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Limited attention, marital events and hedge funds☆

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ABSTRACT

We explore the impact of limited attention by analyzing the performance of hedge fund managers who are distracted by marital events. We find that marriages and divorces are associated with significantly lower fund alpha, during the six-month period surrounding and the two-year period after the event. Busy managers who manage multiple funds and who are not part of a team are more affected by marital transitions. Inattentive managers place fewer active bets relative to their style peers, load more on index stocks, exhibit higher *R*-squareds with respect to systematic factors, and are more prone to the disposition effect.

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1. Introduction

"Almost a quarter of British motorists admit that they have been so distracted by roadside billboards of semi-naked models that they have dangerously veered out of their lanes."

–Reuters (London), November 2005

"One of my No. 1 rules as an investor is as soon as … I find out that [a] manager is going through divorce, [I] redeem immediately. Because the emotional distraction that comes from divorce is so overwhelming. … You can automatically subtract 10 to 20 percent from any manager if he is going through divorce."[1]

–Paul Tudor Jones II, May 2013

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[1] Jones founded and manages the Tudor Investment Corporation, which has $11.4 BN under management. Jones made the statement at a panel discussion at his alma mater, the University of Virginia. See "Hedge fund legend: if one of my managers is getting divorced, I'll pull my money out,"

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Due to limited attention, motorists are apparently unable to drive within their respective lanes while processing information contained in sexy billboards. Does limited attention also compromise investors' ability to navigate financial markets? The academic literature has shown that limited investor attention impacts market prices and participants in the following ways. Limited attention shapes investor behavior, causing investors to underreact to earnings announcements (Hirshleifer, Lim, and Teoh, 2009) and purchase high volume and high return stocks (Barber and Odean, 2008). Market participants suffering from limited attention neglect important economic links between supplier and consumer firms (Cohen and Frazzini, 2008) and long-term demographic information (DellaVigna and Pollet, 2007), thereby engendering stock return predictability. Investor inattention drives firm behavior; firms are incentivized to release disappointing earnings news on Fridays so as to take advantage of underreaction by distracted investors (DellaVigna and Pollet, 2009). Limited attention can explain category learning (Peng and Xiong, 2006), style investing (Barberis and Shleifer, 2003; Teo and Woo, 2004), and comovement (Barberis, Shleifer, and Wurgler, 2005), and has other asset pricing implications (Hendershott, Menkveld, Li, and Seasholes, 2014). Yet, there is little evidence to suggest that investor inattention *directly* compromises investment performance. This paper fills this void by analyzing the impact of limited attention on the investment performance of hedge fund managers.

The hedge fund industry is an interesting laboratory for investigating the impact of limited attention as the complex and dynamic trading strategies that hedge fund managers employ, which may involve short sales, leverage, and derivatives, often impose extraordinary demands on their time.[2] Consequently, hedge fund investors, such as Paul Tudor Jones II, highly value a fund manager's ability to stay focused in the investment game. Yet, to raise capital and achieve critical mass, hedge fund managers are often sidetracked by capital-raising activities such as speaking at hedge fund conferences, attending capital introduction events, and meeting individual investors. Moreover, as her business grows, a hedge fund manager may find it increasingly difficult to concentrate on her investment duties given the day-to-day demands associated with running a large asset management firm. Indeed, to sharpen their ability to focus in stressful market conditions, some prominent hedge fund managers such as Ray Dalio of Bridgewater Associates have taken to meditation.[3]

Motivated by Jones's claim, we examine the impact of marital events on hedge fund managers' performance using 98 marriages and 76 divorces from publicly available, court-reported data. We argue that marriage and divorce are deeply personal events that distract fund managers from their investment duties.[4] In line with Jones's statement, we find that money managers significantly underperform during a divorce. In the six-month period surrounding a divorce, hedge fund managers underperform by 4.33% per annum relative to the pre-divorce period.[5] After adjusting for co-variation with the Fung and Hsieh (2004) seven factors, the underperformance during the divorce increases to 7.79% per annum. The deleterious effects of a divorce extend beyond the six-month event window. Hedge funds continue to underperform by a risk-adjusted 2.29% per annum up to two years post-divorce. The distraction induced by a marriage has a similar effect on investment performance. In the six-month period surrounding a marriage, hedge fund managers underperform by an annualized 3.13% relative to the 21-month period before the event window. After adjusting for co-variation with the Fung and Hsieh (2004) seven factors, the underperformance during a marriage worsens to an annualized 5.10%. Moreover, for the two-year period post-marriage, hedge funds continue to underperform by an annualized 3.16% after adjusting for risk.

Our results are not driven by the usual factors that explain hedge fund returns. Even after controlling for a myriad of factors that explain fund performance including fund incentives (Agarwal, Daniel, and Naik, 2009), share restrictions (Aragon, 2007), age (Aggarwal and Jorion, 2010), and size (Berk and Green, 2004), we find that both divorce and marriage are associated with significant deteriorations in investment performance. The findings are also not artifacts of the decline in hedge fund risk-adjusted performance over time (Fung and Hsieh, 2004). We match our sample of marital event funds with other hedge funds based on performance in the pre-event window. We find that relative to this matched fund sample, hedge fund alpha wanes by an annualized 10.03% during a marriage and 11.70% during a divorce. We also discuss several alternative explanations for our findings and show that these endogeneity stories are unlikely to drive the bulk of our results.

Are marital events more impactful for busy managers who can ill afford the distractions associated with such events? To investigate, we stratify fund managers into high and low bandwidth groups based on the number of funds managed and on whether a fund manager is part of a team, and redo our multivariate regression analysis. We find that marriages and divorces hurt the performance of managers who control at least two funds more than that of managers running only one fund. Similarly, marital transitions are associated with strong and statistically significant reductions in performance for funds with low bandwidth fund managers who do not belong to a team. Conversely, funds that are team-managed experience more

Business Insider, 23 May 2013 and "Tudor said to open first macro hedge fund in decade," Bloomberg, 2 July 2012.

[2] See "Red Bull-fueled all-nighters put Fortress fund on top," Bloomberg, 17 July 2013.

[3] See "To make a killing on Wall Street, start meditating," Bloomberg, 28 May 2014. According to Lazar, Kerr, Wasserman, Gray, Greve, Treadway, McGarvey, Quinn, Dusek, Benson, Rauch, Moore, and Fischl (2005), meditation experience is associated with increased cortical thickness, suggesting that meditation improves attention, sensory processing, and stress management.

[4] Paul Tudor Jones II, in clarifying remarks after the University of Virginia panel discussion, noted that "life events, such as birth, divorce, death of a loved one and other emotional highs and lows are obstacles to success in this specific field of finance (managing global macro hedge funds)." See "Investor Paul Tudor Jones says mothers can't be top traders," ABC News, 24 May 2013. This suggests that, for hedge fund managers at least, a marriage may not be so helpful for investment performance.

[5] Inferences do not change when we experiment with shorter or longer event windows.

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