



## Style chasing by hedge fund investors



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### ABSTRACT

This paper examines whether investors chase hedge fund investment styles. We find that better-performing and more popular styles are rewarded with higher inflows in subsequent periods. This indicates that investors compare hedge fund styles in terms of recent performance and popularity, and they subsequently reallocate funds from less successful to more successful styles. Furthermore, we find evidence of competition between individual hedge funds of the same style. Funds outperforming the other funds in their styles and funds whose inflows exceed the average flows in their styles experience higher inflows in subsequent periods. One of the reasons for competition among same-style funds is investors' search for the best managers. The high minimum investment required to invest in a hedge fund limits investors' diversification opportunities and makes this search particularly important. Finally, we show that hedge fund investors' implementation of style chasing in combination with intra-style fund selection represents a smart strategy.

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### 1. Introduction

Hedge funds, like many other investment classes, can be categorized into investment styles. Long-short equity hedging, managed futures, and event-driven and convertible arbitrage are among the most popular hedge fund investment styles of the past decade. The importance of investment style grows with the number of individual assets or funds in an investment class. In large investment classes, such as stocks or mutual funds, investors often prefer to allocate their portfolios by selecting among investment styles rather than by selecting among individual assets, an approach referred to as “style investing” (Barberis and Shleifer, 2003). In the hedge fund industry investment style information seems to be particularly important. Style information is one of the few accessible indicators for a hedge fund's strategy, while the strategy itself is a determining characteristic of the fund's activity. Consequently, it is very likely that sophisticated investors, who are prevalent in the hedge fund industry, search for better performance using style information. Therefore, we expect that information regarding a hedge fund's investment style has an important impact on the investment decisions of hedge fund investors.

Consistent with the style investing hypothesis (Barberis and Shleifer, 2003) investors categorize risky assets into styles and

subsequently allocate money to each style according to its relative performance. There are a number of studies testing style investing for different financial sectors (see, for example, Barberis et al., 2003; Pomorski, 2004). However, to our knowledge, none of these studies addresses style investing for hedge funds. We propose to fill this gap by examining how hedge fund style is taken into consideration in the investment decision process. We investigate whether hedge fund investors chase well performing and more popular hedge fund investment styles and examine the effect of style information on the selection of individual funds within a particular style.

Our study contributes to the hedge fund literature in a number of ways. First, the study includes empirical tests that illustrate whether style investing takes place in the relatively new and rapidly growing asset class of hedge funds. This knowledge will provide insight into how style investing affects the hedge fund industry specifically and the financial market in general. The inflow of money to the best-performing styles may have an important impact on the prices of the underlying assets of those styles. Furthermore, the inflow of money into a specific style can lead to an increase in the number of funds offered in that style, affecting competition between those funds. Eventually, this could lead the overall performance of the style to diminish. This implies that investors face decreasing returns to scale at the style level, in line with Berk and Green's (2004) model at the individual fund level. In accordance with Berk and Green's model, Naik et al. (2007) show that

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capacity constraints at the level of investment styles are responsible for declining risk-adjusted returns over the period 2000–2004.

Second, the paper examines whether investors take style-related information into account when deciding whether to invest in individual funds. A substantial part of the hedge fund literature investigates the determinants of individual hedge fund flows. Past performance as well as fund characteristics such as the compensation scheme for the manager, fund manager characteristics, and presence of share restrictions appear to have a significant impact on fund flows (see, for example, Agarwal et al., 2009; Baquero and Verbeek, 2006; Ding et al., 2009; Li et al., 2011). However, none of the previous studies examines whether individual fund flows are affected by information on a fund's parameters relative to its style. In this study we investigate how within-style performance and popularity of individual hedge funds affect money flows into and out of those funds.

Finally, the paper examines whether style chasing is a smart strategy for investors. Previous studies have suggested that investment decisions based on past performance, and in particular based on past performance at the style level, are not necessarily advantageous. In the case of funds-of-funds, Fung et al. (2008) find strong evidence of diminishing returns to scale in combination with inflow of new money in better-performing funds. Naik et al. (2007) show that capacity constraints affect future returns of some hedge fund strategies. Yet despite these findings, we suggest that a strategy of style chasing in combination with intra-style fund selection may nevertheless be effective.

Owing to the particular characteristics of hedge fund investors, it is especially interesting to investigate whether this investor clientele indeed engages in effective investment strategies. Hedge fund investors are considered to be more sophisticated than mutual fund investors. However, hedge fund investors are confronted with liquidity restrictions due to, for instance, lockup periods. An investment decision in a hedge fund or hedge fund style cannot easily be reversed in the short term. This implies that a hedge fund investor needs to be more convinced of the appropriateness and the timing of the investment decision.

