

Study says return-chasing could be “driving a wedge between fund and investor returns”

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When conducting due diligence on a hedge fund, it's appropriate to ask a manager for their AUM history along with their return history. After all, studies (and intuition) say that assets start to flow into a fund only after it has put some solid numbers. Naturally, young hedge funds have fewer assets than more mature ones.



But studies show that emerging managers also produce out-sized returns. Skeptics of hedge fund indexes suggest that young funds only report their results publicly if they have achieved positive early results - leading to a “back-fill bias”. Others say that it's simply easier to produce good returns with less assets under management. But whatever the reason, it seems that the golden years for many hedge funds happen early in life.

This is a useful observation for funds of funds and other hedge fund investors who are trying to tilt the playing field in their favour. But it also has a profound implication on the returns actually experienced for the average hedge fund investor. Essentially, those who invest in a fund after a hot start in life experience a much lower overall return than those lucky enough to have gotten in the ground floor.

Studies have long shown that the propensity to jump horses in mid-race leads to lower returns for equity investors than for the market as a whole. Now **a study on hedge funds** shows that this axiom also applies to hedge fund investors.

Ilija Dichev and Gwen Yu of the University of Michigan studied the “dollar-weighted returns” experienced by hedge fund investors and found them to be about 4% *lower* than the average returns actually experienced by hedge funds themselves. As the authors argue, that's “*large enough to reverse existing evidence of 3 to 5 percent outperformance for hedge funds*” and is significantly higher than the drag experienced by stock investors (which is only 1.5%).

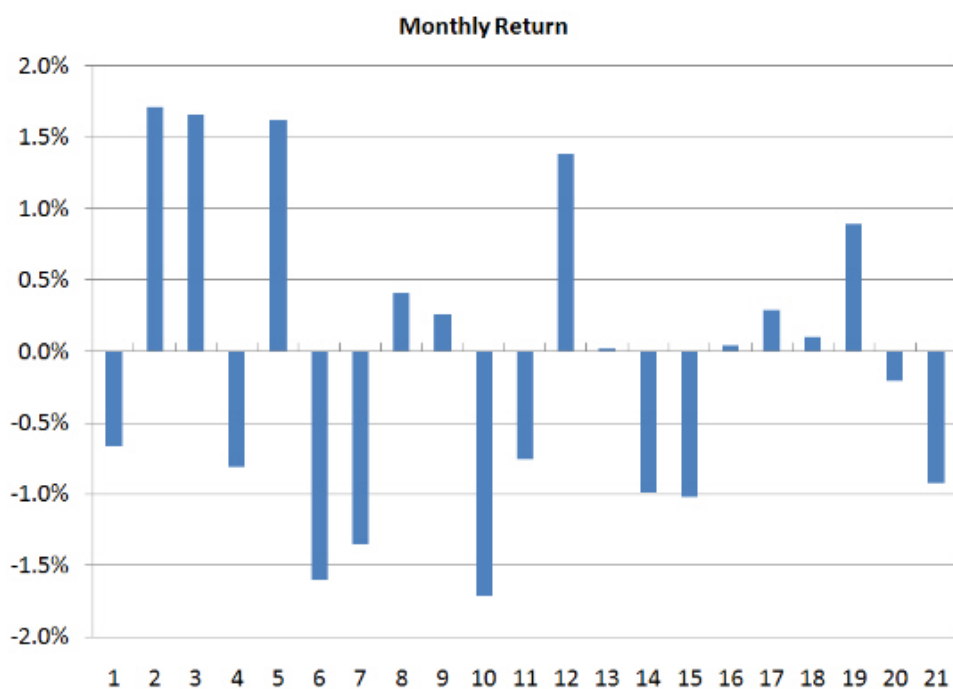
But things get worse for “star” managers where the gap between the returns actually experienced by the average dollar in the fund widens to 8 or 9% *lower* than the return of the fund itself.

