OPPORTUNITIES INVESTING WITH EARLY LIFECYCLE HEDGE FUNDS: A PREQIN & 50 SOUTH CAPITAL STUDY

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preqin

50 SOUTH CAPITAL
A SUBSIDIARY OF NORTHERN TRUST CORPORATION

About the Data

Early lifecycle hedge funds as presented in this report were determined by the launch date of a fund manager's first-time fund across any fund tracked by Preqin. Any hedge fund managed by this firm within the first three years of this launch would be appropriately pooled within an Early Lifecycle Manager Hedge Fund Benchmark. Once this three-year threshold had been satisfied, all hedge funds managed by this firm would transition and be represented in the Established Hedge Fund Benchmark. All benchmark returns contained within this report are comprised of unweighted averages of constituent fund net returns.

For this study, a total of 1,591 unique hedge funds across 1,254 unique hedge fund managers were analyzed for the construction of the Early Lifecycle Manager Hedge Fund Benchmark, which encompasses 35,424 individual net monthly return data points to generate the benchmark track record from January 2012 until June 2019. In addition, the Established Hedge Fund Benchmark utilized performance data across 4,744 unique hedge funds across 2,289 unique hedge fund managers amounting to 233,138 individual net monthly return data points.

Data Pack

The data behind all of the charts featured in this report is available to access for free. Ready-made charts are also included that can be used for presentations, marketing materials and company reports.

To access the data pack, please contact: julie.canna@50southcapital.ntrs.com

The Early Lifecycle Hedge Fund Opportunity

Hedge funds early in their lifecycle are outperforming established managers by almost 4% per annum

New hedge fund launches, particularly the largest, create headlines in the media. Each year, the number of hedge fund firms that launch and the number that close are barometers for the health of the industry. New hedge fund launches may get the attention of the media, but not always the attention of investors.

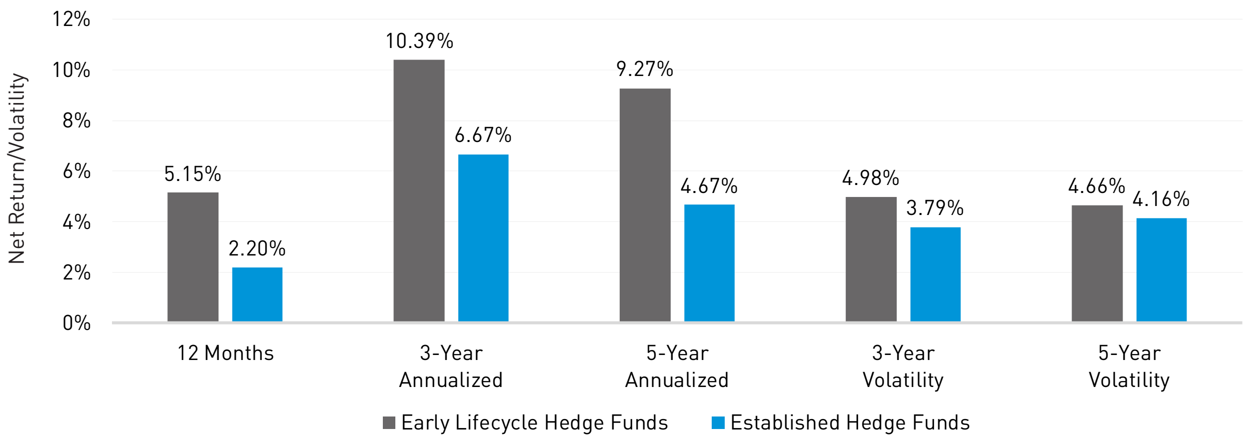
Although some investors will evaluate and invest in the early years, or even at launch, many will systematically avoid early investments in hedge funds, and instead require a three-, five- or even 10-year track record before considering a hedge fund for investment. Preqin data shows that, in 2019, only half of hedge fund investors would consider evaluating an early lifecycle hedge fund, and even fewer would actually invest. These results have changed little over the past five years.

