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Asset Gathering by Hedge Fund Firms

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Newsletter of the BNP Paribas Hedge Fund Centre at SMU

Summary

- Mission of the BNP Paribas Hedge Fund Centres
- Asset Gathering by Hedge Funds Firms by Melvyn Teo
- Update on the Centre's Activities

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.

Asset Gathering by Hedge Fund Firms

Melvyn Teo[1]

Abstract

We explore agency issues within hedge fund firms. We find that firms that launch many funds tend to underperform other firms by between 3 to 5 percent per year after adjusting for risk. These findings are strongest for firms offering funds that pursue many distinct strategies, invest in a variety of geographical regions, locate in a gamut of countries, and offer different base currencies. Our results allow fund investors to distinguish, ex-ante, firms that focus on delivering alpha from those that focus on gathering assets.

As businesses, hedge fund firms constantly need to find the right balance between raising capital and preserving investment performance. For a firm, raising enough capital ensures that it has the critical mass to sustain operations. Critical mass allows it to spread out compliance, technology, and other fixed costs over a larger asset base as well as retain talent. However, firms that are too successful with raising capital often run into capacity issues that erode away performance. Moreover, the very act of raising capital may divert principals' limited time away from investment related activities, thereby potentially crimping investment performance.

Naturally, some firms gravitate towards asset gathering while others prefer to focus on investing. How do we differentiate the latter from the former? Clearly it is not enough to observe assets under management since that does not measure intent but merely the combined result of capital raising efforts, investment performance, and the fund raising climate. We therefore seek to understand firms via the choices that they make with regards to the number of funds, strategies, investment regions, countries, and base currencies offered. These metrics provide a sneak peek into the business minds of the principals operating hedge fund firms.

To facilitate the analysis, we first merge Barclayhedge, HFR, and Lipper Tass databases. These are some of the largest and most widely used databases in hedge fund research. The sample period extends from January 1996 to December 2010. In total, the combined database consists of 22,031 funds of which 13,778 funds stopped reporting returns at the end of our sample period. We note that the funds in our sample belong to 6,940 distinct fund families.

Do firms that launch many funds underperform other firms? Does the number of funds managed by a firm signal its intentions on the asset gathering front? Additionally, in previous work we find that firms tend to protect their flagship funds at the expense of other funds. If this behavior is detrimental to investors then we should find a negative relationship between the number of funds launched or managed by a firm and firm performance.

[1] Melvyn Teo is Professor of Finance and Director, BNP Paribas Hedge Fund Centre at the Singapore Management University. E-mail: melvynteo@smu.edu.sg. Phone: +65-6828-0735. This research is inspired by conversations with Bill Fung. We thank Narayan Naik for helpful suggestions and comments.

To investigate, each year we sort firms into five portfolios based on the number of funds that they have launched and hold these portfolios for a year.[2] As there are many firms with only one fund, we group those firms into portfolio 1 and sort the rest of the firms equally into the other four portfolios.[3] Next, we evaluate the returns of these five portfolios after adjusting for risk using the Fung and Hsieh (2004) 7-factor model. The risk adjustment is done by regressing the portfolio returns on the seven factors over the entire sample period. The results in Figure 1 and Table 1 accord with intuition. Firms that conceive many funds tend to deliver poorer risk-adjusted returns relative to firms that do not offer a host of funds to their investors. Relative to the firms in portfolio 1, firms in portfolio 5 (which have launched 7.64 funds on average) underperform by on average 2.46 percent per year before adjusting for risk and by 3.05 percent per year after adjusting for risk.

