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### Hedge Funds and Analyst Optimism

Melvyn TEO

Singapore Management University, melvynteo@smu.edu.sg

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# Newsletter of the BNP Paribas Hedge Fund Centre at SMU

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## Summary

- Mission of the BNP Paribas Hedge Fund Centres
- Hedge funds and analyst optimism, by Sung-Gon Chung and Melvyn Teo
- Update on the Centre's Activities

## Mission of the BNP Paribas Hedge Fund Centres

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

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 its sister centres at the London Business School and HEC. 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 funds and analyst optimism

Sung-Gon Chung and Melvyn Teo<sup>1</sup>

## Abstract

We find that analysts are more likely to issue favorable recommendations for stocks predominantly owned hedge funds. Moreover, these optimistic recommendations translate into poorer stock performance over the next three to six months. Hedge funds take advantage of these flattering reports by concurrently offloading their stock holdings. Our results suggest that analysts are reluctant to downgrade stocks held by their most important clients.

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“Wall Street research departments are rapidly organizing themselves to serve their best paying customers: hedge funds”

-Institutional Investor Magazine, 14 October 2003

In a post-Spitzer era, Wall Street research departments can no longer partake in the revenues from investment banking. Instead, anecdotal evidence suggests that sell-side analysts now cater increasingly to hedge funds which trade frequently and can therefore generate the brokerage commissions needed to sustain research.<sup>2</sup> Analysts are spending more time on the phone with their hedge fund clients and churning out new research products geared towards hedge funds.<sup>3</sup> Some market observers have raised concerns that hedge funds wield so much power over analysts that they often pressure analysts to write reports in line with the funds' views.<sup>4</sup> One worry is that, while sell-side analysts no longer need to contend with investment banking-driven agency issues, they must now grapple with new, hedge fund-induced conflicts of interests.

In this newsletter, we explore the relationship between hedge fund stock holdings and sell-side analyst recommendations. We ask the following: Are analysts more likely to issue favorable recommendations for stocks held by hedge funds? If so, are those favorable recommendations biased, i.e., do they forecast returns negatively? Finally, do hedge funds take advantage of the recommendation optimism by offloading their shares of stocks heavily favored by analysts?

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<sup>1</sup> Sung-Gon Chung is Assistant Professor of Accounting at the Singapore Management University. Melvyn Teo is Associate Professor of Finance and Director, BNP Paribas Hedge Fund Centre at the Singapore Management University. E-mail: [melvynteo@smu.edu.sg](mailto:melvynteo@smu.edu.sg). Phone: +65-6828-0735.

<sup>2</sup> See “Unsettled on Wall Street” Institutional Investor Magazine, 14 October 2003. Hedge fund trading volume now accounts for 40 to 50 percent of the daily trading volume in US stock markets (Cox, 2006). Moreover, according to Greenwich Associates, Wall Street collects \$33 million a year in trading commissions from the average hedge fund versus \$16 million from the average mutual fund.

<sup>3</sup> “Hey Big Spender, Analysts on Call” International Herald Tribune, 6 March 2007.

<sup>4</sup> “Hedge Funds and Equity Research: Fair Comment or Foul?” The Economist, 1 April 2006, and “SEC Looks at Hedge Funds' Trades” The Wall Street Journal, 13 February 2009.

Our empirical analysis indicates that analysts are more likely to issue buy and strong buy recommendations for stocks held by hedge funds. After controlling for a variety of factors affecting analyst recommendations, we show that stocks predominantly owned by hedge funds in a given quarter are more likely to attract favorable recommendations from analysts in the next quarter. The effect is economically and statistically significant. A ten percent surge in hedge fund ownership, engenders a 10.43 percent increase in the probability that an analyst will issue a buy or strong buy recommendation next quarter.

Next, we show that stocks held by hedge funds do not deserve the praise lavished by analysts in their research reports. We find that the returns to buy and strong buy recommendations are more negative when hedge funds hold large positions in the stock. The three- and six-month size-adjusted returns are 2.9 percent and 6.0 percent lower, respectively, for the top decile of stocks sorted by hedge fund ownership than for the bottom decile of stocks.

