Smaller funds have higher returns.
They are also less risky.

From Star to Founder EastRock

Don't Trust Your Gut. Smaller Funds Are Safer.

Adam Shapiro

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AT A DINNER EARLIER THIS MONTH, I described East Rock's strategy to a hedge fund manager and a Wall Street lawyer. I explained how we typically back star managers who have recently launched new investment firms.

Earlier in the evening, we'd had lively debates about politics, economic development, AI and parenting. My dinner mates loved a good argument. But they did not push back on the idea that smaller funds provide better returns than larger funds. It matched their intuition and they accepted my assertion that there is substantial data to prove it.

The lawyer, however, was convinced we were taking more risk.

"But you are betting on a horse who has not yet run a race!"

He nearly screamed the words, with a finger in the air. The hour was late, and the wine was kicking in.

I may have screamed back. I hope I didn't. But his analogy struck a nerve with me because it reflects a widely held opinion on a topic I care a lot about, and it's wrong. It reminds me of the saying "no one ever got fired for buying IBM," which was true until it wasn't. Perhaps no one gets fired for investing in a brand name fund, but a growing body of data and analysis tells us that focusing on smaller funds (typically run by newer firms) is actually a safer way to go.

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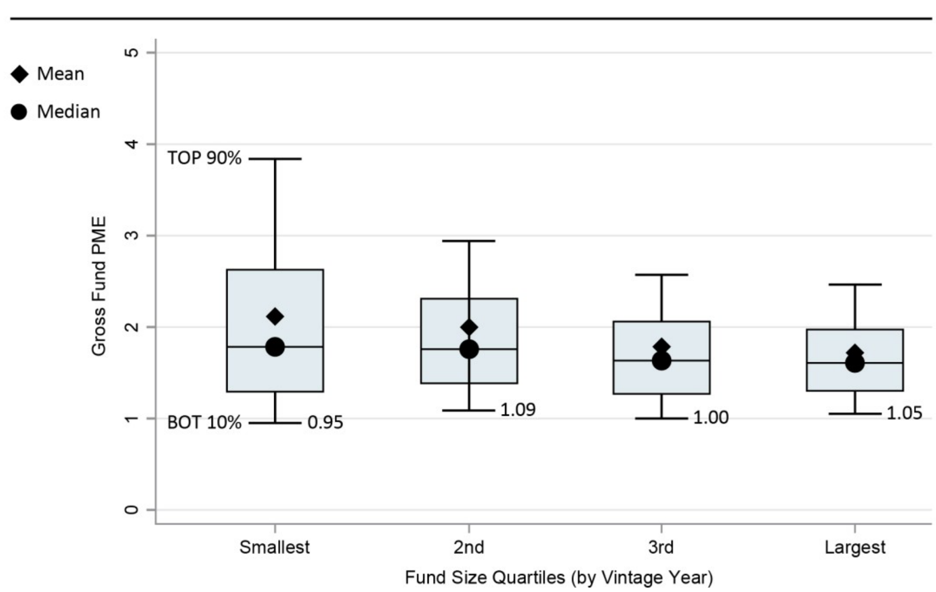
My dinner conversation prompted me to revisit the work I described in The Research You Haven't Seen On Emerging Private Equity Firms.

You may recall how impressed I was with the data on PE deals and funds assembled by Braun, et al. Some new slides they've put out continue to offer great fodder.

But I was disappointed to hear one of the authors argue at a recent private equity conference that larger buyout funds are lower returning but less risky than smaller buyout funds. The data behind this claim is represented in the following graph.

HOW DOES THE GROSS FUND PME DISTRIBUTION CHANGE WITH FUND SIZE?



	Smallest	2nd	3rd	Largest
Mean PME	2.14	1.98	1.74	1.76
SD	1.23	1.00	0.87	0.66
Mean Fund Size	99.8	292.0	688.6	3042.0

Note: PME ("Public Market Equivalent") is a metric that scales private fund performance to public market performance. PME of 1 equals public market performance. Higher than 1 is better than market. Lower is worse.

Does this data support the idea that larger funds are safer?

- In the context of investing in a single fund, **there are hints it might, but the case is weak**. The 2nd quartile (2nd smallest) is the safest in terms of 10th percentile PME; the Largest quartile falls in second place. The Largest funds have the lowest standard deviation, but it's unclear that this demonstrates lower risk. [Footnote 1 explains why]

- In the context of a multi-fund portfolio, which is what really matters, the answer is **no**.

In fact, a portfolio of the Smallest funds is not only superior to the Largest funds in terms of return and risk, but the safety can be achieved while investing in the same number of underlying deals via small funds versus large funds, thus preserving upside.

A bit of analysis makes this clear.

The Smallest funds make 10 investments per fund on average, while the Largest funds make 21 investments per fund. So let's consider an investment in two of the Smallest funds versus one of the Largest funds. Both cases give you roughly 20 underlying deals.

[Important Side Note: Given the higher level of deal concentration among smaller funds, it is amazing that the 10th percentile PMEs are so similar between the Largest funds and Smallest funds. The Smallest funds must be making better investments and/or investments that are not highly correlated with each other, which is a key to risk reduction.]

Which would be the better strategy?

