THE GLOBE AND MAIL

Why smaller funds often are the outperformers

KEVIN FOLEY
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Our Napa Valley shuttle driver offered a surprising insight: "You've chosen all the big wineries but not necessarily the best wines or the most memorable experiences. May I suggest a few lesser-known producers where you'll taste the difference and appreciate their craft?"

He was absolutely right, and like wine, the best investments are often made by off-the-beaten-path producers. Yet even in this environment - where truly intriguing investment opportunities are scarce - many investors continue to default to the familiar brands and large funds, despite strong evidence pointing elsewhere.

Why smaller managers win

Research shows that small and emerging fund managers often outperform the large, household name peers, across asset classes, by a significant margin and with less risk.

A recent Morningstar report compares ten years of risk and return data for five of the largest fixed income funds in Canada to five funds from smaller but established Canadian FI managers. The report shows that the smaller funds outperformed by more than 3 per cent per year, on average, with similar volatility, higher risk-adjusted return, and better protection in down markets. Its results reinforce this 2023 Morningstar article.

A 2024 PitchBook Analyst Note: Establishing a Case for Emerging Managers, concluded that "the top emerging managers in multiple strategies can offer higher upside potential than tried-and-true firms." The report examines performance trends across buyout, venture, real estate, and private debt funds.

Similarly, a 2023 Axios article titled Smaller venture funds continue to outperform the largest ones cites a U.S. study of almost 1,400 venture capital funds from 1979-2018, using PitchBook data. A BeachHead study calculates that "small funds outperformed large funds by 254 basis points annually over 5 years, and 220 basis points over 10 years."

Further, a 2020 article in Institutional Investor titled "Large Managers Get the Money, but Small Managers Provide the Performance" discusses how large managers end up producing beta (volatility versus a benchmark) while smaller managers have better opportunities to find alpha (excess returns versus a benchmark), yet the larger ones are still more likely to raise capital.

Certainly not all smaller funds outperform, and not all the time. But more than enough of them, in Canada and globally, across asset classes, with sufficient frequency, can offer an edge. The track record of enough smaller funds and fund managers, in Canada and globally, supports the proposal that they can improve investment portfolios.

In our search for alpha, we gravitate to the largest managers when sometimes we should be looking to the smaller, nimbler ones.

The issue with bias

There are two main reasons why this opportunity for outperformance isn't better known, and one subtle nuance.

Reason #1: Visibility isn't performance

Smaller managers lack the stature, brand equity, and marketing budgets of their large competitors. Yet many offer similarly registered investments and operate under the same regulatory standards, while delivering superior results with demonstrable track records. Market awareness, not quality or opportunity, limits their asset growth.

Reason #2: Familiarity Breeds Comfort

We all know the large fund companies and banks. Their visibility gives us comfort: the conferences, the reports, the branded swag. But this halo effect dulls our critical thinking. Even when these big names underperform, we give them the benefit of the doubt while overlooking better-performing yet lesser-known managers.

The nuance: Structural inertia

Consultants, advisers, outsourced investment management, and institutional allocators often stick to big names due to business model constraints. Their fee structures, scalability needs, and capacity limitations make it hard to research or deploy small and emerging managers, even when they want to.

Further, they can fall victim to the erroneous adage that underperformance by a large, established manager is acceptable. Ironically, these forces entrench the bias further, reinforcing the asset under management dominance of underperforming incumbents.

What can we do?

Most worthwhile small and emerging managers have properly registered funds with enviable track records, conveniently available on Fundserv and across most bank shelves. Yet they're neglected by our outdated allocation process and our bias for familiarity and scale.

Redesigning your process

To capitalize on this opportunity, consider broadening your due diligence scope. Ask your adviser for both known and lesser-known fund options. Seek managers who provide transparency, focus, and alignment. Find the managers who can exploit opportunities that are too small for the giants.

Look for:

1. Strong alignment of interests and skin in the game. Smaller managers tend to own their firms and/or have high employee ownership.
2. Targeted strategies with a defined edge. Smaller managers have the luxury of focusing on a specific and often small themes or anomalies that are just too small for large managers to exploit sufficiently - so they skip it, leaving valuable opportunities for smaller managers. You want that relative value opportunity in your portfolio, and you need to explore the smaller managers to get it.
3. Smaller size allowing nimbleness and alpha capture
4. Sufficient runway for growth without style drift
5. More transparent, collaborative relationships

A Word for the Allocators

A recent foundation RFP process revealed the limitations of many "open architecture" firms, where in practice they rely upon a shockingly short list of large managers. Meanwhile, "closed architecture" advisors excluded external funds entirely, negating this small and emerging manager opportunity.

