BOREALIS

STRATEGIC CAPITAL PARTNERS, LP

The Aftermath: New or Established Hedge Funds?

An Assessment of Post-Crisis Performance

In light of the recent market dislocation associated with COVID-19, and in anticipation of asset owners facing decisions regarding the composition of their hedge fund portfolios, we thought it would be informative to evaluate the historical performance of newly launched managers versus that of more established managers following market crises.

Patrick Sheedy

Principal, Investments

Borealis Strategic Capital Partners is a team of seasoned investment professionals that provides strategic capital to early stage hedge funds.

While each market crisis is unique, we have chosen to analyze manager performance following the Global Financial Crisis of 2008/2009 ("GFC") in this paper – acknowledging several parallels to the current period:

- Severity of market drawdown
- Level of fear and uncertainty
- Prominence of hedge funds in institutional portfolios

Defining "New" and "Established"

Investors frequently debate the pros and cons of investing with newly launched versus established managers, and there is plentiful research supporting the newly launched manager "premium" – that is, these managers often outperform their larger, established peers. However, this research typically does not address which cohort has generated superior returns following market crises.

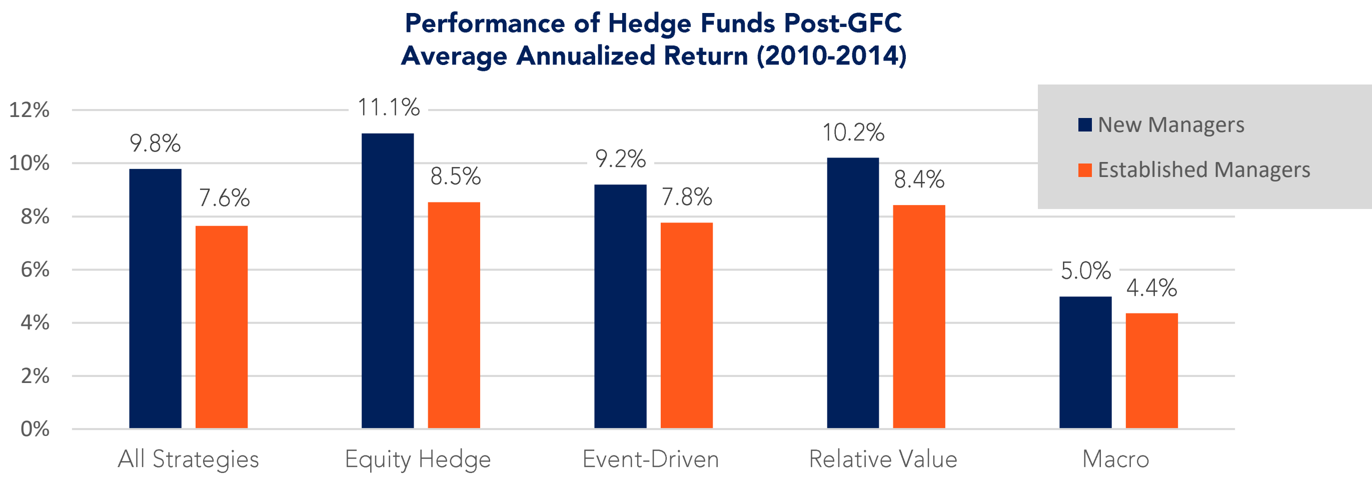
While established managers may have certain perceived advantages, including longer track records, larger teams, and sizeable/loyal capital bases, our research indicates that newly launched managers outperformed established managers during the five-year period from January 1st, 2010 through December 31st, 2014, following the GFC.

For the purposes of this assessment, we define newly launched managers ("New") as those that launched in the second half of 2008 and throughout 2009 and established managers ("Established") as those that launched prior to July 1st, 2008.

