

Alternative Asset Strategies: Early Performance in Hedge Fund Managers

This paper investigates the effects of age on hedge fund performance. In particular, we seek to ascertain whether hedge funds perform better during the early stages of their development. Existing studies seem to lack practicality and conclusiveness, with some studies failing to address adequately the issues of survivor and market biases. Survivor bias results from the tendency of hedge funds with poor performance to drop from available databases, causing industry performance returns to appear better than they are in reality. Market bias suggests that the recent success of many hedge funds results from strong general market performance and not necessarily from hedge fund managers' skills.

Unfortunately, the lack of complete and consistent data makes addressing these biases difficult. As hedge funds disappear from databases, survivor bias becomes embedded in available data. In addition, since most hedge fund databases only have significant information for the past five to ten years (coincident with one of the strongest U.S. equity market periods) market bias would also seem to be inherent in the data.

In order to attempt to address these issues, this study has compiled information from various sources, including "deceased" funds, to create a more comprehensive database of available hedge fund information. Additionally, hedge fund returns were calculated according to age rather than vintage so that not all "early" returns come from the same market period. Where appropriate, subsets of this database were used. In all cases, individual hedge fund return data and not hedge fund style or hedge fund index data was used.¹

Based upon this data, our conclusion is that despite the biases found in the data, investors may gain enhanced returns by investing in young hedge funds if proper due diligence is completed. Hedge funds under three years of age tend to perform better than do older hedge funds without necessarily adding to the volatility of returns.

Hedge fund data hunt

- No central repository for hedge fund data currently exists.
- For this paper, a consolidated database was created from multiple sources of data.

Unfortunately, available information on hedge funds is often flawed and incomplete. The challenge begins with determining the size of the global hedge fund industry. Estimates vary drastically. The United States President's

Working Group estimated that there were between 2,500 and 3,500 hedge funds with between \$200 million and \$300 million each in capital and approximately \$800 billion to \$1 trillion in total assets by mid-1998². Managed Account Reports believed that there were approximately 3,000 hedge funds with about \$205 billion of capital in 1999³. TASS Research approximated that the industry had about 5,000 funds with about \$325 billion of capital under management by the end of 1999 and between \$350 billion and \$400 billion by 2000⁴. Estimates differ for a number of reasons:

¹Hedge fund indices have the tendency to create further biases and inaccuracies in the data. A single hedge fund may be included in multiple indices, meaning that use of the indices in lieu of single fund data may result in double counting. Also, most of the hedge fund indices are self-categorized, meaning that the hedge fund manager often chooses the index in which their fund should be included. Unfortunately, hedge funds are often incorrectly categorized, usually due to inconsistencies in defining strategies. In addition, the fund universe upon which an index is based is not always consistent and may be subject to a survivor bias that cannot be discounted.

²United States President's Working Group on Financial Markets

³www.marhedge.com

⁴Tremont Partners, Inc. & TASS Investment Research Ltd.

- Lack of obligation and/or willingness of hedge funds to reveal information;
- Varying definitions as to what constitutes a hedge fund;
- Misclassification of private investment structures of non-hedge funds and omissions of private investment structures that are hedge funds.⁵

Regardless of the exact size of the industry, the fact remains that few data collectors have been able to gain access to all existing hedge fund information. Even the better-known data providers have incomplete databases. For example, as of February 2001, Managed Account Reports followed 1,300 funds (including fund of funds), TASS/Tremont collected information on 2,600 hedge funds and Hedge Fund Research (“HFR”) included data on 1,700 hedge funds.⁶

EXHIBIT 1: AGES OF HEDGE FUNDS

Age in Months	# of Funds
1 to 12	290
13 to 24	556
25 to 36	561
37 to 48	457
49 to 60	419
61 to 72	292
73 to 84	211
85 to 96	196
97 to 108	139
109 to 120	93
121 to 132	76
133 to 144	59
145 to 156	29
157 to 168	19
169 to 180	28
181 to 192	18
193 to 204	11
205 to 216	11
217 to 228	7
229 to 240	0
241 to 252	3
253 to 264	2

Source: Lazard, TASS, Tremont and HFR

⁵ We define a hedge fund to be an unregulated investment pool seeking high risk-adjusted returns using an investment strategy that is likely to involve leverage, shorting securities or both, primarily in the public securities markets.

