10-2013

Hedge Fund Managers who Eschew Asset Gathering

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Citation

Teo, Melvyn. 2013 October. Hedge Fund Managers who Eschew Asset Gathering. *Hedge Fund Insights*, 2-8.

BNP Paribas Hedge Fund Centre Hedge Fund Insights

Contents

Mission of the BNP Paribas Hedge Fund Centre

The mission of the BNP Paribas Hedge Fund Centre is to facilitate, encourage, and sponsor high-level academic research on hedge funds. The Centre also provides outstanding education to students, executives, and investors, and publishes objective and independent information on hedge funds, while promoting understanding and awareness of alternative investment strategies. Through excellence in research on alternative investments, the Centre is recognized for its capacity to foster stimulating exchange of opinions, and to develop a knowledgeable and objective information base regarding hedge funds.

Specifically, the primary objectives of the BNP Paribas Hedge Fund Centre at the Singapore Management University are to

1. conduct and disseminate high quality academic hedge fund research
2. educate finance practitioners and the investor public on hedge funds, and
3. raise the profile of the hedge fund industry in Asia and Singapore

To achieve these goals, the Centre will collaborate closely with academics at the London Business School. Moreover at all times, the Centre is absolutely committed to the highest ethical conduct and will actively avoid any conflicts of interest with outside parties.

Hedge fund managers who eschew asset gathering

Melvyn Teo[1]

Executive summary

Fund managers may eschew financial rewards for the non-pecuniary benefits from investment management. They may be highly focused on leaving a legacy of stellar returns when they retire and prefer to preserve their ability to generate those returns by staying small. Others may prefer to run small firms so as to devote more of their time and energy into investment activities as opposed to managing people. We empirically zero in on such managers by focusing on funds that have delivered superior returns but do not take advantage of their stellar performance track records to grow capital aggressively. We find that such funds generate alphas that are 5.41 percent per year greater than those generated by funds in the same past performance cohort that take advantage of their track records to raise capital. Our findings cannot be explained by size, fee, or redemption term differentials.

What motivates hedge fund managers? Clearly many are driven by financial rewards. Such managers typically will want to grow their firms' assets under management swiftly so as to maximize fee revenue. Fung, Hsieh, Naik, and Teo (2013) show that such fund managers may find it expedient to leverage off the performance of a successful flagship fund and raise multiple follow-on funds at favorable terms. Yet there may well be other fund managers who eschew financial rewards for the non-pecuniary benefits associated with fund management. These fund managers may care deeply about leaving a legacy of stellar returns when they retire from the asset management world. They may be driven by a love for investing and prefer to spend most if not all of their time on investment activities as opposed to raising capital and managing the firm. Such fund managers may have held senior management positions at bulge-bracket investment banks and have experienced first-hand the agency problems associated with large bureaucracies. These fund managers will be loathed to grow assets too much beyond critical mass. Not only does size tend to crimp fund returns and make it harder to generate a return track record that one can be proud of, but with greater assets under management fund managers will typically have to spend more time managing people and less time investing, an outcome that they would rather avoid.

In this issue of the hedge fund insights, we explore the possibility that some fund managers eschew asset gathering for the non-pecuniary benefits associated with fund management. To zero in on these fund managers, we focus on the subset of fund managers who can grow assets under management substantially given their impressive performance track records, but do not. Our analysis centers on data obtained from the TASS, HFR and BarclayHedge databases and on the 1994-2010 period. We merge these databases by hand

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using fund name. After removing duplicate share classes, the sample includes 17,193 funds of which 11,127 stop reporting by the end of the sample period, leaving us with 6,066 live funds at the end of the sample period. Of the funds in our combined sample, 4,211 funds are unique to TASS, 4,229 are funds unique to HFR, and 5,496 are funds unique to BarclayHedge. Some firms may opt to grow capital by raising many funds as opposed to growing fund aum. To sidestep such issues we only focus on the set of funds whose management companies do not manage other funds.

As a prelude to understanding the return characteristics of the subset of funds that eschew asset gathering, we first sort the funds in our sample every January 1st into five portfolios based on past two-year Fung and Hsieh (2004) alpha. The Fung and Hsieh (2004) factors include the S&P 500 factor (SNPMRF), the size factor (SCMLC), the term spread (BD10RET), the default spread (BAAMTSY), and trend following factors for bonds (PTFSBD), foreign exchange (PTFSFX), and commodities (PTFSCOM).

Table 1 reports the alpha from this quintile sort on past fund alpha. Consistent with the view that hedge fund managers do possess investment skills, we find that hedge fund performance persists after adjusting for risk. In particular, the out-of-sample alpha spread between the high past alpha portfolio (portfolio 5) and the low past alpha portfolio (portfolio 1) is an economically meaningful and statistically significant 5.93 percent per year (t-statistic = 3.12). Given their impressive track records, we argue that funds belonging to portfolios 4 and 5 clearly have the option of raising significant capital.

