GATEMORE

EXECUTIVE SUMMARY

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Is there a negative relationship between hedge fund size and performance?

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The hedge fund sector has grown from a cottage industry in the early 1990s into a behemoth today, in which close to 10,000 individual funds manage a total of $3.17 trillion of global investor capital across a wide range of investment strategies.

Early on, hedge fund investors were almost exclusively wealthy individuals; now they include a variety of endowment, charitable and other institutions. Arguably one of the primary attractions of having money managed by a hedge fund is the manager's willingness and ability to seek out high return, niche investment opportunities that traditional, long only managers are unable to access, or who lack the necessary skills to do so. However, the industry's exponential growth has led experts and academics to question whether hedge fund performance might deteriorate as assets under management (AUM) grow.

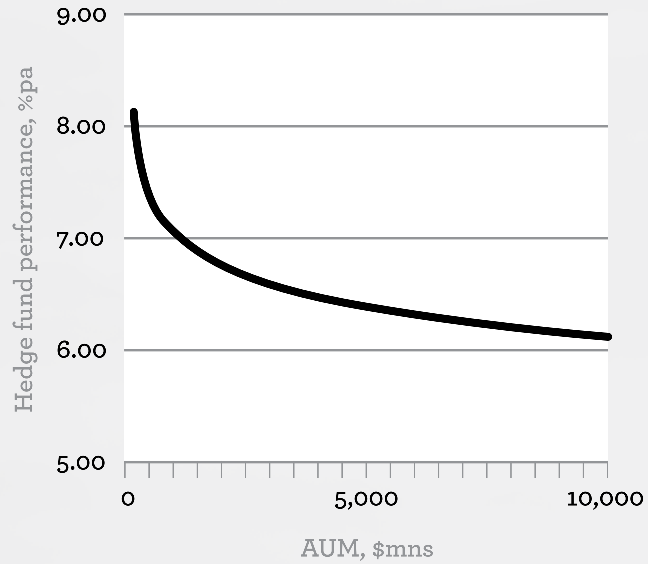
Gatemore Capital Management, a global investment advisor, recently commissioned an academic paper[1] published by Cass Business School's Centre for Asset Management Research to answer this exact question. The Cass study is the most comprehensive study to date on this subject, using data spanning the period from 1994 to 2014.

The study clearly found that there is, indeed, a negative relationship between hedge performance and AUM, as shown in Figure 1. As hedge fund size increases, fund performance decreases, other things being equal. The Cass results show that on average one could expect a $200 million hedge fund to outperform a $1 billion hedge fund by 61 bps per year and to outperform a $5 billion hedge fund by over 120 bps per year.

These findings have significant implications for the institutional investment community, which in general tends to favour the largest, most well-established hedge funds. It is no secret that large institutions such as CalPERS, which recently redeemed from all its hedge funds, have been underwhelmed by their hedge fund performance. Perhaps this can be attributed to the Cass findings.

Investors in hedge funds generally look to the asset class to be a source of additional return within their portfolio. However, this study suggests that if they are overlooking the smaller funds, they are less likely to achieve that additional return and may fall short of portfolio objectives. Also, given that most hedge funds charge fees well in excess of what most traditional long-only managers charge, investors in larger hedge funds are not getting enough value for their money.

Figure 1



Source: Centre for Asset Management Research, Cass Business School

[1] *Clare, A., D. Nitzsche and N. Motson (2015). Are investors better off with small hedge funds in times of crisis?*

> “The Cass results show that on average one could expect a **$200 million** hedge fund to outperform a **$1 billion** hedge fund by 61 bps per year and to outperform a **$5 billion** hedge fund by over 120 bps per year.”

The results summarised in Figure 1 were generated using a dataset that includes all types of hedge funds. However, the Cass study was able to dig even deeper into the data to analyse the most popular hedge fund strategies – the results were striking.

Cass examined funds in the Event Driven, Long/Short Equity and Managed Futures strategies. The findings showed that there is a negative relationship between size and performance for both Long/Short Equity and Event Driven funds, and that this relationship is far more pronounced for the former, as shown in Figure 2. This suggests that Long/Short Equity managers face more significant capacity constraints, or diseconomies of scale, than managers of other strategies.

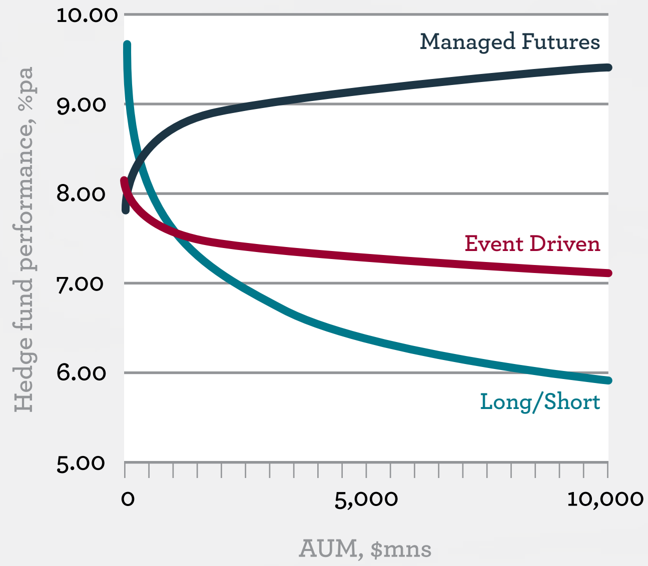
Perhaps even more striking in Figure 2 is that the relationship between size and performance for Managed Futures hedge fund strategies is actually positive. These results suggest that, rather than facing diseconomies of scale, Managed Futures funds may actually benefit from being bigger.

These strategy-specific findings are extremely important for institutional investors. According to the Hedge Fund Research Global Report from Q1 2015[2], the most significant fund flows this year so far were into Long/Short Equity and Event Driven funds, precisely where smaller funds outperform. Given that the institutional investor community tends to invest in larger fund managers, the Cass report implies that this is a wasteful strategy.

Finally, the Cass study examined its greater span of data to explore whether the relationship between performance and size had changed over time. Their results were astounding, especially for investors who view large hedge funds as safer. They discovered that the negative relationship between size and performance was particularly pronounced during periods of financial market stress. The results suggest that rather than protecting clients during these crises, investors in bigger funds suffered disproportionately relative to investors in smaller funds.

The Cass study goes a long way to explain why institutional investors, who overwhelmingly prefer large funds over small ones, have been disappointed by hedge fund returns as a source of return and a preserver of capital.

Figure 2



Source: Centre for Asset Management Research, Cass Business School

[2] *HFR Global Hedge Fund Industry Report: First Quarter 2015*

About Gatemore

Gatemore Capital Management was founded in 2005 with a core belief that successful investing is predicated on marrying a healthy entrepreneurial spirit with institutional discipline. Today Gatemore has offices in New York and London and advises institutions and private clients on over $1.6 billion globally. We have distinguished ourselves by maintaining an unconstrained approach to research which has often led us to investing in smaller funds "away from the crowds." In 2015 Gatemore was named "Outsourced Chief Investment Officer of the Year - UK" at the AI Hedge Fund Awards. For more information, please visit www.gatemore.com.

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