⁶ HedgeWorld

⁷ MAR/Hedge

In creating this study, a more comprehensive hedge fund universe was assembled in order to help compensate for the imperfect information available. Information from TASS/Tremont, hedgefund.net, HFR and Lazard proprietary sources was combined. The TASS/Tremont Graveyard (the “Graveyard”), a collection of 795 funds that do not currently report to TASS/Tremont but did at some time between 1980 and 2000, was also included. After excluding duplicate entries and hedge funds that reported only quarterly performance, the final database had a total of 3477 hedge funds with between one month and 253 months of returns for the period from 1980 to 2000. The distribution of hedge funds by age bucket in the consolidated database can be seen in Exhibit 1. Unless otherwise stated, all analyses and data in this paper were computed using this consolidated database.

The Graveyard contains information on hedge funds that were once included in the larger TASS/Tremont database but have typically not reported returns for more than four months. Some funds stop reporting because of poor performance, but non-reporting does not necessarily equate with the dissolution of a hedge fund, as there are a number of other reasons why a fund might choose to stop reporting.⁷

To verify this, sixty randomly selected hedge funds included in the Graveyard were contacted. Twenty percent of these funds provided explanations other than liquidation for their discontinued reporting. Certain managers discontinue reporting because they are no longer seeking additional assets. Name changes and fund consolidation also resulted in the removal of funds from the databases. Sometimes the reason for removal is as simple as the departure of the person who was responsible for communicating performance to the data provider. In certain instances, hedge funds were included in both the Graveyard and “Live” databases. In these cases, the performance history that appeared the most complete was used and the other was eliminated from the consolidated database to avoid duplication.

Most databases also include an element of self-selection bias. Hedge funds are not required to disclose performance or asset information to anyone other than current investors, and even then information is only given on terms determined by the managers themselves. Reporting to data providers is a voluntary action that many hedge funds will either undertake only for select vendors,

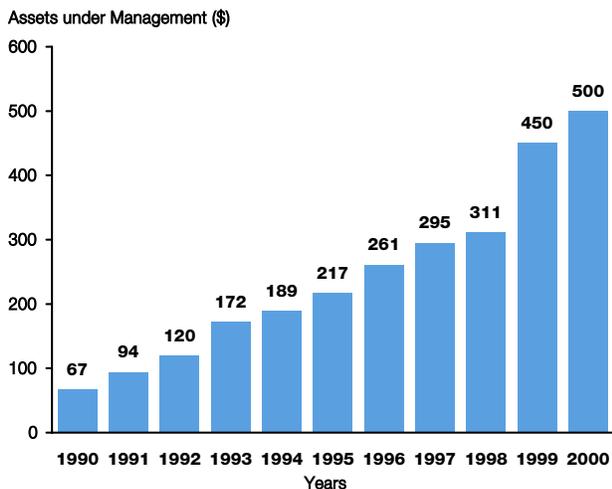
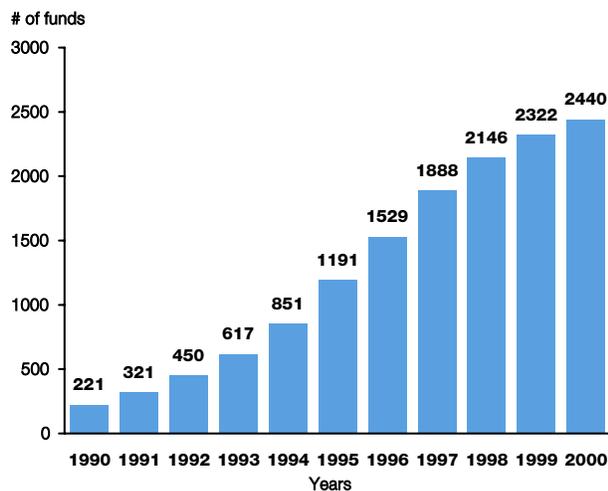
or will not undertake at all. Much like the case regarding these hedge funds contained in the Graveyard, hedge funds choose not to report for a number of reasons, not all of which have to do with poor performance. For example, if a strong performing fund provides their performance returns to a data vendor, it will be included in that data vendor's index. The hedge fund's positive performance will raise the performance of the index and therefore, their own performance will appear less differentiated. Some hedge funds wait to report the results of a new strategy until they are sure they have a proven process. These managers may have established a short track record while performing trials on their investment methods yet may

refrain from publishing performance numbers unless or until they have a positive track record to show. Sufficient information is not available to account correctly for this anomaly, yet we believe that many of these biases counter-balance each other, that the effect of these biases is negligible, and that therefore have been ignored for the purposes of this study.