Table 1: Sort on past fund alpha

	Portfolio 1 (low past alpha)	Portfolio 2	Portfolio 3	Portfolio 4	Portfolio 5 (high past alpha)	Spread (5-1)
Annualized	2.49	3.89	3.81	4.37	8.41	5.93
7-factor Alpha	(1.88)	(4.07)	(4.36)	(4.17)	(5.34)	(3.12)

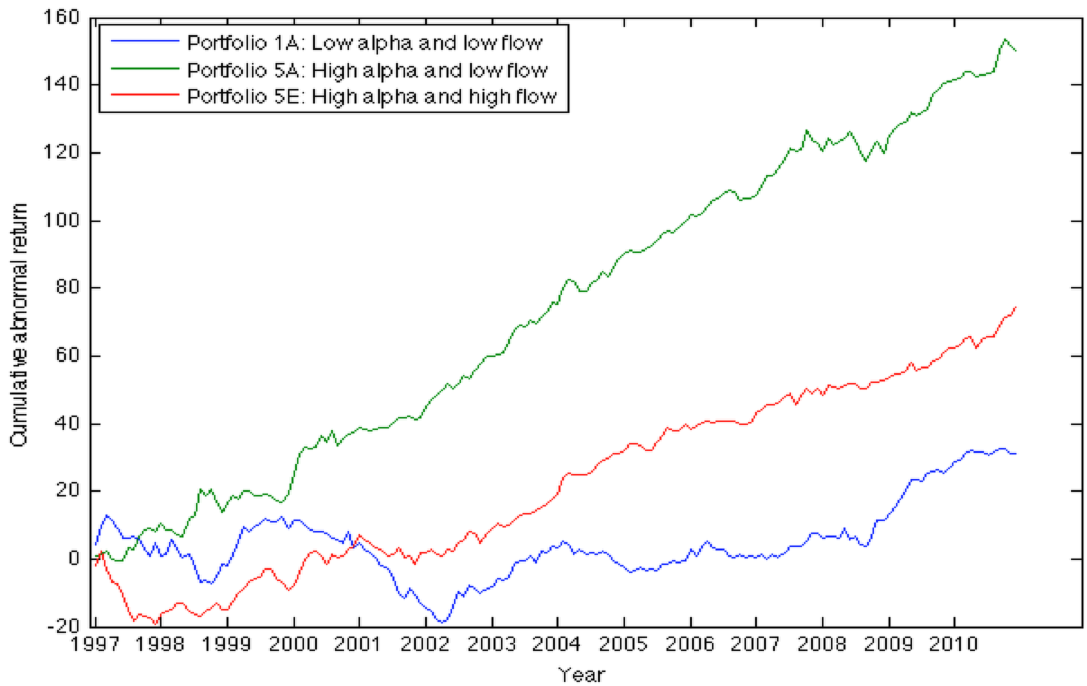
What happens when they do not exercise this option? To zero in on the funds with eschew capital raising, we sort funds first by past two-year alpha and then by past two-year net inflows, and report the portfolio alphas from this double sort in Table 2. We find that the high past two-year alpha funds who raising relatively little capital over the same period tend to outperform other funds within the same past performance group. Specifically, Portfolio 5A delivers an impressive annualized alpha of 10.72 percent. This is 5.41 percent greater than that generated by the corresponding high inflow portfolio in the same performance groups, e.g., Portfolio 5E. Clearly, funds that eschew capital raising are interesting from an investor standpoint precisely because they deliver superior returns in the out-of-sample period.

Table 2: Double sort on past fund alpha and fund flows

	Portfolio A (low past flows)	Portfolio B	Portfolio C	Portfolio D	Portfolio E (high past flows)	Flow spread (A-E)
Portfolio 1	2.23	4.18	2.63	0.28	2.82	-0.59
(low past alpha)	(1.12)	(2.1)	(1.19)	(0.11)	(1.25)	(-0.20)
Portfolio 2	4.56	6.74	3.92	4.13	1.29	3.27
	(2.13)	(4.26)	(2.83)	(2.79)	(0.96)	(1.44)
Portfolio 3	5.46	4.26	5.05	3.48	1.65	3.81
	(3.28)	(3.38)	(3.5)	(2.29)	(1.34)	(2.03)
Portfolio 4	7.00	5.68	4.30	3.39	1.94	5.05
	(4.01)	(3.61)	(2.62)	(2.51)	(1.52)	(2.69)
Portfolio 5	10.72	9.97	8.79	7.00	5.31	5.41
(high past alpha)	(5.51)	(4.15)	(3.08)	(3.07)	(3.15)	(2.40)
Alpha spread	8.49	5.78	6.16	6.72	2.49	
(5-1)	(2.99)	(1.84)	(1.71)	(2.16)	(0.93)	

Figure 1 illustrates the performance of some of the extreme portfolios from the double sort in Table 2. It indicates that funds with impressive past alpha who can but do not engage in aggressive capital raising, i.e., funds in Portfolio 5A (depicted by the green line), tend to outperform funds belonging to the other extreme portfolios.