So long as the PMEs of the two funds selected from the Smallest group are not highly correlated with each other, and it is unlikely they are [Footnote 2 explains why], the answer is:

	2 of Smallest Funds	**1 of Largest Funds**
Median PME (Unchanged)	1.79 BETTER	1.62 WORSE
Mean PME (Unchanged)	2.14 BETTER	1.76 WORSE
Risk of PME Less than 1.05	Less than 10% BETTER	10% WORSE

1 Standard deviations can be extremely misleading when comparing distributions with different medians and different skews. In the distributions above, higher SD does not make a clear case for greater risk because (a) the higher median of the smaller funds creates protection against negative outcomes; and, (b) for smaller funds, variations from the median skew significantly towards the positive side, so the higher SD is actually helpful. This helps explain why the 10th percentile PMEs are so similar across the four quartiles, despite large differences in SD. The Braun slides imply that the extreme portion of the left tail may be worse for smaller funds, though the data is not provided. If true, that would make investing in a single small fund potentially more risky than a single large fund, but in the context of investing in multiple small funds, the remote risk of investing in one poor performer is likely offset by the higher returns of the others.

2 Since PMEs already control for market performance, PMEs within the same vintage tend to be quite dispersed, as can be seen in Table IV here. Also, undesirable correlation can be avoided by not choosing funds focused on identical sectors or managed by the same manager.

The CONCLUSION: Investing with smaller managers represents an opportunity that is higher return AND lower risk than investing with larger managers.

The COROLLARY: If risk is what you care about, diversify more, don't switch to larger managers.

Milton Friedman said that there's no such thing as a free lunch. But choosing to build a portfolio out of smaller funds rather than larger ones seems awfully close for those who have the diligence resources and aren't too large in the amount of capital they need to deploy.

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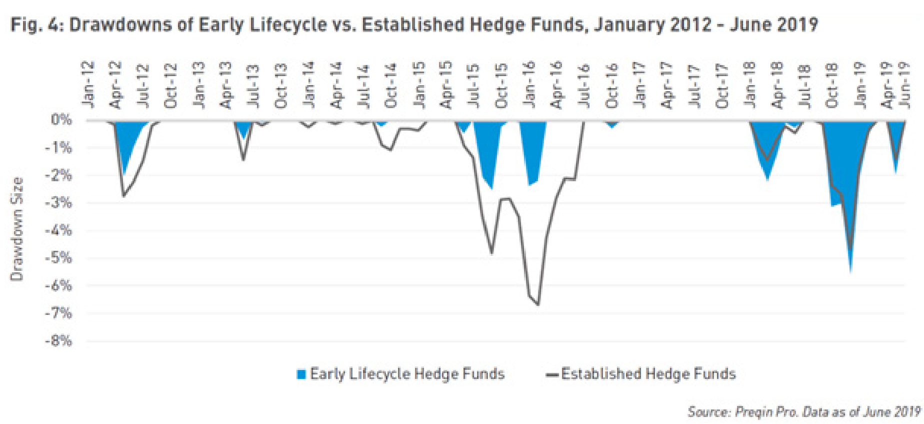
I'll save for another day a lengthy write-up about how the same phenomenon applies to hedge funds. But there is substantial evidence that it does, especially when it comes to protecting capital during crises.

Here is one paper worth reading: [Are Investors Better Off with Small Hedge Funds in Times of Crisis?]

And a 2019 Preqin study shows this visually:



While we have no crystal ball, I strongly suspect that the next crisis will be more of the same. The universe of large hedge funds is becoming increasingly dominated by "multi-strat" hedge funds that primarily earn their returns through low-returning relative value trades that they turbo-charge with substantial leverage.

Multi-strat hedge funds [have grown in AUM from under $400bn in 2011 to over $800bn in 2022 according to the FT], and the press coverage has been highly correlated with recent returns (i.e. glowingly positive).

But history and common sense tell us that these behemoths are hardly too big to fail.

One of the greatest finance books I have ever read, [When Genius Failed], chronicles the blow-up of Long Term Capital Management. [Note: I can't believe that book is 22 years old!]

2006 brought us the [failure of Amaranth, a (then giant) $9.2bn multi-strat](#).

And in 2008 the [now high-flying Citadel lost 55% of its capital and nearly went under](#).

Today, public disclosures allow us to track the nominal leverage of the large multi-strats. Here are three of the most watched:

Multi-Strat Nominal Leverage as of 12/31/22

	Net Assets ($bn)	Regulatory Assets Under Management ($bn)	Nominal Leverage
Millenium	58	391	6.8x
Citadel	52	339	6.6x
Point72	27	140	5.1x
	136	870	6.4x

In an age when prominent large funds are making aggressive use of leverage, the small funds we know are investing much more conservatively. 6x nominal leverage should give any investor pause, in my opinion. If the familiarity of the fund name makes you comfortable, don't trust your gut!

[Hat tip to Seth Stephens-Davidowitz for his assistance and his fantastic book [Don't Trust Your Gut](#) that inspired much of this article.]

NEWSLETTER
From Star to Founder
Insights from partnering with exceptional investment managers as they launch and build new firms

Published by **Adam Shapiro**
Managing Partner @ East Rock Capital, LLC | Generational Wealth Manager

EastRock

65 East 55th St, 33 Fl
New York NY 10022

T 212 630 5000
F 212 624 0231
info@eastrockcap.com