When we evaluate the performance of managers in their early years, though, the argument for investing early is very compelling. This study evaluates the performance of early lifecycle hedge funds, which we define as the first three years of existence, against the performance of funds later in their lifecycle.

Return Data Shows Outperformance following the Financial Crisis

Hedge funds early in their lifecycle have outperformed more established hedge funds by almost 4% on an annual basis over the period studied. This suggests an opportunity for value creation that some investors may be overlooking. Preqin looked at monthly hedge fund returns from 2012 through June 2019 for this study – an arguably mature stage of the industry following the Global Financial Crisis. Investors have demanded the secretive and opaque asset class become more

Fig. 1: Performance of Early Lifecycle vs. Established Hedge Funds



Source: Preqin Pro. Data as of June 2019

institutional and transparent. In this flight to safety, dollars allocated to hedge funds have flowed to the industry's largest, and oftentimes oldest, players – those that were able to make this transition and subsequently allay investors' concerns.

What the data suggests, though, is that investors would have generated higher returns by investing in early lifecycle hedge fund managers. The monthly returns in the first three years of a fund's life are labelled 'early lifecycle managers' and the monthly returns of funds older than three years are labelled 'established managers.' Fig. 1 shows annualized returns of early lifecycle managers outperforming established managers by 3.7% and 4.6% on a three- and five-year annualized basis, respectively. And this outperformance is achieved with just modestly higher risk: standard deviation for early lifecycle managers is only 1.2% and 0.5% higher than for established managers on a three- and five-year basis, respectively.

The annual returns through this period also showed consistent outperformance by early lifecycle managers, which outperformed established managers every single year (Fig. 2). The average annual outperformance over these years is almost 4%. Over the 7.5-year period, the cumulative outperformance by early lifecycle managers relative to established managers is over 36%. Not only did early lifecycle managers outperform, but they protected capital better than established managers in 2018 when markets experienced widespread losses.

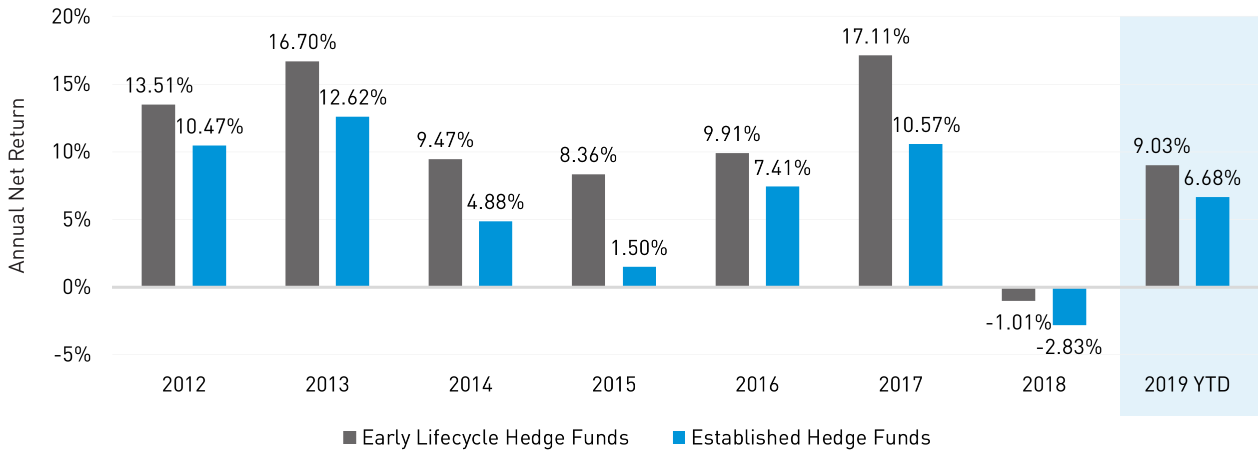
Outperformance Extends across Strategies

The evidence of outperformance from early lifecycle managers persists across strategies. When evaluating the annualized returns of early lifecycle managers since 2012, the three- and five-year returns are higher across each top-level strategy bucket than the overall average return for established managers. This suggests that the opportunity for outperformance from early lifecycle managers may be more strongly correlated to the characteristics of a fund's early life than to a particular strategy.