Figure 1: Returns of extreme portfolios from double sort on past fund alpha and flows



Prior studies on performance persistence have shown that the alpha t-statistic by scaling alpha by its standard error may be a better measure of fund manager investment skill. See, for instance, Kosowski, Naik, and Teo (2007). Therefore we redo the performance sort and the double sort using past two-year alpha t-statistic instead of past two-year alpha. The results, shown in Tables 3 and 4 and Figure 2, are qualitatively similar when we use high past alpha t-statistic as an indicator of the ability to raising capital. In particular, funds that are able to substantially raise capital but do not choose to do so (Portfolio 5A) deliver an annualized alpha of 9.29 percent per year, outperforming all other fund portfolios in the double sort in Table 2.

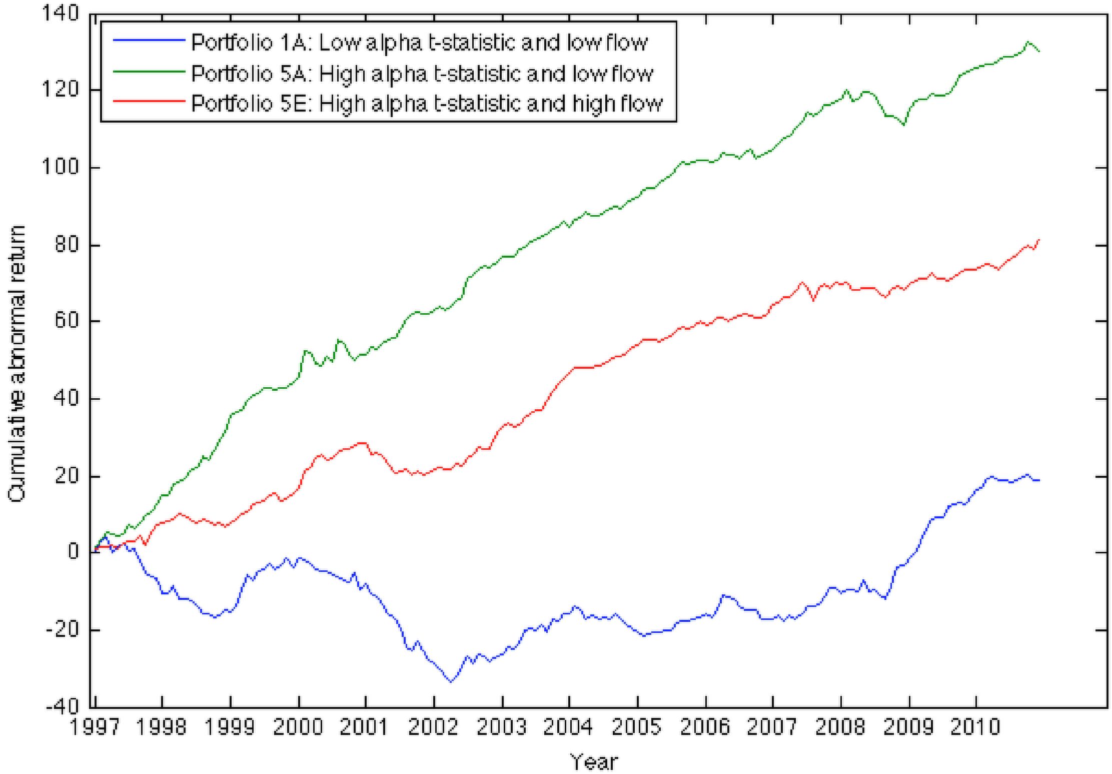
Table 3: Sort on past fund alpha t-statistic

	Portfolio 1 (low past alpha tstat)	Portfolio 2	Portfolio 3	Portfolio 4	Portfolio 5 (high past alpha tstat)	Spread (5-1)
Annualized	2.43	4.9	4.45	4.41	6.73	4.29
7-factor Alpha	(2.05)	(3.99)	(3.67)	(3.78)	(7.32)	(3.16)

