



Information spillovers and performance persistence for hedge funds[☆]

Vincent Glode^{a,*}, Richard C. Green^b

^a The Wharton School, University of Pennsylvania, Philadelphia, PA 19104, USA

^b Tepper School of Business, Carnegie Mellon University, Pittsburgh, PA 15213, USA

ARTICLE INFO

Article history:

Received 15 September 2008

Received in revised form

6 October 2010

Accepted 25 October 2010

Available online 3 March 2011

JEL classification:

G24

G11

D82

Keywords:

Hedge funds

Performance persistence

Disclosure

Information spillovers

ABSTRACT

We present a simple model that rationalizes performance persistence in hedge fund limited partnerships. In contrast to the model for mutual funds of Berk and Green (2004), the learning in our model pertains to profitability associated with an innovative trading strategy or emerging sector, rather than ability specific to the fund manager. As a result of potential information spillovers, which would increase competition if informed investors were to partner with non-incumbent managers, incumbent managers will let informed investors benefit from increases in estimated profitability following high returns realized with the trading strategy or in the sector.

© 2011 Elsevier B.V. All rights reserved.

1. Introduction

Private partnerships, such as hedge funds, have been shown to exhibit persistence in the abnormal performance they generate for investors (see Jagannathan, Malakhov,

and Novikov, 2010; Fung, Hsieh, Naik, and Ramadorai, 2008). Mutual funds, in contrast, show little performance persistence. The persistence that is evident in mutual fund performance is concentrated in the worst performing funds (see Carhart, 1997; Berk and Tonks, 2008) where it appears to be largely attributable to inattention by investors in those funds. Such an explanation for persistence in the performance of hedge funds is inconsistent with the nature of the investor base, which consists of institutions and wealthy, relatively sophisticated individuals. It is also at odds with the facts. Jagannathan, Malakhov, and Novikov (2010) show that performance is persistent for hedge funds that perform well, and are thus able to attract new flows.

An explanation for the sensitivity of mutual-fund flows to performance, despite the lack of persistence in performance, is offered by Berk and Green (2004). In that model, investors learn about heterogeneous ability through past returns, but there are decreasing returns to scale in deploying those abilities. In light of this explanation for

[☆] Discussions with Fernando Anjos, Jonathan Berk, Guillaume Plantin, and Fallaw Sowell have been helpful in formulating the ideas in this paper. We also thank an anonymous referee, Yael Hochberg, Steve Kaplan, Dmitry Livdan, Paolo Volpin, and seminar participants at Carnegie Mellon University, Laval University, UCLA, the 2010 AFA Meetings, the 2009 LBS Private Equity Symposium and the 2008 UBC Summer Finance Conference for helpful comments. Vincent Glode gratefully acknowledges financial support from the Social Sciences and Humanities Research Council of Canada, the William Larimer Mellon fund, and the Center for Financial Markets. This paper supersedes an earlier working paper by the same authors titled: "Information Spillovers and Performance Persistence in Private Equity Partnerships."

* Corresponding author.

E-mail address: vglude@wharton.upenn.edu (V. Glode).

the behavior of mutual funds, hedge fund partnerships present a puzzle. If flows respond to learning about hedge fund returns, as they appear to do, why do managers not expand the fund or raise their fees to capture the rents going forward?

In this paper, we rationalize performance persistence for hedge funds. Our model is based on evident differences in the institutional setting between mutual funds and hedge funds. We show that persistence can be explained through a need for secrecy. The source of superior returns may not be entirely skills or abilities intrinsic to the manager. Superior returns may also be attributable to strategies or techniques that could be expropriated and exploited by others if they were informed about them. This would explain the use of the limited partnership organizational form for certain types of investment funds.

Hedge funds have a common feature, despite the wide range of investment activities they engage in. They are *private*. They are organized as limited partnerships and solicit funds from large, “qualified” investors. This frees them from the elaborate disclosure requirements and oversight mutual funds and publicly traded corporations are subject to. The common choice of organizational form is an endogenous response. A concern that disclosure and oversight, and the associated leakage of information, would erode their ability to generate rents is a natural place to look for a common, primitive determinant of this choice, consistent with empirical findings by Agarwal, Jiang, Tang, and Yang (2010). Our model could explain why this organizational form is often associated with persistence in excess returns.