Studying the returns from established managers by the same strategy buckets reveals early lifecycle manager outperformance in every strategy for each period, with just one exception: established macro strategies funds outperformed early lifecycle macro managers by just 0.49% during the 12-month period ending June 2019 (Fig. 3). However, during the entire evaluation period, the average outperformance of early lifecycle managers over established managers at the strategy level ranged from 1.4% for credit strategies to 10.9% for macro strategies.

These results suggest that investors can benefit from investing in early lifecycle hedge funds as part of a robust hedge fund program. That said, these observations are not intended to diminish the returns that can be realized from investing in established funds. There are many examples of hedge funds that have extended strong track records far past their early years, maintaining the passion and drive they had when they started out in the industry. This is very difficult to do and we often observe that returns level off as assets grow and businesses become more complex.

Fig. 2: Performance of Early Lifecycle vs. Established Hedge Funds, 2012 - 2019 YTD



Source: Preqin Pro. Data as of June 2019

What Drives Stronger Returns Earlier in a Manager's Life?

Each hedge fund is unique and there is no singular reason for outperformance. However, there are characteristics that are common to success in the early years that could be considered causal to this outperformance:

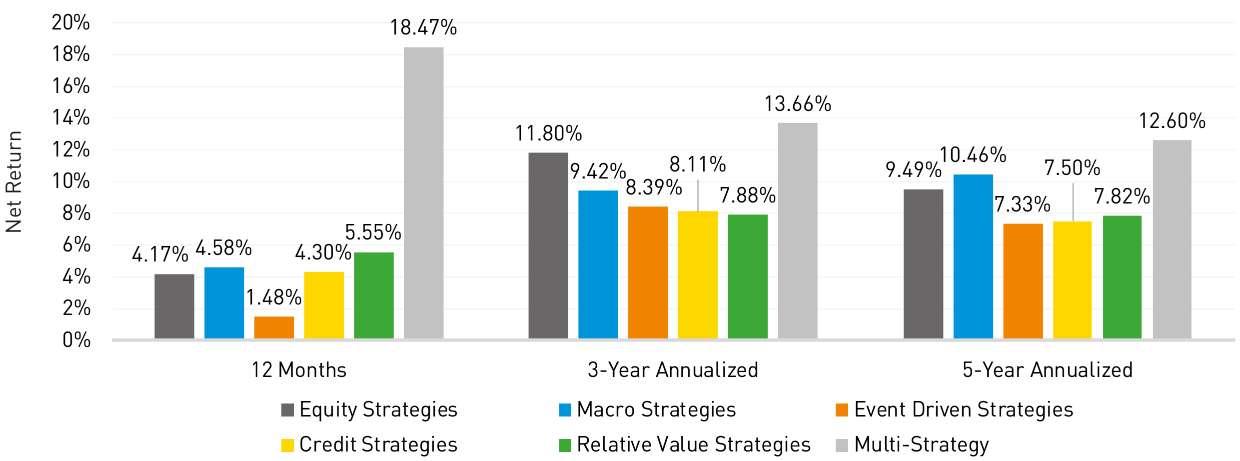
- **Passion for investing.** We believe investment managers often exhibit their highest levels of passion and energy for investing in their earlier years. This may be difficult to maintain longer term, especially when the business has become established and profitable, and the manager has earned the goodwill of its investor base.
- **Driven to succeed.** A portfolio manager's opportunity for professional, financial and personal success is most often achieved in the early years, as it requires an intense focus from the start to not only generate strong returns but also to protect capital during drawdowns.
- **Aligned interests with investors.** Most hedge fund managers, at launch, have not achieved significant personal wealth. In the early years, a hedge fund's incentive fee serves as the primary mechanism for generating substantial profitability for the business and the fund manager, relative to the management fee which is often a much smaller component of revenues. If a manager can generate strong performance for investors, the manager will be rewarded through the incentive fee.
- **Nimble and risk-management focused.** The focus on establishing a track record and keeping the firm in business in the early years often leads to a heightened focus on risk management. Because a manager is also investing a significant portion of its net worth in the fund, it tends to be extra vigilant in limiting fund drawdowns, as seen in Fig. 4. Smaller drawdowns and capital preservation allow for greater compounding of capital over time. Additionally, those early lifecycle managers with relatively smaller asset under management are able to stay focused in their core areas of expertise, and have greater flexibility to manage exposures and risk.

