Emerging managers offer good investment prospects for 2012

By Caroline Varin | Published: 09 January 2012

There are apparent advantages in investing in newly launched hedge funds. Emerging managers are nimbler than their larger peers while allowing investors to negotiate more favourable terms.

Last year was a disappointing one for the hedge funds industry as a whole. However, according to Neuberger Berman, emerging managers have posted better returns than larger funds. Newer hedge funds, says the asset manager, could offer good return prospects for funds of hedge funds and institutional investors in 2012.

Hedge Fund Research (HFR) figures show that the annual performance of less than two-year-old managers in 2008 was -1.76 per cent compared with -11.97 per cent for more established ones. In the third quarter of 2011, with -4.19 per cent, the new managers' annual performance was 1.87 percentage points higher than larger funds.

Neuberger Berman defines emerging managers as funds with less than a three-year track record and below $500m (£323.7m) in assets. In its 2012 outlook the investment manager pointed out that since 2008 new launches have increased and remained robust. In 2011 demand for capital from emerging hedge fund managers exceeded the supply.

The report says the high number of emerging managers coupled with their strong appetite for capital has opened an opportunity for investors. Investing with emerging managers early could allow investors to negotiate more favourable liquidity terms, corporate governance and fee arrangement.

"A number of high-quality managers are underfunded as the result of the majority of inflows going to their larger peers. This means when we as investors find someone with a strong team and a strong infrastructure we can be more aggressive when negotiating terms," says Jeff Majit, managing director at Neuberger Berman.

Luke Dixon, senior investment manager at the UK-based Universities Superannuation Scheme (USS), thinks that, although there is some debate about the empirical evidence that newer funds have outperformed older hedge funds, there is an intuitive appeal to go with new managers.

"They are younger, hungrier and nimbler because their asset size is typically smaller. This should give the managers an advantage," says the USS senior investment manager.

"Of course lower fees ultimately add to the returns but that is one key benefit, size is another one. If you have got a really big ship, it takes a long time to change direction and the cost can be heavy. If you are small you can probably reorient your portfolio from a net-long to a net-short position very quickly and very cost effectively," says Dixon.

For him, this can not only help investors to manage risk but also help them make money.

"We have some of the bigger funds but we also have more of the smaller and mid-sized funds, which probably differentiates us from quite a few of our peers," points out Dixon.

Neuberger Berman also highlights that newer hedge funds have a strong motivation to succeed. "A short track record and a smaller client base mean that emerging managers need to generate strong performance in order to strengthen their reputation and to raise assets," wrote Eric Weinstein, chief investment officer in the company's 2012 outlook.

Jeroen Tielman, chief executive officer of IMQubator, thinks investing in newer funds really makes sense and 2012 could be very much the year for emerging managers. He underlines that "in times of big uncertainty and volatility it is really important to connect with the top talent in the market and with highly motivated people".

Transparency and position-level disclosure is another advantage that emerging funds have over larger ones, according to the Neuberger Berman report.

Neuberger Berman's Majit thinks that in general and over the last 10 years, the industry has become more transparent but that with funds interested in raising capital there is greater willingness to negotiate the frequency and the level of transparency.

Transparency is an important issue for Jeroen Tielman too. He hopes to contribute to setting up a generation of more investor-friendly funds. “As a seeder of hedge funds we provide conduit to emerging managers to align with their investors’ interest,” adds the CEO.

The Neuberger Berman report recognises that emerging managers have fewer resources for operations and therefore require thorough due diligence by potential investors. But the asset manager believes this concern has become less critical.

“The investment due diligence process is the same for a fund that has a two-month track record and $50m and a fund that has 20-year track records and $50bn. On the operational side, due diligence tends to be more complex with smaller funds,” adds Majit.

USS’s Luke Dixon regrets that smaller funds don’t always meet the operational and infrastructural requirements that the pension fund place on them, while Jeroen Tielman points out that emerging managers are very experienced in investing and trading but running a back office is new to them.

Neuberger Berman believes the optimal hedge fund allocation will include a mixed group of less-established managers and larger and older funds, in order to maximise a portfolio’s risk/return profile and diversification.

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