Growth of the hedge fund industry and the aging of hedge funds

- Both the assets under management and number of hedge funds appear to have grown to more than ten times their levels in 1990.
- Looking at the consolidated database, the median age of a hedge fund in the database is between 37 and 48 months.

EXHIBIT 2A AND 2B: RECENT GROWTH IN THE HEDGE FUND INDUSTRY



Source: Lazard, TASS/Tremont and HFR

Most funds contained in the consolidated database of hedge funds are between one and five years old. This finding is not surprising. As seen in Exhibits 2A and 2B, the growth in the industry within the last 10 years has been enormous, with the number of hedge funds more than doubling during the last five years alone. Exhibit 3 shows the growth of the universe as seen in the consolidated database.

EXHIBIT 3: NUMBER OF HEDGE FUNDS ADDED AND OMITTED EACH YEAR IN THE CONSOLIDATED DATABASE.

Year	Additions	Omissions	Net	Balance
1990	49	0	49	221
1991	100	0	100	321
1992	131	2	129	450
1993	170	3	167	617
1994	235	1	234	851
1995	343	3	340	1191
1996	371	33	338	1529
1997	431	72	359	1888
1998	438	180	258	2146
1999	441	265	176	2322
2000	440	322	118	2440

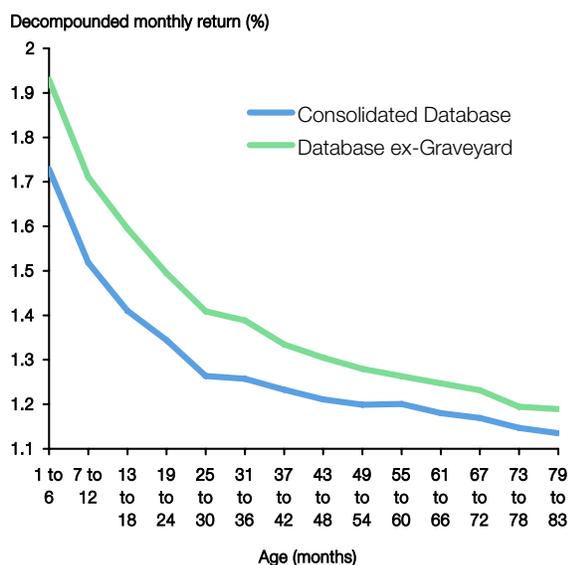
Source: Lazard, TASS/Tremont and HFR

Effects of age and survivor bias on emerging manager hedge fund returns

- Young hedge funds have out-performed older hedge funds on average, even after adjusting for survivor bias.

Recent studies of both mutual funds and hedge funds have concluded that newly established funds often outperform seasoned funds. In spite of this, many hedge fund investors have strict guidelines requiring a minimum track record for hedge fund managers before they will place capital with a fund.⁸ The most common prerequisite is three years of performance data. On the other hand, one could argue that after three years, many risks (such as operational and staffing risks) will have often been reduced. The concept of risk will be discussed in more detail later in this paper. Although reductions in these risks given a multi-year track record is an intuitively

EXHIBIT 4: AVERAGE DE-COMPOUNDED HEDGE FUND RETURN BY AGE



Source: Lazard, TASS/Tremont and HFR

⁸ Liang, Crossborder Capital and Chevalier and Ellison

⁹ Crossborder Capital, Liang and Fung and Hsieh

¹⁰ No guarantee can be made that all survivor bias has been accounted for, as the Graveyard does not necessarily represent all missing data. However, we believe that the inclusion of the missing data would not materially alter our results.

¹¹ All returns of a performance series were first compounded. We then took the nth root of this compounded return, where n equals the number of performance data points that were compounded. The result was the monthly de-compounded return. In the case that a hedge fund's performance series had less than the maximum data points for a bucket, the greatest number of points was used. For example, if a hedge fund only had 8 months of performance data, its de-compounded monthly return would be included in the average for the "1 to 6" and "7 to 12" age buckets. For the first bucket, the first six months of return data would be de-compounded. For the second bucket, all 8 months of data would be de-compounded and included, even though the hedge fund did not have the full 12 months of performance data. In this analysis not all data points were coincident. In other words, an 18-month track record from 1994-1996 could be included in the calculation with a 15-month track record from 1998-2000.