The Early Bird: Upside and Downside

From an investor's perspective, there are additional benefits to investing with early lifecycle managers. For example, early investors can often drive favourable fee discounts. Most hedge funds recognize the value of securing capital early by offering founder's share classes with lower management fees and/or incentive fees that can be enjoyed for the life of the investment. Larger investments by anchor-investors can often drive fees even lower.

Early investors can also negotiate other terms, including future capacity, modified liquidity triggers and additional transparency to gain greater insights into the portfolio, which is particularly helpful in the absence of a longer track record. Further, early lifecycle hedge fund investors often experience a closer GP-LP relationship, with more frequent and in-depth conversations with the Founder and Portfolio Manager, and the research team. This relationship and deeper level of dialogue can allow the investor to better understand the portfolio and establish more robust expectations regarding the investment program, leading to more informed decision-making regarding the investment.

Fig. 3: Performance of Early Lifecycle Hedge Funds by Top-Level Strategy



Source: Preqin Pro. Data as of June 2019

But what might the downside be? Arguably, the biggest risk of early lifecycle investing is hedge fund failure. And failure rarely means a total loss of capital: it often results from a manager's inability to generate sufficient or consistent returns to support and grow the business into a sustainable entity. While the risk of a manager closing down is higher in the early years, this risk has been reduced due to the institutionalization of the industry over the past 10 years. Today, it is more costly to start a hedge fund due to greater regulatory oversight and reporting requirements, as well as investor expectations for third-party administration and blue-chip service providers for audit, legal and custodial services. These demands raise the bar for those considering going out on their own and launching a hedge fund business.

Compounding this, there are now high-quality third-party service providers that can augment compliance, trading and technology. And although it comes at a price, these external service providers provide valuable services for a manager's business operations, allowing the manager to devote greater energy to the investment portfolio. Reduced business risk is one of the greatest benefits to more hedge funds becoming institutional investment options.

While a reduction in business risk is a benefit to the industry as a whole, the data presented here represents average returns, and not every new hedge fund will outperform established hedge funds. The challenge is finding those with the best chance of outperforming. Some early lifecycle hedge funds receive significant attention at launch due to a manager's pedigree and experience; but many firms and funds are launched with little fanfare. This is where an investor's network, contacts and reputation are critical in gaining access and getting early looks at managers. Finding hedge funds early is one challenge, but the more important determinant of success is identifying whether a manager is skilled and can generate unique, risk-adjusted performance over time.

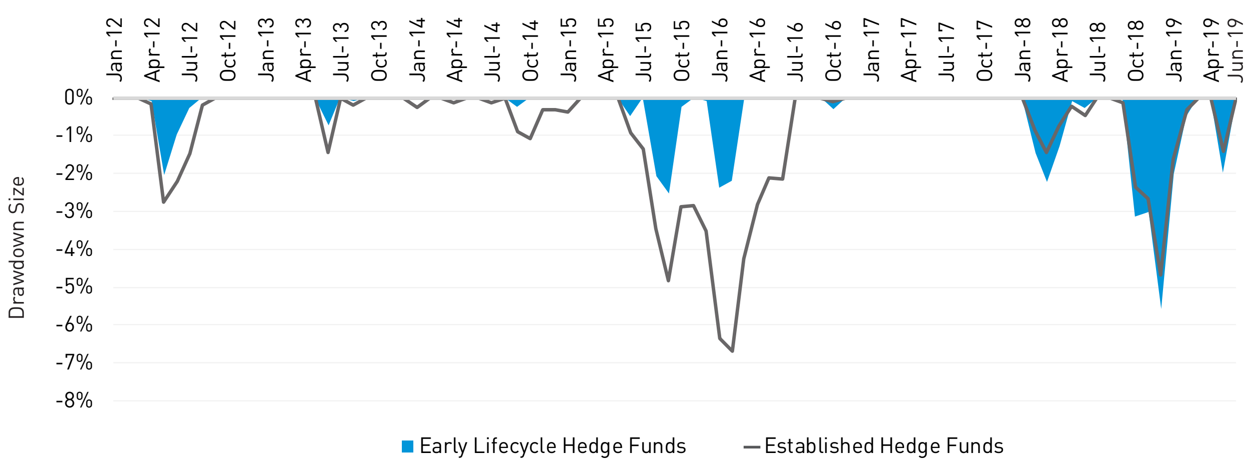
How Do You Find the Best Managers?

