Fund of Funds of Large Managers
Manager Overlap <sup>1</sup>	12%	81%
Managers in Portfolio <sup>2</sup>	37	17

- Limited correlation of underlying managers' returns with one another
- Less sensitivity to high levels of market volatility given limited exposure to crowded trades.

Source: Protégé Partners and a top institutional fund of funds, based upon position-level information obtained from 13F filings.

Please note that Protégé does not claim to know the positions held by other institutional fund of funds.

Data as of: December 31, 2011

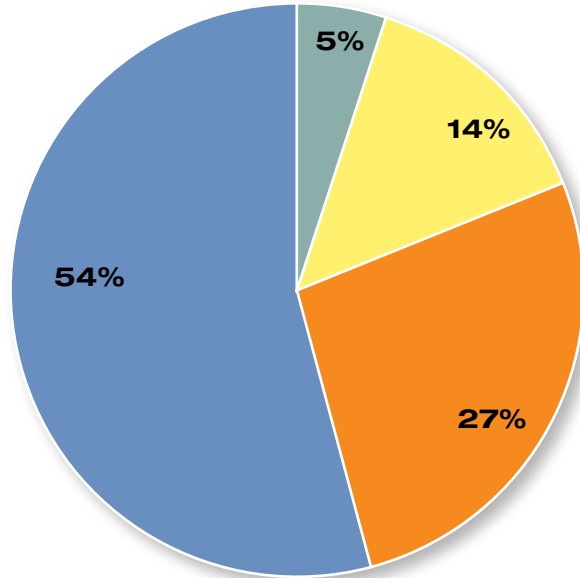
<sup>1</sup> Percentage of managers in portfolio that have at least one position in common.

<sup>2</sup> The number of managers in the Protégé portfolio does not include private equity managers or managers of funds that have indicated that they are in liquidation and may not include managers for which a full redemption notice has been submitted, or funds and managers that have gated or suspended redemptions, if any. The percentage of manager overlap additionally does not include funds for which we do not have position level transparency.

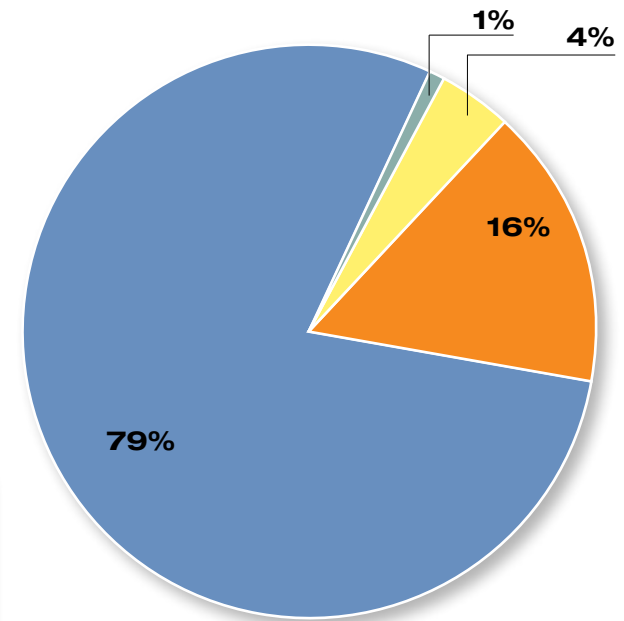


## Smaller Hedge Funds Can Invest Across Market Cap Spectrum

Fund of Funds of  
Smaller Managers



Fund of Funds of  
Large Managers



■ Micro Cap  
■ Small Cap  
■ Mid Cap  
■ Large Cap

Source: Protégé Partners and a top institutional fund of funds, based upon position-level information obtained from 13F filings.

Please note that Protégé does not claim to know the positions held by other institutional fund of funds.

Data as of: December 31, 2011

Micro Cap: <\$250 MM; Small Cap: >\$250 MM-\$1B; Mid Cap: >\$1B-\$5B; Large Cap: >\$5B.

Protégé Partners information does not include position information for private equity managers or managers of funds that have indicated that they are in liquidation and may not include managers for which a full redemption notice has been submitted, or funds and managers that have gated or suspended redemptions, if any. The percentage of manager overlap additionally does not include funds for which we do not have position level transparency.

- A wider investment universe that requires more resources
  - Sourcing
  - Monitoring
  - Operational due diligence
  - Risk management
  - Headline risk
  
- Smaller managers have limited capacity
  
- Experience in selecting smaller managers is key



*“Warren E. Buffett announced Monday that his company, Berkshire Hathaway, had hired a **young hedge fund manager** to oversee a ‘significant portion’ of its investment portfolio, adding a new name to the mix of players who are someday expected to take the reins at Berkshire.”*

**— NY Times**

If a smaller manager is good enough for Berkshire...

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