The issue isn't a lack of desire to perform, but logistics: cost of manager coverage, lack of scalability, and percentage of ownership rules. But here lies the opportunity.

These large allocators could improve returns by:

- Building distinct small-manager pools
- Launching fund-of-fund sleeves
- Creating hybrid sleeves, enabling the smaller-fund additions to complement their larger funds

This approach could enhance returns and diversify exposures, and it could even reverse the unfortunate reputation for “good governance, weak returns”. It might also provide a welcome solution to the trend of competing on fees alone.

Outperformance awaits

We crave bespoke experiences in most areas of life. Yet when it comes to investing, we often choose the big and well-known.

That comfort comes at a cost.

The return, diversification, and risk mitigation opportunity with smaller and emerging managers is well-documented, underutilized, and ripe for exploitation.

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THE GLOBE AND MAIL

Digging deeper on why smaller funds can often outperform. (part 2)

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"Money flowing to managers that are so large means that their approach will be more beta than anything else, and their returns will be restricted," says PivotalPath CEO Jon Caplis in an Institutional Investor article. "Smaller managers will get smaller and smaller on a relative basis, but they'll be able to generate unique performance and do interesting things....The bigger guys can't do it, but they can raise more capital."

In our previous piece, *Why smaller funds often are the outperformers*, we established that smaller funds and fund managers offer coveted opportunities for outperformance. Yet, despite this, large managers tend to dominate asset growth.

In this follow-up, we dig deeper - highlighting the mechanics and behavioral elements that can give smaller managers a distinct edge. If you're building or advising on a portfolio, this is a framework to reconsider smaller funds in your capital allocation.

Let's start with a reminder: access to smaller funds is typically no more complex than with large ones. Most are readily available on standard platforms and are offered in the same prospectus or offering memorandum formats. Now let's dig into the differentiators.

Skin in the game

Smaller managers often have high employee ownership - in the firm and in the funds. That alignment creates urgency, care, and a direct line between decision-making and outcomes. It also creates inherent cost control. These managers know that performance, not marketing, drives growth, and that they *need* that growth to survive and thrive.

Fund structure and niche expertise

Smaller funds tend to be built around a clear, defined edge: a sector (student housing), an asset class (investment-grade credit), or even a strategy type (music royalties). This clarity of purpose often enhances both due diligence and performance. A good example:

a corporate credit fund that removes interest rate risk entirely, run by a manager with deep credit experience, cultivated market access, and a proven track record.

Tools

Larger funds often stick with long-only exposures, sometimes mirroring benchmarks. Smaller funds are more likely to embed tools like shorting, hedging, leverage, and derivatives - creating opportunities for better precision and performance. They often benefit from the efficiency of a prime broker. Crucially, these tools are applied within a strategy-specific context, not solely for directional bets or to mimic an index as many larger funds often do. These additional tools equip the smaller manager to be more prescriptive and nimbler.

Benchmarks, as tools, not targets. Bigger opportunity set.

Many smaller managers use benchmarks for reference but not for replication, while many of the larger funds hope to simply beat a benchmark by 50 basis points, even if that is a negative return. By aiming for the best exposures within a strategy, rather than largely mirroring an index, the smaller managers create natural opportunity for outperformance. They select these opportunities from a larger pool, which is often less researched and undervalued. These select exposures also introduce desirable uncorrelated returns and often better total portfolio risk outcomes.

Absolute return

This topic overlaps with benchmarking above. Many smaller funds are established to be absolute return focused, meaning that they plan to produce positive returns in all market environments, not simply deliver the index. Absolute return frames fund manager risk and thought process, tending to produce lower volatility and lower correlation, and stabilization, which are all great for portfolios. Thoughtful security selection and position sizing reflect a deep commitment to capital preservation and compounding.

Active management

Without the constraint of benchmark mirroring, small active managers can make high-conviction calls, trim risk, and rotate quickly. Their fund structures are often designed to facilitate agility - allowing them to move in and out of positions that large funds might not be able to meaningfully access or position effectively for their portfolio size. These curated exposures differentiate small manager agility, when on offence or defence. Too often, active management in large funds is inherent housekeeping in lieu of productive portfolio management.

Runway

As large funds grow, style drift can become an issue. Smaller managers, still within their optimal capacity zone, can stay true to their investment thesis and position sizing discipline. They don't need to expand mandates to accommodate inflows. Sufficient runway bolsters effective active and absolute return efforts.

Position size, flexibility, and agility

Building on the point above, yet worth differentiating, smaller funds can act on compelling opportunities that are too small for large managers to consider – resulting in less competition. They can often accomplish this without moving market prices meaningfully. This agility, both in entering and exiting positions, often leads to better execution, a smoother path, and higher potential return.