Figure 1: Firms sorted on number of funds

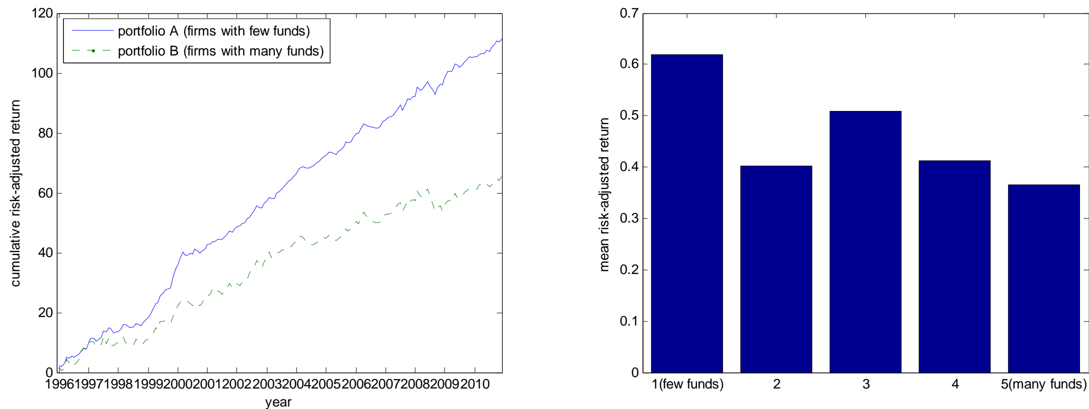


Table 1: Firms sorted on number of funds

Portfolio	Excess return (percent/ year)	*t*-statistic of excess return	Alpha (percent/ year)	*t*-statistic of alpha	SNPMRF	SCMLC	BD10RET	BAAMTSY	PTFSBD	PTFSFX	PTFSCOM	Adjusted R^2
Portfolio 1 (few funds)	8.39	5.63	7.43	8.63	0.24	0.15	0.03	0.10	-0.01	0.01	0.00	0.69
Portfolio 5 (many funds)	5.93	3.96	4.38	3.95	0.19	0.12	0.12	0.17	-0.01	0.01	0.00	0.48
Spread (1-5)	2.46	4.08	3.05	5.56	0.05	0.04	-0.09	-0.07	0.01	0.00	0.00	0.24

How do we further distinguish between firms that gravitate towards gathering assets from firms that prioritize performance? One way is to explore the impact on firm performance of firm

[2] We assume that funds conceived in the same month are share class duplicates. Inferences do not change when we sort based on the number of funds currently managed as opposed to the number of funds launched by the firm.

[3] Sorting the sample into five equal firm portfolios delivers similar, albeit less sharp, results.

attributes such as the number of strategies employed by the funds under management, the distinct geographical regions that those funds invest in, the countries in which those funds are based, as well as the number of distinct base currencies offered within the family. In an effort to gather assets, firms may over extend themselves by venturing into investment strategies and regions for which they do not have a comparative advantage. Other firms may launch many funds with different base currencies and in a variety of countries so as raise capital by catering to a diverse investment clientele.

Of course, some firms may have good reasons for offering many strategies, investing in diverse geographies and setting up funds in different locales. These firms may have investment skills that span a diverse set of strategies and regions. Other firms may choose to set up funds in other countries to capture the local informational asymmetries described in Teo (2009). One way to differentiate between firms that over extend themselves for marketing reasons is to condition on the number of funds launched or managed by the firm.

In that effort, we sort our sample of hedge fund firms into terciles based on the number of funds and then within each number tercile, we sort firms into terciles based on the number of distinct strategies, investment regions, countries, or base currencies offered. The results for the three by three double sort on the number of funds and strategies are reported in Figure 2 and Table 2. They indicate that conditioning on the number of funds and strategies is helpful in distinguishing firms that over extend themselves from other firms that do not. Firms that offer many funds and many strategies underperform firms that offer few funds and (relatively) many strategies by 5.03 percent per year before adjusting for risk and by 5.64 percent per year after adjusting for risk. In addition, Figure 2 indicates that much of the variation in performance across firms in Figure 1 is driven by the subgroup of firms that engage in a diverse set of investment strategies.

