

Hedge funds sold stocks quickly while mutual fund investors suffered larger losses during crisis

August 25 2011

A new study of stock trading during the financial crisis of 2007 to 2009 found that hedge funds sold their stocks much more aggressively than mutual funds at the first signs of poor performance.

These selloffs occurred in response to falling [stock values](#), the study found. Hedge fund investors withdrew almost three times as much of the money they invested as compared to mutual fund investors.

As a result, the total returns of mutual funds were much worse during the crisis than were those of hedge funds.

That means ordinary investors – who are more likely to own mutual funds – were hit hardest by the drop in stock prices, while hedge fund investors were able to limit their losses.

"Hedge fund investors rushed to the exits when stock prices started falling. As a consequence, hedge funds heavily sold their stocks. That left mutual fund clients to bear the full brunt of the falling market," said Itzhak Ben-David, co-author of the study and assistant professor of finance at Ohio State University's Fisher College of Business.

Ben-David conducted the study with Francesco Franzoni of the Swiss Finance Institute and University of Lugano and Rabih Moussawi of The Wharton School at the University of Pennsylvania.

The findings, which are included in a forthcoming paper in the journal *The Review of Financial Studies*, were a surprise to the researchers.

"When we think of hedge fund investors, most experts see them as the people who rush in whenever there is a stock crash or economic crisis to find a way to make money. They are seen as sophisticated investors who find a way to exploit a bad situation for their own benefit," Ben-David said.

"But we found that they did the exact opposite during this crisis. They got out of the stock market quickly -- and that certainly didn't help to stabilize the market. It was something we did not expect to find. At least we did not expect the phenomenon to be so pronounced!"

Hedge funds are private investment vehicles meant for wealthy investors who seek higher than average returns through sophisticated and often aggressive tactics. Many hedge fund investors are institutions, such as insurance companies, pension funds, and university endowments.

This study relied on a new data set that originates from matching the institutional ownership of U.S. stocks from Securities and Exchange Commission filings to a proprietary list of hedge funds available to the researchers. These data are then matched to proprietary data to draw information on hedge fund characteristics, performance and ownership structure. In addition, the researchers used other databases that provided information on mutual funds.

They especially focused on the period from the third quarter of 2007, when the [financial crisis](#) began, through the first quarter of 2009.

The results showed that hedge funds sold stock quickly at the first sign of losses. During the last two quarters of 2007, hedge funds reduced their stock holdings about 10 percent. Then, during the last two quarters

of 2008, hedge funds sold about 30 percent of their portfolios.

Meanwhile, mutual funds' sales of stock were about 10 times less during the crisis than were those of hedge funds, according to the study.

The quick exit from the stock market helped hedge fund investors to limit their losses when compared to mutual fund clients, Ben-David said. The quarterly returns for hedge funds were down only about 1.82 percent during the time of the study, compared to 7.22 percent for [mutual funds](#).

Why did hedge fund managers sell so quickly during the crisis?

Ben-David said one reason was that hedge funds typically borrow money to make their purchases, and their lenders asked for their money back as [stock](#) prices started falling.

The other reason is that hedge fund investors just pulled their money out of the funds. This behavior was exacerbated by some of the practices and regulations of individual hedge funds. Some funds limit the amount of money investors can take out of the fund at any one time, or after a certain date. These rules are designed to allow the hedge funds to complete long-term, often risky, transactions.

"These restrictions give investors an incentive to run more quickly for the exit if they are losing money. We found that hedge funds that had these restrictions saw more investors pull their money out," Ben-David said.

"Investors in these types of funds are very jumpy. For every bit of bad news, they start to think about getting their money out while they still can."

The fact that institutional investors are heavily involved in hedge funds also played a role, he said.

Institutional investors are managing other people's money – it is not their own. That means they may be extra careful in their investments. They don't necessarily get rewarded if their investments make more money than expected, but they could be fired if they lose [money](#), Ben-David said.

Overall, the results suggest that, at least during this crisis, hedge funds operated much differently than expected.

"Hedge funds are often seen as providing some social benefits because they buy stocks when other people are avoiding the market. But we didn't see that during this crisis," Ben-David said.

Provided by The Ohio State University

Citation: Hedge funds sold stocks quickly while mutual fund investors suffered larger losses during crisis (2011, August 25) retrieved 20 March 2024 from <https://phys.org/news/2011-08-hedge-funds-sold-stocks-quickly.html>

<p>This document is subject to copyright. Apart from any fair dealing for the purpose of private study or research, no part may be reproduced without the written permission. The content is provided for information purposes only.</p>
--