Alpha Capture

Alpha is the generation of excess return, adjusted for risk. While alpha is elusive, many of the structural elements discussed here make repeatable alpha more likely for the smaller funds and fund managers. As noted in the previous article, data supports the idea that smaller funds can outperform - even after accounting for risk.

Freedom and transparency

Finally, smaller funds often come with fewer clients, more direct communication, less benchmark constraint, greater transparency, less internal politics, and stronger client engagement and alignment. This means better-informed investors, leading to more effective portfolio design. In practice, a fund manager should care as much about their first investor as their next investor.

This article isn't an argument against large funds. They serve an essential role, but their dominance is unfortunate. The full investing landscape is richer when smaller funds are given their due consideration. For many portfolios, a combination of large and small mandates can offer the best of both worlds: broad exposure plus high-conviction, alpha-generating managers who are invested.

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INVESTMENT EXECUTIVE

Adding the value of small managers

An argument for doing business with smaller asset management firms, and how to get from here to there.

Kevin Foley, YTM Capital, August 21, 2025

The question facing Canadian financial advisors is no longer why smaller funds matter but how to put them to work in client portfolios.

Evidence has shown that smaller funds often outperform larger peers — frequently with similar or even lower risk. They bring unique structural and behavioural advantages: niche expertise, greater agility and the freedom to invest differently.

For investment advisors ready to move from theory to practice, there are established best practices behind the prudent implementation of allocations to smaller funds and fund managers.

Valuable business development considerations

In crowded markets where large managers pile into the same trades, smaller funds remain one of the few areas where genuine alpha is still achievable — often with exposures uncorrelated to core portfolio holdings and less risk.

These smaller managers are likely to enhance performance, diversify risk and expand your toolkit. They can provide advisors with competitive differentiation. Most portfolios look remarkably alike because they source from the same limited manager universe. A purposeful allocation to smaller funds can set your results and manager recommendations apart, something that clients will appreciate.

And smaller managers have skin in the game. Your allocation can be a relationship, not just a transaction. That can translate into better access, through separately managed accounts, niche strategies, co-investment opportunities and priority on capacity or partnership arrangements.

Allocating with purpose

A structured, consistent approach will neutralize many of the perceived risks associated with non-household-name managers. More importantly, this will position you to capture the performance and diversification benefits that smaller funds can deliver — while enhancing your value as an advisor.

Step 1: Clarify your thesis. Define why smaller funds belong in your recommendation set — as alpha generators, diversifiers or risk mitigators. Be explicit: absolute return, lower correlation, specific sector expertise or targeted volatility reduction.

Step 2: Expand your sourcing pipeline. Move beyond the usual large-manager databases. Consider firms like Global Manager Research, industry associations such as the Canadian Association of Alternative Strategies & Assets, relevant conferences, curated LinkedIn groups, peer networks and referrals.

The best opportunities often come through non-traditional channels. They are out there.

Step 3: Adapt due diligence for scale. Maintain standards but flex your process. Smaller managers may not present data in your preferred format immediately. But the good ones have robust information, strong track records and deep expertise.

Credentials matter. For example, a former corporate bond market-maker with both chartered accountant and chartered financial analyst designations may run a proven credit fund worth considering.

Step 4: Right-size allocations and mandates. Structure allocations meaningful to managers but aligned with your client's risk profile and liquidity needs.

Consider scaling in over time. Prioritize differentiated managers with niche advantages and explore creative structures such as revenue sharing in select mandates or opportunistic co-investments.

Step 5: Integrate into governance. Document your smaller-manager strategy. Establish reporting and transparency requirements up front.

Review liquidity terms, gating, valuations, subscription mechanics and distribution policies. Commit to regular reviews, site visits and commentary assessments to manage risk effectively.

You don't have to overhaul your entire process to benefit from including smaller funds.

Five approaches

This is not an exhaustive list, but in terms of the mechanics of bringing on a smaller asset manager, consider these tactics.

1. Complement or replace an existing holding. Swap part of a traditional allocation with a smaller fund that has delivered persistent outperformance with equal or lower risk. Five per cent more per year in fixed income, for example, is a lot.

2. Target an absolute return allocation. Strengthen risk/return by inserting a smaller manager with complementary characteristics and demonstrable absolute return benefits.

3. Bolster alternatives. Slot smaller funds into the 20%–30% alternatives allocation when they serve a defined role.

3. Create a dedicated sleeve. Package smaller fixed income, hedge or venture funds into dedicated sleeves to capture alpha while diversifying risk.

4. Pilot through small carve-outs. Gain experience with a new manager with a 1%-2% allocation before scaling. Done correctly, these strategies are likely to deliver value, for you and your clients, no matter the market conditions.

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