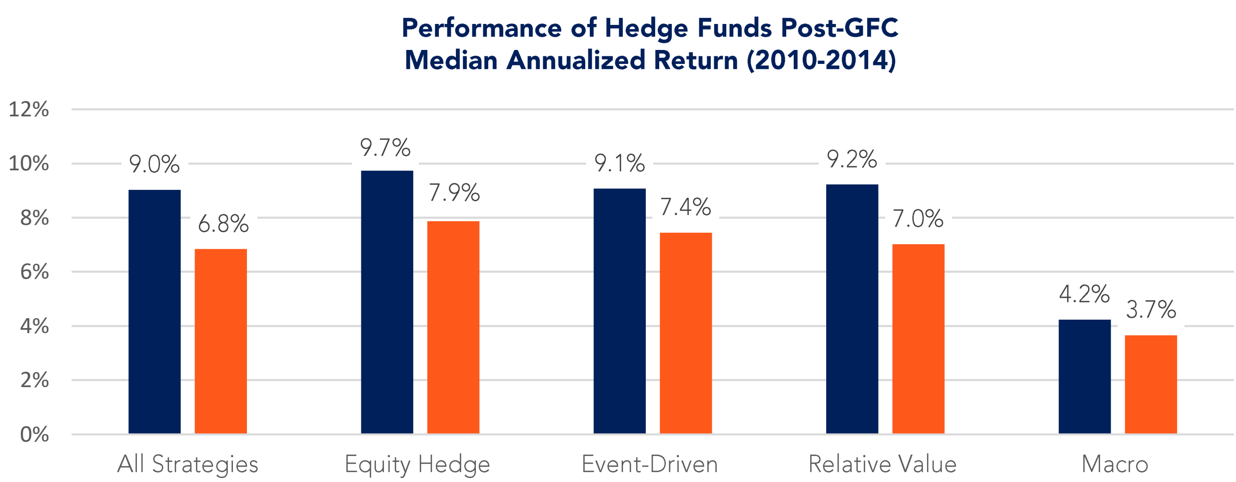
Performance Following the Global Financial Crisis

Both average and median New manager returns exceeded Established manager returns over the five-year period, and this outperformance is persistent across all strategy groups, as shown below.

The analysis presented is from the perspective of investors with existing hedge fund portfolios who may benefit from high water marks. For investors considering investing "fresh" capital in Established or New managers, they may not benefit from high water marks; without existing high water marks, the difference in returns between Established and New managers would only be further enhanced.



Data source: HFR, Inc.



Data source: HFR, Inc.

Please see disclosures for information regarding the use of statistics, graphs, and charts. Please refer to the Appendix for more information about the information shown above.

Why the Outperformance from New Managers?

In both benign and dislocated markets, we believe New managers outperform due in part to their outsized motivation, singular focus, nimbleness/agility, and broader opportunity set – accordingly, we are not necessarily surprised by the results. In fact, we believe there are certain advantages unique to starting a business and building a portfolio during stressed market environments:

Availability of Talent

Challenging markets often make high quality talent available to New managers, as existing funds either face insurmountable challenges and/or decide to return investor capital. Senior, experienced front and back office personnel may be open to new opportunities they would not have pursued in more benign environments. Further, from the New manager's perspective, the price for attracting talent and building a team can be advantageous.

Portfolio "Dry Powder"

New managers can invest objectively and offensively into dislocated markets; this "fresh" portfolio can provide the manager a psychological advantage, allowing her to think longer-term about the opportunity set – "playing to win."

Lack of Legacy Portfolio Positions

Crises often create problem positions that may require disproportionate time, resources, and capital from Established managers. This can be a distraction and lead to a defensive posture – "playing not to lose" – when a more forward-looking approach might be warranted.

Fewer Distractions

Established managers often have complex businesses – more employees, LPs, strategies / investment vehicles, and counterparties – which may require them to shift their time and attention away from portfolio management. New managers, on the other hand, are more likely to have the ability to focus on the portfolio and rapidly changing opportunity set, thus benefiting from their relatively lean, simple businesses.

Valuation

During times of extreme market volatility, despite best efforts, some Established managers with more mature portfolios may hold hard-to-value Level 3 assets carrying valuations that may not fully reflect the extent of the impairment brought on by the market event. Consequently, future investors could be negatively impacted as these positions are realized.