¹² Because the majority of the hedge funds with less than 36 months of performance data had been launched during the strong equity markets of the late 1990's, we performed the exercise a second time. Using only those funds that had at least 84 months of contiguous data (693 hedge funds in all) to insure that every fund had observations in each age category, we again came to the same conclusion: de-compounded monthly returns were higher during the hedge funds' early life versus post-median age. We further examine the effects of the market in the next section titled, "Effects of market bias on emerging hedge fund returns."

¹³ Annualized survivor bias was measured as the difference between the average annualized returns for hedge funds by age in the consolidated database versus the database without the Graveyard.

appealing concept, there is reason to believe that by waiting to see a substantive track record, investors may be foregoing considerable upside potential.

To determine accurately whether young funds perform better than older funds, the impact of survivor bias should be considered. Survivor bias is the Darwinian idea that surviving hedge funds will continue to report performance and failing hedge funds will tend to stop reporting, thus making hedge fund database returns appear better than they are in reality. A number of studies have attempted to compute the effects of survivor bias.⁹ Estimates of this impact range from 0.2% to almost 4.0% per annum, a potentially large difference. Again, inconsistencies found in the hedge fund data are likely responsible for some of the variation in estimates of survivor bias.

The average returns for the consolidated database with and without the Graveyard were compared to measure the survivor biases found in the database without the Graveyard.¹⁰ The results can be seen in Exhibit 4.¹¹ In both instances, there was considerable value-added evident in this historical data to support the case for investing in hedge funds during their early lives, despite the fact that the spread between the performances of young and old funds narrowed when the Graveyard data was included.¹² For example, Exhibit 5 shows that funds aged between 1 and 6 months outperformed funds in the median age group by 0.60% per month on average when the Graveyard was excluded. That spread was reduced to 0.50% when the consolidated database was used to include the Graveyard data in the study.

In general, survivor bias seems to have a greater effect on younger funds than on older funds. Exhibit 6 shows that survivor bias in the database is greatest in hedge funds that are younger than 18 months, probably because younger funds that experience poor performance drop out of the databases more quickly than do more-established funds.¹³ The largest difference between returns was found in the 1 to 6 month age group in which survivor bias

EXHIBIT 5: INCREMENTAL MONTHLY RETURN
GAINED VERSUS MEDIAN AGE GROUP
HEDGE FUNDS

Age (Month)	Database ex-Graveyard	Consolidated Database
1 to 6	0.60%	0.50%
7 to 12	0.38%	0.29%
13 to 18	0.26%	0.18%
19 to 24	0.16%	0.11%
25 to 30	0.07%	0.03%
31 to 36	0.05%	0.02%
37 to 42	0.00%	0.00%
43 to 48	-0.03%	-0.02%
49 to 54	-0.05%	-0.03%
55 to 60	-0.07%	-0.03%
61 to 66	-0.09%	-0.05%
67 to 72	-0.10%	-0.06%
73 to 78	-0.14%	-0.09%
79 to 83	-0.15%	-0.10%

Source: Lazard, TASS/Tremont and HFR

EXHIBIT 6: ANNUALIZED SURVIVOR BIAS BY AGE

Age (Month)	Annualized Survivor Bias
1 to 6	2.9%
7 to 12	2.8%
13 to 18	2.6%
19 to 24	2.1%
25 to 30	2.0%
31 to 36	1.8%
37 to 42	1.4%
43 to 48	1.3%
49 to 54	1.1%
55 to 60	0.9%
61 to 66	0.9%
67 to 72	0.9%
73 to 78	0.6%
79 to 83	0.7%

Source: Lazard, TASS/Tremont and HFR

accounts for approximately 2.9% annually, decreasing steadily to 0.7% per annum by the time funds are between the ages of 79 and 84 months. These findings are in line with measurements of survivor bias from other studies. Liang calculated survivor bias to be over 2% per year.¹⁴ Fung and Hsieh calculated annual survivor bias to be about 1.5% for hedge funds and as high as 3.5% for commodity trading advisors.¹⁵

Effects of market bias on emerging manager hedge fund returns

- The bull equity environment during the 1990s does not appear adequately to explain the additional performance of young hedge funds.