Identifying whether a manager has a skill that is repeatable over time – and assessing whether the returns justify the risk – is as much art as science. Although past performance is no guarantee of future performance, it is helpful to have data to analyze in order to build conviction around a manager's investment process. The due diligence exercise for an early lifecycle manager is more difficult due to limited or incomplete data to evaluate. Instead, a mosaic must be built from a variety of independent data points to identify and verify skill. This requires a high degree of qualitative assessment, utilizing experience and advanced interview techniques to gain insights through position-level discussions, reference calls with past associates and co-workers, interviews with members of the team, and partial track records from prior firms.

While this picture of success can be difficult to stitch together, we find that successful firms often share the following commonalities:

- **Solid, well-resourced business plan and operational infrastructure.** Just because an investment manager is good at evaluating businesses, does not always mean they can run a business. The most successful firms have put considerable upfront thought into their plans for building and growing the business over a multi-year period based on growth in assets. Putting a

Fig. 4: Drawdowns of Early Lifecycle vs. Established Hedge Funds, January 2012 - June 2019



Source: Preqin Pro. Data as of June 2019

solid plan in place with proper funding to back the plan creates a higher chance of success. A robust infrastructure is important to ensure operations are designed to support the strategy and are in line with the long-term objectives for the business. Operational due diligence is critical to identify and mitigate risks at an early stage, emphasizing an alignment of interests between the manager and its investors.

- **Clearly defined investment process.** The process should be well articulated and align with the Portfolio Manager's stated investment philosophy. A clearly defined process, while important at any stage of a manager's life, is critical in the early years. It provides a singular focus for the team and a framework for repeatability in capturing a manager's particular edge. Importantly, it creates a singular lens for evaluating unsuccessful investments, creating a feedback loop for improvement. From an investor's perspective, this is where you start to establish expectations for the portfolio. Setting expectations for all aspects of the business and portfolio allows you to monitor the success of the investment over time.
- **Robust risk management framework.** It is important that a manager has a clearly articulated view on risk – often, this is their first experience managing a portfolio independently. Investing can be an emotional experience and a manager's risk framework needs to be articulated at multiple levels, starting at the position level and rolling up into a complete portfolio risk view. Understanding the risks that a manager will take is important in determining whether the expected return justifies the risk taken.
- **Alignment of interests and incentives.** From day one, it is important to see a manager invest a significant portion of their net worth in the fund. Providing 'skin in the game' aligns them with their investors, and is important for a manager of any size and stage. As a manager earns incentive fees, we expect the majority of those proceeds to be rolled back into the fund.

Investing in hedge funds would be easy if there was one formula for success. Unfortunately, there are many paths and models for a manager to be successful in the early years and beyond. This uniqueness is often what creates the edge for a particular manager. And it makes hedge fund returns different and complementary to most investor portfolios.

The Emerging Opportunity

The data shows that emerging hedge fund managers may offer significant benefits and potential for higher returns. An advisor experienced in early lifecycle investing can help investors to identify the most compelling new managers, and also to intentionally and systematically allocate to new hedge fund launches. Early lifecycle manager-focused portfolios may be particularly appealing to larger allocators that have set restrictions on track record, fund size or the percentage ownership of a fund their investment can represent. Whatever the ultimate path to investment, early lifecycle hedge funds present an increasingly appealing opportunity.

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