Do hedge funds take advantage of the overly optimistic analyst prognostications by conveniently offloading their stock positions? We show that when analysts issue optimistic recommendations on stocks held by hedge funds, the funds are more likely to reduce their positions in those stocks during the same quarter. In particular, for any given quarter, when the mean analyst consensus for a stock is equal to or greater than a buy, hedge funds are 11.1 percent more likely to unwind their positions in the same stock. Conversely, under the same circumstances, other institutional investors are 25.2 percent less likely to sell a stock.

These findings suggest that hedge funds, by pressurizing sell-side analysts into issuing overly optimistic recommendations on stocks that they hold, are able to offload their equity positions to other unsuspecting institutional investors.

## **Data**

Our data set consists of the intersection of four large databases: the Thompson Financial 13F institutional database constructed from institutional investors' 13F filings, the I/B/E/S database of research analyst recommendations, the Centre for Research in Security Prices at Chicago (CRSP) stock data, and Compustat firm characteristics data. The sample period extends from the third quarter of 2003 to the last quarter of 2008. We time our sample to start after the April 2003 Global Research Analyst Settlement which curtails investment banking driven conflicts of interest amongst sell-side analysts.

We cull our main variable of interest, hedge fund long position data, from the Thompson Financial 13F institutional database. Institutions with more than \$100 million in equities must report their equity ownership in quarterly 13F filings to the Securities and Exchange Commission (henceforth SEC). The majority of institutions (such as pension funds, endowments, mutual funds, and hedge funds) are required to report equity positions in excess of ten thousand shares or \$200,000 in market value for all firms traded on an exchange or quoted on the Nasdaq National Market System. The institutions report aggregate holdings for their firm, e.g., hedge fund family, regardless of how many individual fund portfolios they manage.

To identify hedge fund families in the Thompson Financial 13F institutional database, we draw on the filtering methodology of Brunnermeier and Nagel (2004). First, every year, we obtain from Bloomberg a list of hedge funds that report 13F filings. Next, we look up each hedge fund by name in the 13F institutional database. We find records for 1,011 managers. These are the relatively large managers that hold sufficient amounts of U.S. stocks to exceed the \$100 million reporting threshold. Then, we discard some managers because hedge fund assets only make up a small part of their aggregated institutional portfolio. For each manager, we check whether the firm is a registered investment adviser with the SEC. Registration is a prerequisite for conducting non-hedge fund business such as advising mutual funds and pension plans. If the institution is not registered, we include it in our sample. If the manager is registered, we check the manager's Form ADV. To include a registered manager in our sample, we require (a) that at least 50 percent of its clients are "Other pooled investment vehicles (e.g., hedge funds)" or "High net worth individuals," and (b) that it charges a performance fee. This process leaves us with 711 managers.

During our sample period, the I/B/E/S dataset records 194,507 recommendations for 6,343 unique companies made by 7,367 analysts at 514 brokerages. The Thompson Financial 13F database reports holdings data on 8,104 unique companies. The intersection of the four databases contains 4,872 unique companies. I/B/E/S codes recommendations from one (strong buy) to five (sell). As is standard, we reverse the order so that larger numbers indicate more buoyant recommendations. One issue is that new, reiterated, or revised recommendations arrive and are recorded by I/B/E/S irregularly and relatively infrequently when compared to earnings forecasts. We resolve the relative lack of timely analyst recommendations by focusing on the most recent recommendations recorded in the one-year window ending in quarter  $t$ . Therefore, we implicitly assume that in the absence of a revision, a three-quarter-old recommendation is still current in quarter  $t$ .

## Empirical evidence

Our first set of tests focuses on the effect of hedge fund long equity holdings on the level of analyst recommendations. We ask whether sell-side analysts are more likely to issue buy and strong buy recommendations for stocks predominantly held by hedge funds.