Dollar-weighted returns on an individual fund level

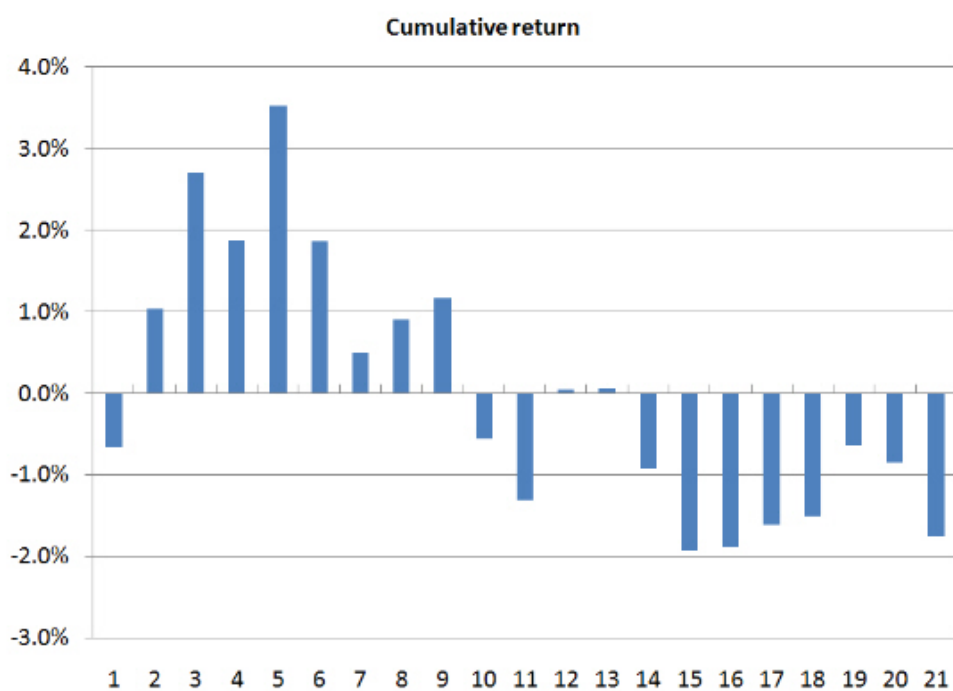
Hedge fund marketers are keenly aware of the importance of dollar-weighted returns. When a fund is down, relationship managers will often check to see when a particular client or group of clients entered

the fund. This is sometimes used as a rough proxy for a particular client's "stickiness" or propensity to ride out a draw down. For example, a client who has lost money since entering the fund is seen as a higher priority than a client who had previously made a boat-load of money and has since given back only a small part of those returns. In other words, a client's "vintage" is important.

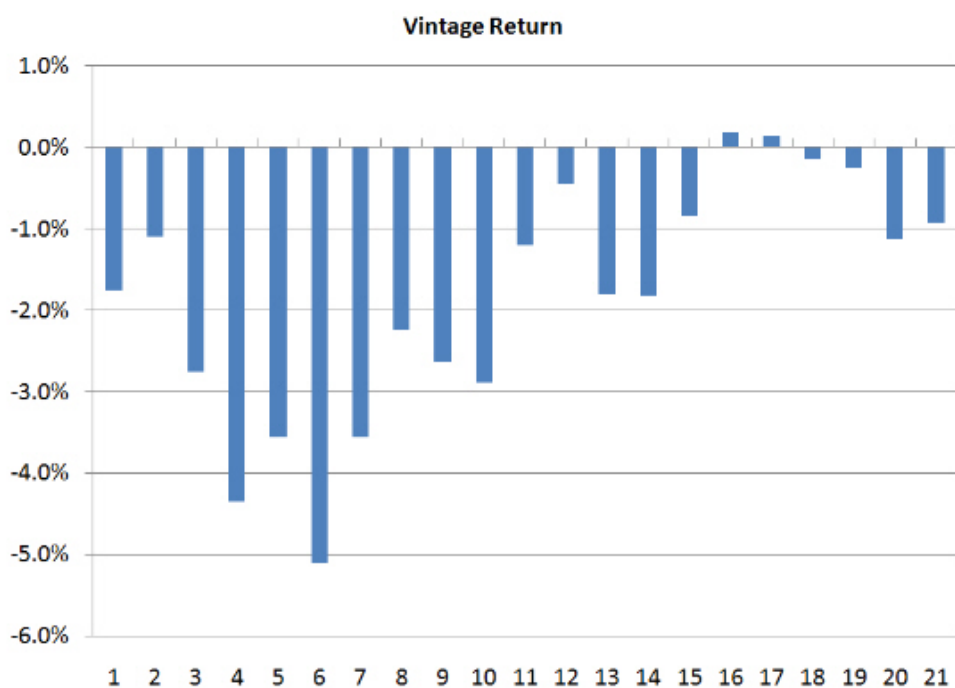
The following simple randomly-generated illustration makes the point (our example, not in the Dichev & Yu paper). Let's say a fund has the following monthly returns:



And a cumulative return of...



Then the cumulative return (by the end of month #21) experienced by those who invested at the beginning of each individual month ("vintage return") would be:



Obviously, the investor who dove in at the peak experienced the worst cumulative return. In this randomly-generated example, the fund itself (from time=0) produced a -1.8% return. But the experience of its investors could differ wildly depending on when the average dollar entered the fund (hopefully not at the end of month 5!).

From the fund level to the industry level

Unfortunately Dichev and Yu find that many funds do particularly well right before a major bump in assets. Or put another way (and placing the onus on the investors), *investors are return-chasers*.

In conclusion, Dichev and Yu issue the following ominous warning about the effect of recent hedge fund draw downs:

"...the documented results are likely a conservative estimate of the dollar-weighted effects in hedge funds. Our sample finishes in 2006, capping a string of reasonably good years for hedge funds in the early and mid-2000's. Since the capital exposure of hedge fund investors has been steadily increasing over time, the recent sharp negative worldwide returns can only increase the performance gap between fund and investor returns, perhaps in a rather material way."

One key question remains unanswered in this paper, however. How much of this should be blamed on the manager, how much on the investor and how much on unavoidable human nature?



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