Our main findings are as follows. First, we find that styles that perform better and are more popular in a given period are rewarded with higher inflows in subsequent periods. Moreover, style popularity positively affects the subsequent money-flows of funds related to popular styles. Second, we find that the style effect is not equal for funds within a style: better-performing and more popular funds within a style experience higher inflows in subsequent periods. We explain this result by the presence of intra-style competition, a result that is consistent with the findings of Getmansky (2005). Finally, our results show that style chasing, as implemented by hedge fund investors, seems to be a wise strategy. We find that while style chasing alone does not generate profits, style chasing is profitable when implemented together with the search for the best funds within a particular style.

The remainder of this paper is organized as follows. In Section 2 we describe the data, and we present some summary statistics from our sample of hedge funds. In Section 3 we develop and motivate our hypotheses, and in Section 4 we formally test the hypotheses and perform a number of robustness checks. Section 5 concludes.

## 2. Data

Our survivorship free dataset, provided by the Trading Advisor Selection System (TASS) database, contains information on 2917 hedge funds reporting in US dollars over the period 1994–2003. The dataset includes individual fund total net assets under management (TNA) and raw returns retrieved from fund reports.

**Table 1**

Descriptive statistics of cross-sectional characteristics of individual hedge funds.

Fund characteristics	Mean	St. Dev	Min.	Max.
Live Funds	0.65	0.48	0	1
Minimum Investment (mill.\$)	0.76	0.14	0.001	25.00
Management Fee (%)	1.42	0.87	0	8
Incentive Fee (%)	18.70	5.28	0	50
High Water Mark	0.41	0.49	0	1
Leveraged	0.73	0.44	0	1
Personal Capital	0.55	0.50	0	1
Open to Public	0.13	0.33	0	1
Domicile Country US	0.49	0.50	0	1

*Note:* This table presents summary statistics on some of the cross-sectional characteristics of our sample for the period between the 1st quarter of year 1994 and the 4th quarter of year 2003. *Live Funds* is a dummy variable with value one for funds reported as live at the end of the sample period. *Minimum Investment* is the monetary value in millions of US \$ that an investor is requested to allocate to invest in a fund. *Management Fee* is a percentage of the fund's net assets under management that is paid annually to the managers for administering a fund. *Incentive Fee* is the percentage of profits above a hurdle rate that is given as reward to the managers. *High Water Mark* is a dummy variable with value one for funds having this type of policy. *Leveraged* is a dummy taking the value one if the fund makes active and substantial use of borrowing according to TASS definitions. *Personal Capital* is a dummy variable indicating that the manager invests his or her own wealth in the fund. *Open to Public* is a dummy variable with value one for funds open to public investments. *Domicile Country US* is a dummy variable with value one for funds whose domicile country is the US.

Reported raw returns are net of fees. Furthermore, we exclude data on closed-end funds (156 funds in total), since investment in this type of funds can be done only at initial fund issuing. We also exclude data on funds-of-funds (FOFs) (487 funds in total) from the initial sample, because FOFs have different investor composition than individual hedge funds have. Whereas the majority of FOF clients are private investors, clients of individual hedge funds are mostly so-called high net worth individuals and institutional investors. Hence, clients of FOFs and those of individual hedge funds may differ in their levels of sophistication. Thus, the investment decision process of FOFs' investors can considerably differ from the investment decision process of individual hedge fund investors.

We employ quarterly calculated data to observe the short-term dynamics of investment flows. In addition, the use of quarterly data reduces the patterns of serial correlation that characterize hedge fund returns when these are analyzed on a monthly basis (Getmansky et al., 2004). To insure a sufficient number of past performances required for our analyses, we focus our attention only on funds with return history available for at least five quarters. We exclude observations with extreme changes in TNAs. All observations with changes higher than 300% (there were 83 such observations) or lower than –90% (there were 44 such observations) are excluded. Our final sample consists of 33,064 fund-period observations for 2274 individual funds. It includes 229 funds as of the end of the first quarter of 1994, and 1331 funds as of the end of the last quarter of 2003, accounting for about 27 billion US dollars and 195 billion US dollars respectively.<sup>1</sup> Hence, the assets under management have grown by more than six times over the sample period.

In Table 1 we provide some cross-sectional characteristics of individual funds. The table reveals that the average level of minimum investment in an individual hedge fund is remarkably high: above \$750,000. The highest level of minimum investment is \$25 million. The incentive fee can be as high as 50%, while the maximum management fee in our sample of funds is 8%. The majority of the hedge funds (approximately 73%) make use of leverage,

<sup>1</sup> This represents nearly 24% of the total for the entire industry estimated by Hedge Fund Research of about \$820 billion of assets under management as of 2003 (see L'Habitant, 2007).

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