The baseline cross-sectional regression that we estimate can be expressed as:

$$\begin{aligned}
 BUY\_CONSENSUS_{j,t+1} = & a + bHF\_HOLD_{j,t} + cOTHER\_INST\_HOLD_{j,t} \\
 & + dVOLUME_{j,t} + e \log(ME_{j,t}) + f(BE/ME)_{j,t} \\
 & + gLAG\_CAR_{j,t} + \varepsilon_{j,t}
 \end{aligned} \tag{1}$$

where  $BUY\_CONSENSUS_{j,t+1}$  is an indicator variable that is equal to one when the mean consensus recommendation for stock  $j$  at quarter  $t+1$  is greater than or equal to a buy,  $HF\_HOLD_{j,t}$  is the total shares of a stock  $j$  held by hedge funds at the end of quarter  $t$  and scaled by the number of shares outstanding, and  $OTHER\_INST\_HOLD_{j,t}$  is the total shares

of stock  $j$  held by other institutions at the end of quarter  $t$  and scaled by the number of shares outstanding. In addition, for stock  $j$ ,  $VOLUME_{j,t}$  is daily volume scaled by shares outstanding and averaged over the last six months,  $ME_{j,t}$  is market equity,  $(BE/ME)_{j,t}$  is book-to-market equity, and  $LAG\_CAR_{j,t}$  is past six-month, size decile-adjusted, buy and hold return. We control for the stock specific variables to account for the potential impact of stock size on analyst recommendations and in response to Jegadeesh, Kim, Krusche, and Lee's (2004) findings that analysts generally recommend high volume, extreme growth, and positive momentum stocks. The independent variable  $OTHER\_INST\_HOLD$  is included so as to cater for the possible influence of institutional investors who do not manage hedge funds (see Ljungqvist, Marston, Starks, Wei, and Yan (2007)). We also estimate regressions on a second indicator variable  $BUY\_REC$  that takes a value of one when the individual analyst recommendation is a buy or strong buy, and equals to zero otherwise.

Table 1				
Regressions on analyst recommendations				
This table reports results from regressions on consensus recommendations and individual analyst recommendations. Two sets of regressions are estimated. The dependent variables include: BUY_CONSENSUS, and BUY_REC. BUY_CONSENSUS is an indicator variable that is equal to one if the average recommendation is equal to or greater than a 'Buy', and is equal to zero otherwise. BUY_REC is an indicator variable that is equal to one if the individual recommendation is a 'Buy' or 'Strong Buy', and is equal to zero otherwise. Logit regressions are estimated. All the dependent variables are measured in quarter t. The independent variables include the following: HF_HOLD is the sum of shares of a firm held by hedge funds at quarter t-1 scaled by shares outstanding at the end of the quarter. OTHER_INST_HOLD is the sum of shares held by other institutions (excluding hedge funds) at quarter t-1 scaled by shares outstanding at the end of the quarter. ME (in \$ millions) is the market value of equity measured at the end of quarter t-1. BE/ME is the ratio of book value at quarter t-2 to market value of common equity measured at the end of a quarter t-2. LAG_CAR6 is six-month size decile-adjusted buy-and-hold returns ending in a quarter t-1. VOLUME is the daily volume scaled by shares outstanding and averaged over the six months preceding the end of a quarter t-1. The standard errors are clustered by firm and year to account for within-firm and within-year correlations in residuals. The z-statistics and t-statistics derived from the standard errors are in parentheses. The evaluation period extends from the third quarter of 2003 to the fourth quarter of 2008. *Significant at the 5% level; **Significant at the 1% level.				
Independent variables	BUY_CONSENSUS		BUY_REC	
HF_HOLD	1.827** ( 10.65)	1.474** ( 7.85)	1.123** ( 5.83)	1.043** ( 4.39)
OTHER_INST_HOLD		-0.022 (-0.18)		(-0.07) (-0.92)
Log(ME)		-0.336** (-9.28)		-0.039** (-2.71)
BE/ME		-1.023** (-20.71)		-0.846** (-12.95)
LAG_CAR6		0.900** ( 8.78)		0.516** ( 8.24)
VOLUME		-0.021** (-7.51)		-0.005** (-3.57)
Adjusted/Pseudo R-Square	0.003	0.073	0.001	0.0166
Number of observations	60,544	60,476	316,855	316,695

The results in Table 1 indicate that the coefficient estimates on the  $HF\_HOLD$  variable in both these regressions are positive and statistically significant. They suggest that, following a ten percent surge in hedge fund ownership and after controlling for covariation with the other variables, the probability next quarter that the recommendation consensus or an individual

analyst recommendation will be greater than or equal to a buy increases by 14.74 percent and 10.43 percent, respectively.