Arguments against the validity of studies on the attractive performances of young funds often claim that the apparently alluring returns are either the results of the most recent bull market, or the impact of self-selection and the instant-history phenomenon. Recall that the database used in this study includes hedge fund returns from 1980 to 2000. Although the majority of young hedge funds were indeed launched during one of the most notable bull markets in history, last decade's markets have

had their share of difficulties. Both the Japanese Nikkei and high yield bonds tumbled in 1990. The rise of U.S. interest rates (1994) and the Mexican peso crisis (1994-1995) caused many global market dislocations in the middle of the decade. The Asian crisis (1997-1998), Russian debacle (1998) and the demise of Long-Term Capital Management led to anything but effortless markets to navigate through as the decade ended.

In order to attempt to determine if hedge fund performance was the result of the market environment, data return series were created for both the S&P 500 and Lehman Aggregate Bond Indices that were coincident with each of the hedge fund data series contained in the consolidated database.¹⁶ The correlation between the de-compounded hedge fund returns of the consolidated database and the S&P 500 and Lehman Aggregate Bond Indices was -0.23 and -0.64, respectively. As can be seen in Exhibit 7, neither the S&P 500 nor the Lehman Aggregate Bond Index display the same downward sloping pattern displayed by the hedge fund universe.¹⁷

Furthermore, the continuous performance of hedge funds versus the performance of the market indices over the same time frame was studied. Exhibit 8A and 8B show the

¹⁴ Liang

¹⁵ Fung and Hsieh

¹⁶ Method used was similar to the method described above that was used to observe survivor bias as described in Note 11. De-compounded monthly return series were created to be coincident with the return series of each hedge fund. The returns were then averaged.

¹⁷ S&P 500 and Lehman Aggregate Bond Indices are used for illustrative purposes to demonstrate market conditions coincident with hedge fund returns.

results of using the 693 hedge funds from the consolidated database that had at least seven years of uninterrupted returns. Again, the indices do not show the hedge fund returns' downward-sloping pattern indicating superior returns in the early part of the data history.¹⁸ Therefore, it would appear that the performance of the market indices (and theoretically the market environment) does not adequately explain the out-performance of hedge funds during the early stages of their development.

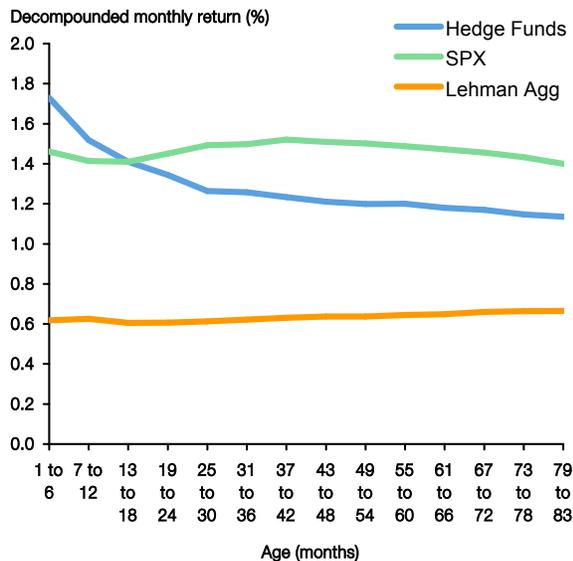
Preserving performance integrity and understanding the constraints of size: Bigger isn't necessarily better

- Anecdotal evidence suggests that new hedge fund managers are hungrier and more agile.

Explanations for out-performance in younger hedge funds remain largely anecdotal. New managers are often thought of as "hungrier" than their mature competitors and

therefore work harder to extract higher returns. As new funds increase in age, their managers may become more complacent and less driven, thereby diminishing returns. New managers have a more pronounced need for positive returns. Because they are in a new business environment, the new hedge fund manager is often highly concerned about attracting enough assets from investors to cover business expenses and earning incentive fees quickly to possibly hire new personnel, retain current personnel and/or stay motivated. As a manager develops, it is generally assumed they will have attracted sufficient assets to run the business effectively, diminishing the former concern. Also, if the manager has performed well, accumulated personal wealth would allow them to become less dependent on incentive fees for extra income. The psychological aspect of the situation may address the fact that a new hedge fund manager usually wants to prove their talent, but that after gaining considerable assets and earning appealing fees, they may become more complacent.