The dilemma facing fund managers is illustrated by a widely reported incident involving hedge fund manager John Paulson, who became famous (and very wealthy) by betting against mortgage-backed securities, and one of his former investors who, backed by two investment banks, implemented a similar investment strategy. The *Wall Street Journal* reported on January 15, 2008:

It was the spring of 2006, and Mr. Paulson, seeking investors for a new fund, gave Mr. Greene a peek at his plan. Mr. Greene didn't wait for the fund to open. He beat his friend to the punch by doing the same complex mortgage-market trade on his own.

The problem evident in the Paulson case, and the concerns evidenced by hedge funds for confidentiality, suggest that what investors learn from past returns is not limited to ability or talent unique to the manager, as assumed by Berk and Green (2004) for the mutual fund industry. Neither are these concerns consistent with models of “soft information” applied to venture capital, which Kaplan and Schoar (2005) show exhibit persistence, as do Hochberg, Ljungqvist, and Vissing-Jørgensen (2010). Investors (and managers) may also be learning about the profitability of innovative trading strategies and this information, if known to others, would attract imitation and competition.

Our model considers this possibility in a setting similar to that of Berk and Green (2004). As in their paper, both managers and investors learn about the profitability of the

fund through past performance. Future profitability in Berk and Green (2004) depends negatively on assets under management, due to decreasing returns to scale. This is also the case in our model, but in addition the investments made by other partnerships in the same sector or using a similar trading strategy reduce profitability to incumbents going forward.

In the model, there is an infinite number of potential limited partners (LPs), whereas the number of potential general partners (GPs) is finite. In dealing with investors, the GP makes the first take-it-or-leave-it offer, consistent with the GP's abilities or skills being the ultimately scarce resource. The critical question is why high expected performance going forward should increase the outside option, or reservation price, of the LPs in deciding whether to accept or reject the offer. To illustrate the intuition, we first fix the number of potential GPs exogenously. We later illustrate how the set of potential GPs can be determined endogenously through a fixed cost of entry.

We assume that any party with information useful in estimating future returns credibly and fully discloses it to outsiders when soliciting their participation. The reservation price of an LP being solicited by a GP is determined by the LP's ability to approach new potential GPs and disclose information about the future performance of the trading strategy with which the LP has been investing. Each such disclosure to a new GP, if expected profits are positive, adds a competitor, and thus reduces potential profits for the incumbents.

At each stage of the game, the reservation price of an LP dealing with an offer from a GP is determined by the LP's expected payoff from approaching a new GP and making him an offer. The reservation price of the new GP, responding to an offer from an LP, is determined by his ability to disclose information to, and solicit capital from, a new LP. Thus, the expanding set of competitors that results from the search for alternative partners acts like a discount factor in an alternating-offer bargaining game.

We formulate this game recursively, and solve for the expected payoffs of the various parties as functions of the number of GPs currently informed and investing using the same trading strategy or in the same sector, the number of GPs who could potentially imitate the incumbents, and the current estimated profitability. We then examine conditions under which secrecy is an equilibrium, and the incumbent LP agrees to continue as a partner in a subsequent period. Since the reservation price of the LP is increasing in the expected returns of the strategy going forward, his share of those profits will be as well. Returns to investors will persist across periods for a given hedge fund.

Our focus on the consequences of information spillovers leads us to abstract from many obviously important features of the contracting environment for hedge funds. We ignore asymmetric information and moral hazard. As a result, investment is “first-best.” The form of the contract between managers and investors is irrelevant. Our intent is not to minimize the importance of these considerations, but we instead focus on returns across periods, rather than contracting over the life of a given fund. If a general partner has positive information about future performance that can be disclosed credibly

Download English Version:

<https://daneshyari.com/en/article/959650>

Download Persian Version:

<https://daneshyari.com/article/959650>

[Daneshyari.com](https://daneshyari.com)