Table 4: Double sort on past fund alpha t-statistic and fund flows

	Portfolio A (low past flows)	Portfolio B	Portfolio C	Portfolio D	Portfolio E (high past flows)	Flow spread (A-E)
Portfolio 1	1.36	2.92	2.68	2.59	2.72	-1.37
(low past alpha tstat)	(0.78)	(1.65)	(1.38)	(1.08)	(1.26)	(-0.52)
Portfolio 2	5.23	8.4	3.91	4.08	3.02	2.21
	(2.1)	(3.84)	(2.25)	(1.99)	(1.74)	(0.71)
Portfolio 3	7.33	5.95	5.41	4.31	-0.18	7.51
	(4.03)	(2.94)	(3.28)	(1.93)	(-0.11)	(3.43)
Portfolio 4	4.37	7.69	5.56	4.08	0.31	4.05
	(2.5)	(5.48)	(2.72)	(2.07)	(0.19)	(1.80)
Portfolio 5	9.29	6.97	5.67	5.13	5.80	3.49
(high past alpha tstat)	(7.00)	(5.09)	(3.93)	(3.62)	(5.25)	(2.32)
Alpha tstat spread	7.93	4.05	2.99	2.55	3.08	
(5-1)	(3.76)	(1.79)	(1.21)	(0.97)	(1.38)	

Figure 2: Returns of extreme portfolios from double sort on past fund alpha t-statistic and flows



Why do hedge funds that eschew asset gathering outperform other funds? Is it simply because they are smaller than other hedge funds and therefore more nimble and better able to take advantage of a wider range of investment opportunities in the markets? To understand the potential driver or drivers of the outperformance, we estimate regressions on hedge fund alpha and include and independent variables past 2-year fund flow, past 2-year fund alpha, the natural logarithm of fund size, as well as other variables that may be able to explain fund performance. The coefficient estimates are reported in Table 1. We find that across a variety of regression specifications, low past fund inflows are associated with high fund alpha even after controlling for fund size. This indicates that the superior risk-adjusted performance of funds that avoid raising capital cannot be fully explained by their presumably smaller size.

Table 1: Regressions on hedge fund alpha

Independent variables	Dependent variable Fund monthly alpha		
past 2-yr mean monthly alpha	0.183	0.204	0.201
	(5.41)	(6.10)	(6.03)
past 2-yr mean monthly flow	-1.844	-1.552	-1.629
	(-3.52)	(-3.03)	(-3.11)
log(AUM)		-0.036	-0.035
		(-2.54)	(-2.41)
Management fee (%)			0.026
			(0.53)
Performance fee (%)			0.006
			(1.61)
Redemption period (months)			-0.002
			(-0.28)
Year dummy	No	Yes	Yes

Indeed the results in Table 1 are not surprising given the characteristics of the funds in Portfolio 5A (high past alpha, low past flows). The average AUM for Portfolio 5A funds is US$39.79m, which is actually higher than the average AUM for funds in Portfolio 5 (high past alpha). Therefore, size cannot explain the higher alpha of Portfolio 5A funds relative to the other funds in Portfolio 5. Moreover the average management fee (1.50%), performance fee (19.54%), and redemption period (3.39 months) for funds in Portfolio 5A are also not significantly different from that for funds in Portfolio 5.

How else can we explain the outperformance of fund managers who eschew asset gathering? One view is that these fund managers by devoting more of their time and energy into investment activities as opposed to fund raising are better positioned to deliver stellar returns. Moreover, their reluctance to capitalize on a bout of good performance and aggressively grow assets under management suggests that these fund managers value investment performance above everything else. It is not surprising therefore that they deliver on that which they prioritize.

Conclusion

The findings in this research piece underscore the importance of managerial motivation to the performance of the fund. It also alludes to the potential organizational diseconomies of scale that afflict the hedge fund industry. Managers that eschew asset gathering judiciously avoid such agency issues by maintaining a streamlined organization structures that allow them to focus on investment activities. Indeed, it is perhaps ironic that investors who wish to maximize their financial well being are best served by managers who eschew financial rewards for the non-pecuniary benefits associated with running an asset management firm. Naturally, the twin challenges for investors are finding such managers and persuading them to accept new capital.

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Update on the Centre's Activities

Education

Our annual hedge fund conference was held in the morning of 18 October 2013. The speakers for the event included Chris Gradel from Pacific Alliance Group, Owi Ruivivar from Goldman Sachs, Wong Kok Hoi from APS Asset Management, and Professor Melvyn Teo from SMU. Topics discussed at the conference included the impact of the anticipated Fed tapering on capital markets, the sustainability of China's economic growth story, the efficacy of Abe's third arrow, and the effects of the increased regulatory scrutiny and compliance costs on the hedge fund industry. 250 people registered for the conference including 166 practitioners.

For more information regarding the BNP Paribas Hedge Fund Centre at SMU and our upcoming activities, please contact Ms Karyn Tai, centre coordinator (Tel: +65-6828-0933, E-mail: hfc@smu.edu.sg) or visit our webpage at http://www.smu.edu.sg/centres/hfc/index.asp. We look forward to receiving your suggestions and comments.