Do stocks held by hedge funds deserve the praise lavished by analysts? Our next set of tests focuses on the post recommendation performance of stocks owned by hedge funds and favored by analysts. Specifically we test whether the size decile-adjusted, buy-and-hold, three-month and six-month returns following the consensus measuring window are affected by the interaction between hedge fund ownership and the indicator variable that is equal to one when the consensus equals to or exceeds a buy recommendation. The return regression that we estimate is as follows:

$$\begin{aligned}
 STOCK\_RET_{j,t+2} = & a + bBUY\_CONSENSUS_{j,t+1} + cHF\_HOLD_{j,t} \\
 & + dBUY\_CONSENSUS_{j,t+1} * HF\_HOLD_{j,t} + e \log(ME_{j,t}) \\
 & + f(BE / ME)_{j,t} + gLAG\_CAR_{j,t} + \varepsilon_{j,t}
 \end{aligned} \tag{2}$$

where  $STOCK\_RET_{j,t+2}$  is either the three-month or six-month, size decile-adjusted, buy-and-hold return starting in quarter  $t+2$  for stock  $j$ , and the other variables are as per defined earlier.

The results for the regression on three-month size-adjusted returns are reported in the leftmost column of Table 2. The coefficient estimate on the interaction between  $BUY\_CONSENSUS$  and  $HF\_HOLD$  is negative and statistically significant at the one percent level ( $t$ -statistic = -2.73). It indicates that stocks predominantly held by hedge funds do not deserve the buy and strong buy recommendations lavished on them by analysts. Together with the previous findings, this suggests that analysts issue overly optimistic reports for stocks predominantly held by hedge funds. Inferences remain largely unchanged when we estimate the analogous regression on six-month returns. See column three of Table 2. The coefficient estimate on the interaction variable is again negative and statistically significant (at the five percent level).

To gauge economic significance, we replace  $HF\_HOLD$  with  $RANK\_HF\_HOLD$ , a decile-ranked variable of  $HF\_HOLD$  scaled by nine, and re-estimate the return regressions. The decile-ranked variable takes values between zero and nine. Therefore,  $RANK\_HF\_HOLD$  takes values between zero and one. The coefficient estimate on the interaction between  $BUY\_CONSENSUS$  and  $RANK\_HF\_HOLD$  reflects the difference in three-month (or six-month) returns between stocks in the top and bottom hedge fund ownership deciles, whose consensus recommendation equals to or exceeds a buy. The results reported in columns two and four of Table 2 suggest that stocks favored by analysts in the top hedge fund ownership decile underperform stocks favored by analysts in the bottom hedge fund ownership decile by 2.9 percent and 6.0 percent over the subsequent three and six months, respectively.

Newsletter, October 2010

**Table 2**  
**Regressions on stock returns**

This table reports OLS regressions on three-month and six-month size decile-adjusted buy-and-hold stock returns. The dependent variables are measured starting in quarter t. The independent variables are as follows: BUY\_CONSENSUS is an indicator variable that is equal to one if the average recommendation in quarter t-1 is equal to or greater than a 'Buy', and is equal to zero otherwise. HF\_HOLD is the sum of shares of a firm held by hedge funds at quarter t-2 scaled by shares outstanding at the end of the quarter. RANK\_HF\_HOLD is the decile ranked variable of HF\_HOLD divided by nine so that RANK\_HF\_HOLD ranges from zero to one. ME (in \$ millions) is the market value of equity measured at the end of quarter t-1. BE/ME is the ratio of book value at quarter t-1 to market value of common equity measured at the end of a quarter t-1. LAG\_CAR6 is six-month size decile-adjusted buy-and-hold returns ending in a quarter t-1. VOLUME is the daily volume scaled by shares outstanding and averaged over the six months preceding the end of a quarter t-1. For each dependent variable, two sets of regressions are estimated: The first set includes BUY\_CONSENSUS and HF\_HOLD. The second set includes BUY\_CONSENSUS and RANK\_HF\_HOLD. The regression standard errors are clustered by firm and year to account for within-firm and within-year correlations in residuals. The t-statistics are in parentheses. The evaluation period extends from the third quarter of 2003 to the fourth quarter of 2008. \*Significant at the 5% level; \*\*Significant at the 1% level.

