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journal homepage: www.elsevier.com/locate/jfecHedge funds and discretionary liquidity restrictions[☆]Adam L. Aiken^a, Christopher P. Clifford^{b,*}, Jesse A. Ellis^c^a *Quinnipiac University, United States*^b *Gatton School of Business, University of Kentucky, United States*^c *North Carolina State University, United States*

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ABSTRACT

We study hedge funds that imposed discretionary liquidity restrictions (DLRs) on investor shares during the financial crisis. DLRs prolong fund life, but impose liquidity costs on investors, creating a potential conflict of interest. Ostensibly, funds establish DLRs to limit performance-driven withdrawals that could force fire sales of illiquid assets. However, after they restrict investor liquidity, DLR funds do not reduce illiquid stock sales and underperform a control sample of non-DLR funds. Consequently, DLRs appear to negatively impact fund family reputation. After the crisis, funds from DLR families faced difficulties raising capital and were more likely to cut their fees.

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1. Introduction

Hedge funds invest in complex and illiquid assets. Because they offer redeemable claims to investors, however,

their strategies and survival are constrained by their ability to retain outside financing (Shleifer and Vishny, 1997). As such, hedge funds typically maintain ordinary share restrictions, such as lockups and infrequent withdrawal periods, to attenuate the outflow of capital from their funds. These restrictions ensure that, under normal market conditions, the funds can invest in illiquid assets and have the flexibility to meet redemptions without resorting to selling illiquid portfolio assets at fire sale prices. However, market conditions during the financial crisis of 2007–2009 were anything but normal. As market liquidity dried up and performance suffered, many funds found themselves subject to substantial withdrawal requests that overwhelmed ordinary share restrictions, creating the potential for the funding liquidity spiral discussed in Brunnermeier and Pedersen (2009). In order to combat a run on the fund's assets, nearly one in three hedge fund managers enacted mechanisms such as gates and side pockets that served to prevent investor withdrawals from the fund. These restrictions were imposed at the discretion of fund managers and were in addition to the ordinary share restrictions of the fund. In this paper, we

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examine the determinants of discretionary liquidity restrictions (DLRs) and their consequences for investors and hedge fund firms.

There are many discretionary mechanisms that fund managers can employ in order to restrict investor liquidity. These include outright suspensions, partial suspensions or gates, and separately designated investments such as side pockets. Most hedge fund agreements give the manager the option to restrict investor liquidity by invoking DLRs when redemptions would force the fund to sell illiquid assets too quickly at unfavorable prices. The value of DLRs for hedge funds and investors remains a contentious issue, especially given their prevalence in the recent financial crisis. Managers argue that by initiating DLRs the fund can protect investors from liquidity runs and ensure that assets can be sold at fair values after markets stabilize. However, restricting redemptions may be costly for investors as it impairs their option to “vote with their feet” by removing capital from poorly performing funds (Fama and Jensen, 1983). In addition, DLRs can create conflicts of interest between investors and managers, as some managers might abuse their discretion and restrict investor liquidity as a means of preserving fund capital and earning excess fees. The notoriety of DLRs in the press is partly due to investor outrage over being unable to access their capital.¹ Despite this media attention, to our knowledge, this is the first paper to empirically examine hedge funds and DLRs.

In this paper, we utilize a hand-collected data set of hedge fund holdings from a sample of institutional investors, providing a first look at the use of DLRs by hedge funds. We begin by documenting the incidence of DLRs over the period 2006–2011 and find them to be especially prevalent during the financial crisis. Though most partnership agreements allow for managers to enact DLRs in extreme circumstances, few hedge funds exercised that right prior to the financial crisis. In 2006, for example, only 5.8% of the funds in our sample had enacted a DLR. By the end of 2009, 31.6% of funds in our sample had enacted such a restriction. This is consistent with reports in the popular press that the widespread use of DLRs during the crisis came as a surprise to many investors.²

Motivated by the prevalence of DLRs during the financial crisis, we seek to understand the economic determinants that led funds to restrict investor liquidity and examine the impact these restrictions had on hedge funds and their investors. We find that DLR funds perform worse, have larger outflows, more liquidity risk, and more illiquid assets than non-DLR funds. These results suggest funds were more likely to establish DLRs when they faced a greater imbalance between investor demand for liquidity and the fund's cost of supplying liquidity. This is consistent with the argument that funds at greater risk of a liquidity spiral suspend redemptions in order to avert a potentially damaging run on the fund's capital. We also find, however, that DLRs are more common among funds that charge

higher fees and thus have greater incentives to prolong fund survival, suggesting a possible conflict of interest inherent in the decision to restrict investor liquidity.

When we examine the performance of funds after they enact DLRs, we do not find evidence that investors benefit from sacrificing their ability to redeem capital. We compare DLR funds to a control group of similar funds that chose not to restrict withdrawals and find that DLR funds underperform the control sample in each of the eight quarters following the DLR initiation by nearly 2.0% per quarter; five of these eight performance differences are statistically significant at conventional levels. In the two years following the DLR initiation, the average cumulative performance of DLR funds is 15.4% lower than that of the control funds. This underperformance is difficult to reconcile with the notion that managers enacted DLRs to protect investor interests because fund assets were temporarily undervalued. Moreover, we note that underperformance does not illustrate the full cost of DLRs for investors. By diminishing their withdrawal rights, DLRs levy an implicit liquidity cost on investors who, all else equal, would prefer access to their capital. Reflecting this implicit cost, secondary market prices for illiquid hedge fund interests implied an average discount to stated net asset value (NAV) of more than 50% throughout the crisis period.

Given that DLR funds face reduced redemption risk, they should also face reduced pressure to sell their illiquid assets. To test this conjecture, we examine hedge fund trading using stock holdings data from 13F filings. Interestingly, we do not find evidence that DLR funds were less likely to sell their illiquid stocks, either compared to peer funds or to the liquid stocks in their own portfolio. When considered in conjunction with their poor post-DLR performance, the selling behavior of DLR funds casts doubt on the proposition that DLRs served investor interests by preventing costly fire sales.

Finally, we examine whether DLR funds and their family affiliates face a reputational penalty for restricting investor liquidity during the crisis. We find that hedge funds with family members that enact a DLR during the crisis have a more difficult time raising capital after the crisis than funds without DLR family members. This effect is stronger when reputation plays a more prominent role in investor decisions, such as when the family's flagship fund enacts a DLR. Further, funds with DLR family members are more likely to reduce management and incentive fees after the crisis. This suggests that the negative spillover effects from DLRs damage the reputation of the hedge fund family, as funds associated with DLRs may have had to reduce their fees in order to win back investor favor and compete for capital in the post-crisis period.

This paper is related to the literature examining the interaction between funding and liquidity risk and the issues that may arise when institutions have an asset-liability mismatch. In a seminal paper on the mechanics of bank runs, Diamond and Dybvig (1983) illustrate how providing investors liquid redeemable claims while holding illiquid assets subjects the bank to the self-fulfilling prophecy of a bank run. Brunnermeier and Pedersen (2009) argue that shocks to liquidity in asset markets or funding markets can spill over into one another, creating a

¹ For example, “Side-pocket solution to illiquidity,” *The Financial Times*, 1/21/2008.

² See “Hedge-fund investor goal: An exit plan,” *The Wall Street Journal*, 9/9/2009.

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