



Funds of Funds: the Elderly are Vibrant – as Long as They Grow up First

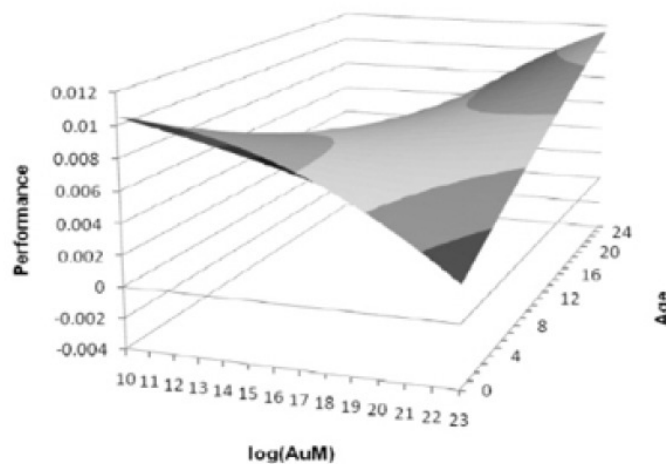
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American novelist Mark Twain once wrote that ageing was “an issue of mind over matter. If you don’t mind, it doesn’t matter.” While this may be sage advice for most of us, it’s apparently not applicable to hedge funds of funds.

A recently updated study by Roland Füss of the European Business School, Dieter Kaiser of the Frankfurt School of Finance & Management and Anthony Strittmatter of the University of Freiburg finds that ageing has a dramatic impact on returns.

But the direction of that impact depends significantly on the size of the fund in question. The study of over 600 funds of funds concludes that young large funds do much better with a few years of experience under their belts. However, small young funds that never really grow are more likely to produce worse returns after a few years of trying.

The chart below from their paper summarises its key findings:



This saddle-looking shape shows that young funds with few assets (left point on the saddle) post an average return of around 1% a month. Funds that began life with more assets (bottom corner of saddle), on the other hand, tended to start with lower returns.

But as these rookies progress, the story changes. The small funds did poorly as they grew old and the large funds actually got their acts together. Large funds that made it to the quarter-century mark were doing quite well while the smaller members of their cohort flailed around. This makes intuitive sense, really. If your fund was 25 years old and still wasn’t very large, you must not have been cranking out very attractive returns.

A final note about this report: the demographics of sample of funds of funds used in the study reveals a lot about the fund of funds industry. The table below (with our circles added for emphasis) shows that while the average fund of funds studied had assets of US\$139 million, the median was only US\$47.5 million. In other words, the sample was very skewed to the right (the multi-billion dollar mega-funds).



Table 1: Descriptive Statistics of Monthly Data from Unbalanced Panel

	Performance (in %)	Age (in years)	Size (in mil USD)
Observations	42,726	42,726	42,726
Mean	0.76	5.00	139
Median	0.75	3.84	47.5
Min	-49.98	0	0.02
Max	68.54	27.85	8,760
Standard Deviation	2.21	4.24	322
Skewness	1.06	1.32	9.8
Kurtosis	63.44	4.88	168.42

It's tough to make money at US\$139 million AUM, let alone US\$47.5 million. But half the funds in this study had even less than that. We hypothesize that many of these tiny funds never actually get beyond the so-called "friends and family" stage.

The bottom line here is that young funds of funds can do well, but they need to grow before they get old. If not, they may be well served by another of Mark Twain's famous observations:

"The first half of life consists of the capacity to enjoy without the chance; the last half consists of the chance without the capacity."

Christopher Holt is a hedge fund expert who specialises in 130/30 strategies and publishes the widely respected blog AllAboutAlpha. He was formerly the head of institutional sales for JC Clark, a US\$400 million Canadian hedge fund manager. Prior to JC Clark, Holt spent ten years in the management consulting industry with various firms including Ernst & Young. More of Holt's insightful musings can be found at www.allaboutalpha.com.

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