Concluding Thoughts

The COVID-19 crisis will present unique risks and opportunities, but the experience for New and Established managers following the GFC is instructive. Should this crisis and subsequent recovery bear similarities to the GFC, we hope this research provides an informative framework for deploying capital in the aftermath.

Appendix – The Underlying Data

As explained earlier in this paper, we analyzed the performance of two groups of managers ("New" and "Established") following the GFC:

- New: Managers that launched in the 18-month period between July 1st, 2008 and December 31st, 2009 (145 funds)
- Established: Managers that launched prior to July 1st, 2008 (726 funds)

We analyzed monthly returns for active funds from the HFR hedge fund database, as of March 2020, classified as Equity Hedge, Event-Driven, Relative Value, and Macro. Returns are reported net of fees and we did not adjust for fee differentials across managers. This query yielded 5,184 unique fund results, and after limiting each firm to one fund (the one with the earliest inception date), we analyzed a total of 1,688 unique funds. We then evaluated each group's performance (average and median) over the 3, 5, and 10-year periods beginning January 1st, 2010. While the charts above highlight a 5-year time period, we also ran the analysis over 3 and 10-year timeframes, and the results were consistent.

3- Year Performance Analysis (January 2010 - December 2012)		
All Strategies		
	New	Established
# of Firm/Funds	145	726
Average Annualized Return	10.65%	7.02%
Median Annualized Return	9.08%	5.88%
Equity Hedge		
	New	Established
# of Firm/Funds	64	401
Average Annualized Return	11.42%	7.06%
Median Annualized Return	9.61%	6.28%
Event-Driven		
	New	Established
# of Firm/Funds	21	80
Average Annualized Return	9.42%	8.73%
Median Annualized Return	8.92%	6.94%
Relative Value		
	New	Established
# of Firm/Funds	41	107
Average Annualized Return	12.76%	9.53%
Median Annualized Return	12.91%	8.17%
Macro		
	New	Established
# of Firm/Funds	19	138
Average Annualized Return	4.89%	3.98%
Median Annualized Return	2.58%	2.98%

Data source: HFR, Inc.

5- Year Performance Analysis (January 2010 - December 2014)		
All Strategies		
	New	Established
# of Firm/Funds	145	726
Average Annualized Return	9.78%	7.64%
Median Annualized Return	9.03%	6.85%
Equity Hedge		
	New	Established
# of Firm/Funds	64	401
Average Annualized Return	11.13%	8.54%
Median Annualized Return	9.74%	7.88%
Event-Driven		
	New	Established
# of Firm/Funds	21	80
Average Annualized Return	9.20%	7.76%
Median Annualized Return	9.07%	7.45%
Relative Value		
	New	Established
# of Firm/Funds	41	107
Average Annualized Return	10.21%	8.43%
Median Annualized Return	9.23%	7.02%
Macro		
	New	Established
# of Firm/Funds	19	138
Average Annualized Return	4.99%	4.36%
Median Annualized Return	4.24%	3.66%

10- Year Performance Analysis (January 2010 - December 2019)		
All Strategies		
	New	Established
# of Firm/Funds	145	726
Average Annualized Return	6.81%	5.49%
Median Annualized Return	6.57%	5.12%
Equity Hedge		
	New	Established
# of Firm/Funds	64	401
Average Annualized Return	7.32%	6.41%
Median Annualized Return	6.96%	6.08%
Event-Driven		
	New	Established
# of Firm/Funds	21	80
Average Annualized Return	7.39%	5.75%
Median Annualized Return	7.63%	5.37%
Relative Value		
	New	Established
# of Firm/Funds	41	107
Average Annualized Return	7.52%	5.79%
Median Annualized Return	7.67%	5.30%
Macro		
	New	Established
# of Firm/Funds	19	138
Average Annualized Return	2.93%	2.44%
Median Annualized Return	3.31%	2.64%

Data source: HFR, Inc.