Independent variables	Dependent variables			
	Three-month return		Six-month return	
BUY_CONSENSUS	0.010** ( 5.66)	0.018** ( 8.25)	0.022** ( 4.95)	0.036** ( 4.81)
HF_HOLD	0.061 ( 1.15)		0.145 ( 1.59)	
RANK_HF_HOLD		0.02 ( 1.41)		0.046 ( 1.70)
BUY_CONSENSUS × HF_HOLD	-0.106** (-2.73)		-0.245* (-2.44)	
BUY_CONSENSUS × RANK_HF_HOLD		-0.029** (-2.96)		-0.060* (-2.41)
Log(ME)	0.001 ( 1.47)	( 0.00) ( 1.50)	0.004* ( 2.02)	0.004* ( 2.06)
BE/ME	0.025 ( 0.90)	0.025 ( 0.90)	0.082 ( 1.34)	0.082 ( 1.35)
LAG_CAR6	-0.008 (-0.34)	-0.008 (-0.34)	-0.037 (-0.62)	-0.037 (-0.62)
Adjusted R-square	0.003	0.003	0.011	0.012
Number of observations	60,110	60,110	60,113	60,113

Do hedge funds take advantage of the optimistic prognostications of sell-side analysts by concurrently unwinding their stock positions? Our third set of tests examines changes in hedge fund ownership for stocks that are heavily favored by sell-side analysts. If hedge funds successfully pressure analysts into issuing optimistic reports on the stocks that they hold, then the funds will be highly incentivized to offload their positions in those stocks to take advantage of the market's reaction to analysts' buy and strong buy recommendations.

To test this, we estimate the following OLS and logit regressions:

$$\Delta HF\_HOLD_{j,i} = a + bBUY\_CONSENSUS_{j,t} + c \log(ME_{j,t}) + d(BE/ME)_{j,t} + eLAG\_CAR_{j,t} + \varepsilon_{j,t} \quad (3)$$

$$HF\_SELL_{j,i} = a + bBUY\_CONSENSUS_{j,t} + c \log(ME_{j,t}) + d(BE/ME)_{j,t} + eLAG\_CAR_{j,t} + \varepsilon_{j,t} \quad (4)$$



where  $\Delta HF\_HOLD_{j,t}$  is the change in hedge fund ownership in stock  $j$  in quarter  $t$ ,  $HF\_SELL_{j,t}$  is an indicator variable that equals to one when the change in hedge fund ownership in stock  $j$  is negative in quarter  $t$ , and equals to zero otherwise, and the independent variables are as per defined previously.

The results from the regressions are reported in the first and second columns of Table 3. They indicate that hedge funds are more likely to sell stocks that attract buoyant recommendations. Specifically, the coefficient estimate on *BUY\_CONSENSUS* in the logit regression indicates that hedge funds are 11.1 percent more likely to sell a stock when the consensus is greater than or equal to a buy during the same quarter. Hedge funds appear to be trading against the recommendations of sell-side analysts. This effect is statistically significant at the one percent level ( $t$ -statistic = 5.28).

