2017: The Year of Smaller Hedge Fund Managers

Stockholm (HedgeNordic) – Smaller hedge fund managers will continue to outperform larger funds in 2017, predicts Don Steinbrugge, Managing partner of Agecroft partners. This, he says, follows a trend stretching through November 2016, and is demonstrated by the HFRI Fund weighted composite, which was up 4.54% against the HFRI dollar weighted composite gain of 1.90% in November YTD.

Because of the high concentration of flows to the largest managers with the strongest brands, with almost 70% of industry assets invested with firms with over USD 5 billion in AUM, many of these large managers' assets have swelled well past the optimal asset level to maximize returns to investors, according to Mr Steinbrugge. It becomes increasingly difficult to add value through security selection as firms become ever larger, he believes, as managers then also have an incentive to reduce the risk in their portfolio to retain assets, which in turn lowers expected returns.

"Small and mid-sized hedge funds will see increased flows during 2017 due to increased sophistication of institutional investors, poor recent performance of many of the largest well known hedge funds, the pressure institutional investors are receiving to enhance returns, and the belief that smaller, more nimble managers have an advantage in a performance environment increasingly dependent on security selection," says Mr. Steinbrugge. "This is especially true for small managers operating in less efficient markets or capacity constrained strategies. These flows will be concentrated in a very small percentage of managers."

Mr. Steinbrugge expects to see positive flows to hedge funds of funds with specific industry niche expertise, and a continued evolution in hedge fund fee structures for large institutional allocations. With hedge fund fees under extreme pressure from large institutional investors, there will be "continued evolution in how hedge fund fees are structured to attract and retain large institutional investors," he says, as he sees managers pursuing one of three paths ahead in 2017: 1) Schedules that tier fees based on the size of allocation, 2) Tailored fees to address specific issues of prospective institutional investors, and 3) a Hedge Fund light management fee only.

Mr. Steinbrugge is also predicting continued outflows of assets from the hedge fund industry by large institutional investors, though perhaps less than anticipated. Conversely, he expects hedge fund industry assets to reach an all-time high in 2017, for the ninth year in a row, an increase that will be driven by "the disconnect between the mainstream media's coverage of the industry and the reasons why investors continue to allocate to hedge funds. We forecast redemptions of 3% of industry assets and average gains of 5% resulting in a net increase of 2% of industry assets."

Other predictions for the coming year from Mr. Steinbrugge are: increased alpha due to decreased correlations and higher volatility due to the different impacts on companies, sectors and markets of President-elect Trump's envisaged restructuring, and that there will be a continued increase in fund closures due to investor redemptions.

"The hedge fund industry is over saturated with an estimated 15,000 funds," he says. "We believe approximately 90 per cent of all hedge funds do not justify their fees, which is evidenced by the mediocre returns of hedge fund indices… Investors are increasingly likely to redeem from underperforming managers, leading to an increase in fund closures."

Read the full interview here.

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