Figure 2: Firms sorted on number of funds and strategies

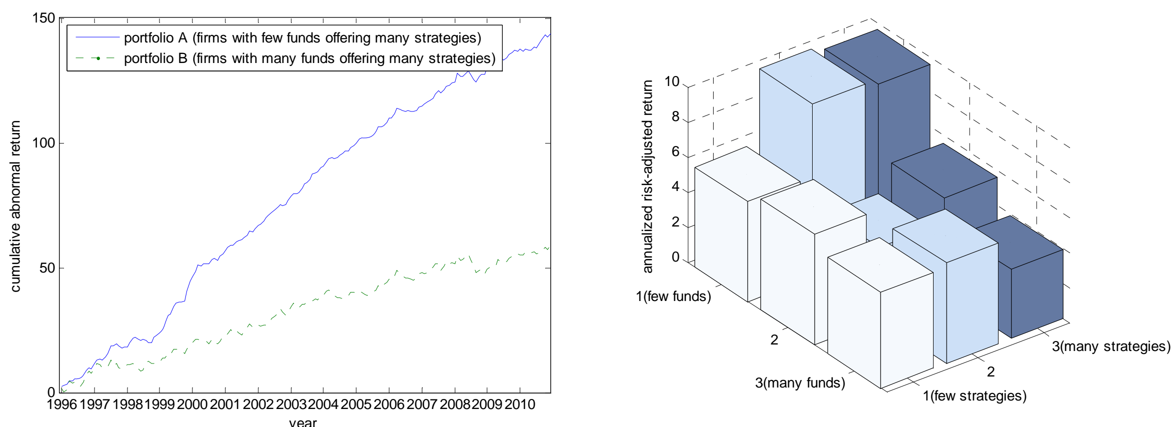


Table 2: Firms sorted on number of funds and strategies

Portfolio	Excess return (percent/ year)	*t*-statistic of excess return	Alpha (percent/ year)	*t*-statistic of alpha	SNPMRF	SCMLC	BD10RET	BAAMTSY	PTFSBD	PTFSFX	PTFSCOM	Adjusted R^2
Portfolio 3 (few funds, many strategies)	10.57	6.79	9.57	9.96	0.24	0.16	0.03	0.11	-0.01	0.01	0.00	0.65
Portfolio 9 (many funds, many strategies)	5.54	3.89	3.93	3.43	0.15	0.10	0.14	0.18	-0.01	0.01	0.01	0.40
Spread (3-9)	5.03	5.64	5.64	6.62	0.09	0.05	-0.11	-0.07	0.00	0.00	0.00	0.25

We obtain similar inferences when we explore the association between investment performance and the number of investment regions, countries, or base currencies, conditional on the number of funds. These results are evident from Figures 3, 4, and 5. For example, we find that conditional on investing in a variety of investment regions, firms with many funds significantly underperform firms with few funds. Likewise, conditional on having a presence in many countries, firms with many funds tend to underperform firms with few funds.