**Table 3**  
**Regressions on changes in stock ownership**

This table reports regressions on changes in hedge fund ownership and on changes in other institutional investor ownership. The dependent variables include  $\Delta HF\_HOLD$ ,  $HF\_SELL$ ,  $\Delta OTHER\_INST\_HOLD$ , and  $OTHER\_INST\_SELL$ .  $\Delta HF\_HOLD$  is the change in hedge fund long positions in quarter  $t$ .  $HF\_SELL$  is an indicator variable that is equal to one if  $\Delta HF\_HOLD$  is negative, and it equal to zero otherwise.  $\Delta OTHER\_INST\_HOLD$  is the change in other institutions' positions in quarter  $t$ .  $OTHER\_INST\_SELL$  is an indicator variable that is equal to one if  $\Delta OTHER\_INST\_HOLD$  is negative, and is equal to zero otherwise. The independent variables are as follows: *BUY\_CONSENSUS* is an indicator variable that is equal to one if the average recommendation in quarter  $t$  is equal to or greater than a 'Buy', and is equal to zero otherwise. *ME* (in \$ millions) is the market value of equity measured at the end of quarter  $t-1$ . *BE/ME* is the ratio of book value at quarter  $t-2$  to market value of common equity measured at the end of a quarter  $t-2$ . *LAG\_CAR6* is six-month size decile-adjusted buy-and-hold returns ending in a quarter  $t-1$ . We estimate OLS and Logit regressions. The standard errors are clustered by firm and year to account for within-firm and within-year correlations in residuals. The z-statistics and t-statistics are in parentheses. The evaluation period extends from the third quarter of 2003 to the fourth quarter of 2008. \*Significant at the 5% level; \*\*Significant at the 1% level.

Independent variables	Dependent variables			
	$\Delta HF\_HOLD$	$HF\_SELL$	$\Delta OTHER\_INST\_HOLD$	$OTHER\_INST\_SELL$
<i>BUY_CONSENSUS</i>	-0.002** (-3.44)	0.111** (5.28)	0.011** (11.43)	-0.252** (-16.98)
<i>Log(ME)</i>	-0.000 (-1.61)	0.053** (4.57)	0.000 (0.49)	-0.018 (-0.78)
<i>BE/ME</i>	-0.003** (-2.75)	0.139 (1.75)	-0.004 (-0.91)	0.121 (1.11)
<i>LAG_CAR6</i>	0.002** (5.44)	-0.178** (-3.90)	0.017** (5.96)	-0.381** (-3.96)
Adjusted R-square	0.002	0.0021	0.012	0.007
Number of observations	57,480	57,480	57,480	57,480

Interestingly, these findings do not apply to other institutional investors. When we estimate the analogous regression with  $\Delta OTHER\_INST\_HOLD$  where  $\Delta OTHER\_INST\_HOLD$  is the change in other institution's stock ownership, the coefficient estimate on *BUY\_CONSENSUS* is positive and statistically significant. This suggests that other institutions are more likely to increase their positions in a stock, when analysts are optimistic. Similar inferences obtain when we estimate the regression with *OTHER\_INST\_SELL*, an indicator that equals to one when the change in stock ownership by other institutions is negative during that quarter, and equals zero otherwise. The coefficient estimate on *BUY\_CONSENSUS* indicates that other institutions are 25.2 percent less likely to sell stock when the consensus is greater than or equal to a buy. These results are reported in columns three and four of Table 3.

## Summary

In line with anecdotal evidence which suggests that sell-side analysts are now under tremendous pressure to generate brokerage commissions, we show that sell-side analysts tend to issue buy and strong buy recommendations on stocks predominantly held by hedge funds. These stocks do not deserve the flattering reports lavished by analysts. The favorable recommendations parlay into poor three-month and six-month stock returns going forward. Moreover, hedge funds take advantage of the optimistic prognostications by concurrently unwinding their stock positions. Our findings suggest that in a post Spitzer-era, the Wall Street research departments that have been forcibly weaned off investment banking revenues must now contend with new hedge fund-induced conflicts of interests.

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## Update on the Centre's Activities

### Education

The centre is mounting a hedge fund executive education program from the 24-26 of November. The course will feature an impressive lineup of instructors including Professor Bill Fung from London Business School and hedge fund managers from Artradis, Apollo, and Alphadyne. The course fee is S\$932 per person after the MAS subsidy and a ten percent early bird discount (for registrations before October 16). You may find out more about our executive education program here: <http://www.smu.edu.sg/centres/hfc/events/hfee10/index.asp>

### Research

The centre sponsored paper "The Liquidity Risk of Liquid Hedge Funds," by Melvyn Teo, has been accepted for publication at the Journal of Financial Economics.

Our call for papers via SSRN has attracted 14 paper submissions from academics all around the world. The research board will decide on the grant recipients by 30 November 2010.

Working versions of centre sponsored papers are available for download from our research webpage

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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](mailto: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.