Hedge funds manipulate stock prices, new research shows

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(Phys.org)—Some hedge funds manipulate stock prices at the end of the month to improve the returns that they report to their investors, a new study suggests.

In a study of 10 years of hedge fund data, researchers found evidence that some funds run up prices on specific stocks they hold on the last day of the month and quarter – especially the last 20 minutes of trading – before they report their returns for the period. But the prices usually fall back the next day, after the abnormally large returns have already been reported to investors.

"Some hedge funds that do this are trying to make themselves look more successful than they really are," said Itzhak Ben-David, an author of the study and assistant professor of finance at Ohio State University's Fisher College of Business.

"What this means is that investors could be getting the wrong messages about the quality of the hedge fund. They're not getting a clear picture of how the fund is doing."

This practice, called "portfolio pumping," is economically significant, Ben-David said. The study found that stocks that have the most hedge fund ownership (in the top 25 percent) see on average an abnormal return of 0.30 percent on the last day of the quarter, most of which reverts back the very next day of trading.

Ben-David conducted the study with Francesco Franzoni of the University of Lugano and the Swiss Finance Institute, Augustin Landier of the Toulouse School of Economics and Rabih Moussawi of The Wharton School of the University of Pennsylvania.

The study (available here) will appear in a forthcoming issue of the Journal of Finance.

In the past, some mutual funds used to engage in portfolio pumping until the Securities and Exchange Commission cracked down on the practice in 2001. But this research suggests that hedge funds haven't been turned off to the practice.

"This is a legal gray area. I think if a hedge fund were to be seen doing this systematically, the SEC would be interested in investigating," Ben-David said.

The dataset used in this study combined a list of hedge fund management companies, mandatory institutional quarterly portfolio holdings reports and information about hedge fund characteristics and performance from 2000 to 2010.

Ben-David said he and his colleagues found evidence of very large stock orders on the last trading days of a month and quarter – orders that were big enough to move the stock prices.

The orders came in not just on the last day, but in the last minutes of the day.

"About half of the average increase in the prices of stocks that are owned by hedge funds takes place in the last 20 minutes of trading," he said.

But these aren't meaningful gains for investors, because most of it reverts back to the original price within the first 10 minutes of trading on the next day.

Not all or even most hedge funds probably participate in this portfolio pumping, Ben-David said. The researchers found evidence that hedge funds that pumped their portfolio in one quarter were more likely to do it again the next quarter.

They also found that hedge funds were more likely to pump their portfolio when they could get more "bang for the buck," he said.

For example, hedge funds were more likely to engage in the practice if they held more than an average number of illiquid stocks, or stocks that aren't heavily traded. That means a hedge fund would not have to spend a lot of money – less than $500,000 – to make a measureable impact on the value of the stock.

Findings showed hedge funds were more likely to engage in stock price manipulation when they had more to gain – especially those funds that were doing particularly well or particularly poorly against competing funds in a specific time period.

"Investors always hear most about the top 10 funds, so fund managers all want to appear in that list. That gives a strong incentive to hedge funds to manipulate when they are near the top," he said.

The researchers also found evidence that hedge funds used portfolio pumping when their returns were near zero for a month or quarter.

"If a hedge fund is just running slightly negative, they can pump up their stock prices to push themselves over into positive territory," Ben-David said. "Positive is always better than negative when you're presenting your results to investors."

That's one reason why there are many more hedge funds with returns slightly above zero than slightly below, he said.

Hedge funds in the middle of the pack are probably least likely to manipulate prices because they have little to gain. Any increase in their fund value is not likely to change perceptions about their performance.

While portfolio pumping hurts investors, e.g., by relying on misstated returns and risk, it can benefit the hedge fund managers whose compensation is tied to end-of-month performance. It can also help companies whose stock prices rise at the end of reporting periods, as some financial contracts may rely on end-of-month stock prices – even if they fall right back the next day.

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