EXHIBIT 7: AVERAGE MONTHLY HEDGE FUND RETURNS BY AGE AND COINCIDENT AVERAGE RETURNS OF THE S&P 500 AND LEHMAN AGGREGATE BOND INDICES



Source: Lazard, TASS/Tremont, PerTrac and HFR

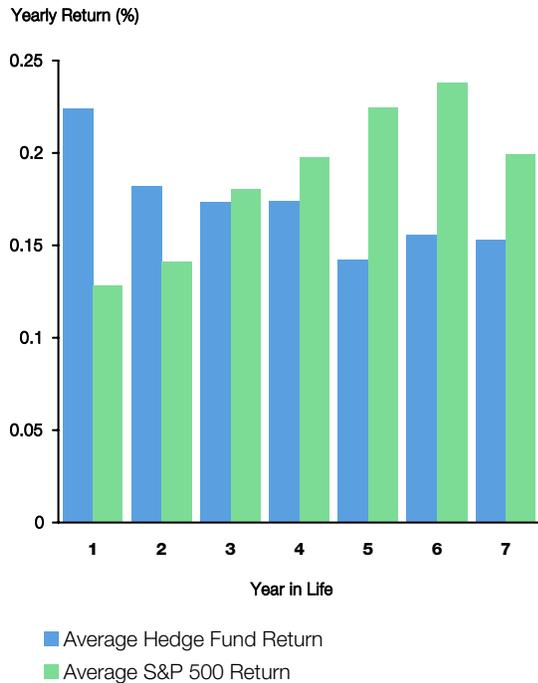
A hedge fund manager's competitive edge may also be inversely related to the amount of assets managed. However, since asset growth information is even scarcer than performance information, quantitative analysis is difficult to perform. Qualitatively speaking, larger assets may decrease a manager's agility, increase slippage on trades or force a manager to over-diversify in order to allocate the assets. The more assets under management, the more attention a manager receives, and the more likely it is that others will mimic their strategy and possibly diminish their returns. Furthermore, some managers find that particular ideas are only profitable as small trades; large funds may be excluded from these opportunities because they cannot deploy enough of their assets into these strategies to make an impact on overall returns.

Midlife crisis

- Hedge fund managers are limiting the amount of capital that they will manage.
- Gaining capacity with quality hedge fund managers will become more challenging as institutional investor demand grows.

¹⁸ The data was bucketed by yearly return and plotted alongside the S&P 500 and Lehman Aggregate Bond Index returns coincident with the hedge fund data series. As before, the hedge fund data series could occur anywhere in the 1980 to 2000 data universe. For example, one series could have been from 1987 to 1992 and another from 1993 to 2000. The annual returns for each year of data were aggregated and averaged across 693 funds. S&P 500 and Lehman Aggregate Bond Indices are used for illustrative purposes to demonstrate market conditions coincident with hedge fund returns.

EXHIBIT 8A: YEARLY PERFORMANCE OF HEDGE FUNDS AND COINCIDENT S&P 500 INDEX RETURNS



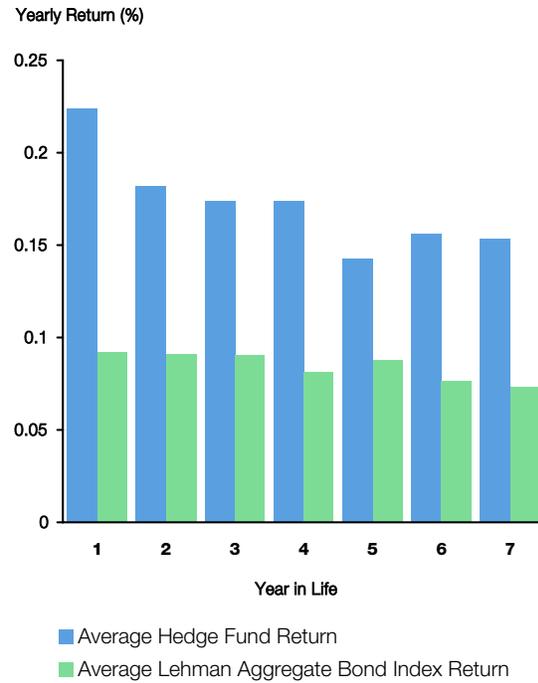
Source: Lazard, TASS/Tremont and HFR

The unconstrained growth and subsequent demise of hedge fund giants have provided a sobering lesson for the industry. Less destructive but equally interesting examples are seen in the splintering of highly successful growth-focused hedge fund groups.