Figure 3: Firms sorted on number of funds and investment regions

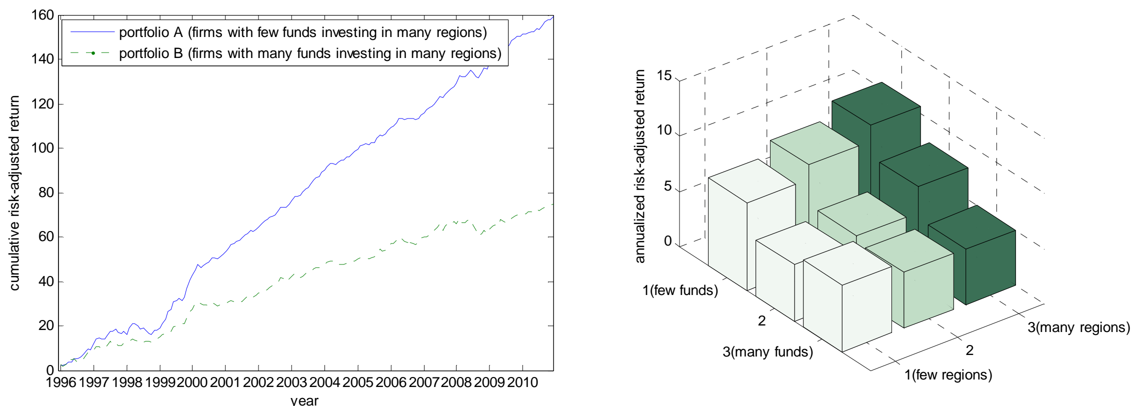


Figure 4: Firms sorted on number of funds and countries

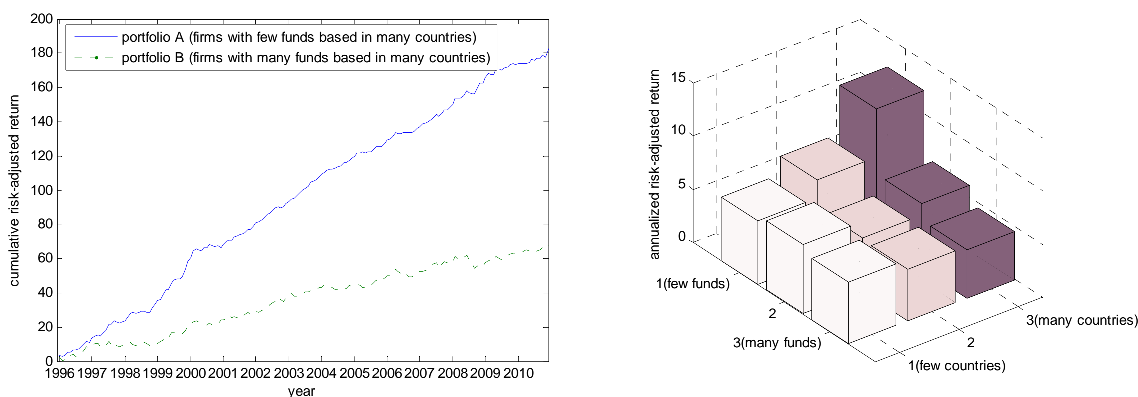
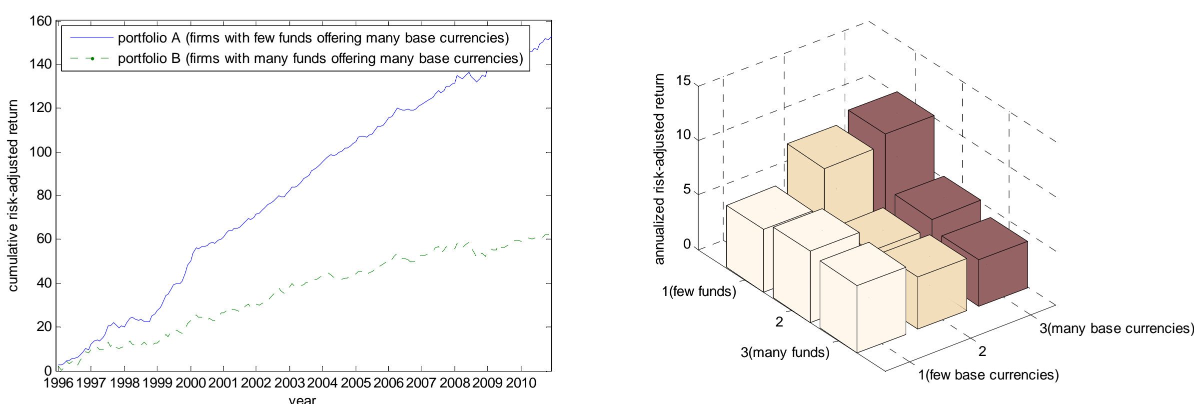


Figure 5: Firms sorted on number of funds and base currencies



Summary

Hedge fund firms are fundamentally business entities. Some focus on gathering assets while others focus on investment performance. We distinguish between these two groups of firms by analyzing the choices that firms make vis-à-vis the number of funds to launch, the strategies to pursue, the regions to invest in, as well as the number of base currencies to offer. By and large the empirical results accord with simple intuition and suggest that firms that launch many funds, engage in a diverse set of strategies, invest in a variety of geographies, set up in different countries, and offer various base currencies tend to over extend themselves in an effort to gather assets. These findings deepen our understanding of the industry and are particularly relevant for sophisticated fund investors. By eschewing firms that gather assets, hedge fund investors can increase their risk-adjusted returns by about 3 to 5 percent per year.

References

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Update on the Centre's Activities

Education

The centre ran a hedge fund executive education program from October 19-20. Practitioners from Pacific Alternative Asset Management Company, BNP Paribas Wealth Management, Barclay Wealth, Shinhan BNP Paribas Asset Management, the Monetary Authority of Singapore, NUS Endowment, and Marsh attended the program. The participants particularly enjoyed the HBS case study discussions, guest lectures by fund managers and Professor Bill Fung's lessons.

The centre organized a half-day hedge fund conference on October 21. The speakers included fund managers from Dymon Asia Capital, Fortress Asia Macro Fund, and Ortus, fund investors from Protégé Partners and JH Whitney, and academic Bill Fung. Professor Bill Fung presented research that showed about how the industry was becoming more concentrated while Danny Yong from Dymon Asia and Willy Ng from JH Whitney spoke about the changes to the Asian hedge fund landscape post-Lehman. The panel discussion centered on the challenges that hedge funds face raising capital, the current investment opportunities, investor attitudes towards hedge funds, and on the problems that deep value fund managers encounter in the current environment.

The centre director moderated a seeding panel at the Barclay Asia Investment Symposium 2011 held at Ritz-Carlton Millenia on November 9. The panelists included Rozenn Peres, Senior Analyst at New Alpha Asset Management, Eric Hoh, Head of Alternatives, Trading and Capital Markets at SEB Merchant Banking, and Edward Moon, Chief Investment Officer at Woori Absolute Partners. The panel touched on the challenges and opportunities facing seeders in Asia as well as the skills needed for successful seeders.

Working versions of centre sponsored papers are available for download from our research webpage at http://www.smu.edu.sg/centres/hfc/research.asp

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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.