Growing hedge funds often have a series of “soft” closes during which they periodically stop taking capital, choosing to take time to digest smaller amounts of new capital to ensure returns are not diluted by increasing assets further. Other hedge funds have chosen to control capital augmentation by accepting additional capital only from existing investors or by allowing capital contributions only in order to replace withdrawals. After hedge fund managers reach their desired capacity, many will have a “hard” close after which no new capital is accepted. In other cases, larger hedge funds have returned investor capital when asset size reaches a diluting level. As most hedge fund managers have a large portion of their net worth invested in their hedge funds, the possible dilution in returns will also have a direct effect on the growth of their personal net worth. Lower performance also directly reduces the incentive fees that compose the majority of a hedge fund manager’s compensation, again discouraging a hedge fund manager from accepting too many assets.

¹⁹ HedgeWorld
²⁰ Pacheco and Macht
²¹ HedgeWorld

EXHIBIT 8B: YEARLY PERFORMANCE OF HEDGE FUNDS AND COINCIDENT LEHMAN AGGREGATE BOND INDEX RETURNS



Source: Lazard, TASS/Tremont and HFR

Demand for quality hedge fund managers remains strong and seems to be increasing at an exponential rate. What used to be a high-net-worth hobby investment has become an institutional standard. According to the 2000 National Association of College and University Business Officers (NACUBO) Endowment Study, most large endowments already have a healthy allocation to hedge funds, and smaller endowments are increasing their current allocations. Plans managing more than \$1 billion, on average, had a 5.6% allocation to hedge funds and plans between \$500 million and \$1 billion, on average, had a 5.0% allocation. Smaller plans with between \$100 million and \$500 million allocated, on average, about 2.6% to hedge funds. Even the smallest endowments with under \$100 million in assets maintained about a 1.4% allocation to hedge funds.¹⁹ In fall of 2000, CalPERS announced it would allocate \$1 billion of its approximately \$170 billion in capital to hedge fund investments.²⁰ Other pension plans are following suit: the \$1.4 billion Oklahoma Firefighters Retirement System recently earmarked \$100 million for hedge fund investments.²¹ Global demand also appears to be growing. Watson Wyatt Worldwide and Indocam Asset Management surveyed 196 European pension plans in 2000 and found that they had less than 1% of their assets in hedge funds but intended to increase

EXHIBIT 9: ANNUAL RETURN VERSUS ANNUAL RISK

Year of Life	Risk (St. Dev.)	Yearly Return
1	4.94%	22.40%
2	4.46%	18.25%
3	4.27%	17.37%
4	4.17%	17.39%
5	4.12%	14.59%
6	4.53%	15.61%
7	4.71%	15.34%

Source: Lazard, TASS/Tremont and HFR

the allocation to around 5% by 2003.²² A recent market phenomenon has seen much-anticipated new managers (often spin-offs from larger hedge funds) fully subscribed almost simultaneously with their launch; this is yet another confirmation that demand is growing rapidly.

As hedge fund managers become progressively more cognizant of the limitations of their ability to manage large asset bases and as capital contributions to hedge funds increase, investors will have to face the challenge of how to gain access to quality hedge funds. If the current environment persists, one way to gain access may be to identify and invest with quality managers early in their lives, before they become capacity constrained.

But there is no free lunch

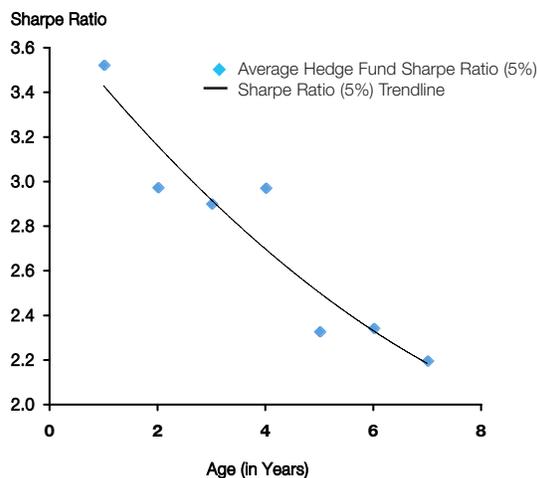
- Qualitative risk assessment is more important when investing with emerging hedge fund managers.

The benefits of investing in emerging hedge funds are only truly attractive if they outweigh any additional associated risks. Using annual standard deviation of monthly returns as a measurement of risk, annual risk versus return for funds when they were one and seven-years old (using the 693 hedge funds that had at least 84 months of data) was compared. As Exhibit 9 shows, there is no clear indication that hedge funds experienced markedly higher volatility during their early years (their

²² HedgeWorld

²³ Sharpe Ratio = (Yearly Return-Risk Free Rate)/Standard Deviation; Risk-Free Rate = 5%

EXHIBIT 10: SHARPE RATIO VERSUS AGE



Source: Lazard, TASS/Tremont and HFR

first 3 years of existence) than during their latter years (years 4 through 7).

In fact, using the Sharpe Ratio to analyze performance in the hedge funds, it appears that the risk/return trade off worsens slightly as age increases, as can be seen in Exhibit 10.²³

Nevertheless, there are still important differences between young and older hedge funds. Mature funds often have less operational risk: daily processes are documented, contingency plans have generally been developed, and support staff is in place, creating additional operational efficiency and proper segregation of duties. Teams are typically more developed and have clearly delineated responsibilities, thus reducing possible lone-man risk that usually accompanies start-up firms. Investment strategies and risk management techniques have also been tested and perfected during their growing years. Lastly, agency risk for an institutional investor is lessened if a hedge fund has a proven track record.

Investing in young and emerging hedge fund managers

- Thorough due diligence is the best way to determine the likelihood that a hedge fund will offer an attractive risk/reward payoff.

- Investing in young hedge funds using a portfolio approach can help reduce risk without overly diminishing returns.

Identifying high-quality new managers becomes increasingly difficult as capital continues to flow into hedge funds; having a strong network within the industry is crucial. Luckily, the growth in number of new hedge funds remains steady, due to financial industry consolidation and restructuring and the continued existence of an entrepreneurial spirit. As financial institutions seek to remove risk from their balance sheets, former proprietary traders have left to establish their own hedge funds, sometimes funded by their former employers. Many traditional buy-side specialists seeking more latitude in their investment process have also chosen to create their own firms. Mutual fund firms have begun launching hedge funds as a way to boost revenues while retaining talented professionals. Large hedge fund institutions are also providing the market with new talent as senior investment professionals become independent or as the funds create spin-offs that help the “mother” firm deal with capacity issues. Financial entrepreneurs and family offices continue to be breeding grounds for new hedge funds.

In our view, understanding a hedge fund manager’s investment strategy and implementation should be the key consideration when placing capital with any hedge fund. Investors should collect information from hedge fund managers through written communication, interviews, site visits and other substantive due diligence to determine if the proposed manager has the potential to generate sustainable, superior risk-adjusted returns under a variety of market conditions. A non-existent or an extremely limited track record offers little help in evaluating the robustness of an emerging hedge fund manager’s strategy. The risks of investing in emerging managers can often be assessed only through qualitative measures because limited historical performance data leads to a lack of valid statistical information. In this case, expertise and experience in choosing hedge fund managers may prove invaluable to an investor.

Emerging managers present the additional challenge of understanding the business risks associated with early-stage investing. Responsible investors must understand the perils of investing in a new firm. An investor needs not only to assess the risks involved with the emerging manager today, but also to assess their plans for future growth and development. Care must be taken in

monitoring progress on execution of the business plan and in understanding the rationale behind the changes in business strategy that will likely occur over time.

Using a portfolio approach to invest in emerging hedge fund managers, an investor can help reduce the risks involved with single-manager investing and gain the advantages of diversification while still maintaining the ability to access the attractive returns that often accompany young hedge fund managers.

Conclusion

The difficulty in investing with emerging managers comes in identifying quality managers early and understanding and evaluating the particular risks associated with these nascent firms. For the time being, there is a plentiful supply of emerging managers. Still, proper due diligence and careful monitoring are key in successfully discovering and gaining capacity with the next generation of leading hedge funds.

Investing with emerging hedge fund managers can offer investors the ability to capture superior returns that seem to accompany a young hedge fund’s developing years as well as the acquisition of and access to potentially scarce future capacity. After reviewing the effects of age and growth of hedge fund assets, there are compelling reasons to believe that investors may be able to derive added return by investing in hedge funds early on in their existence.

As with any investment, emerging hedge funds expose investors to specific risks. Therefore, an investment should only be made provided the investor can adequately assess both the veracity of the investment methodology and the business model being deployed. Investors utilizing a portfolio approach to investing in young hedge fund managers can help reduce volatility and single-manager risks.

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