'Hot' hedge funds come up short for investors, researchers find

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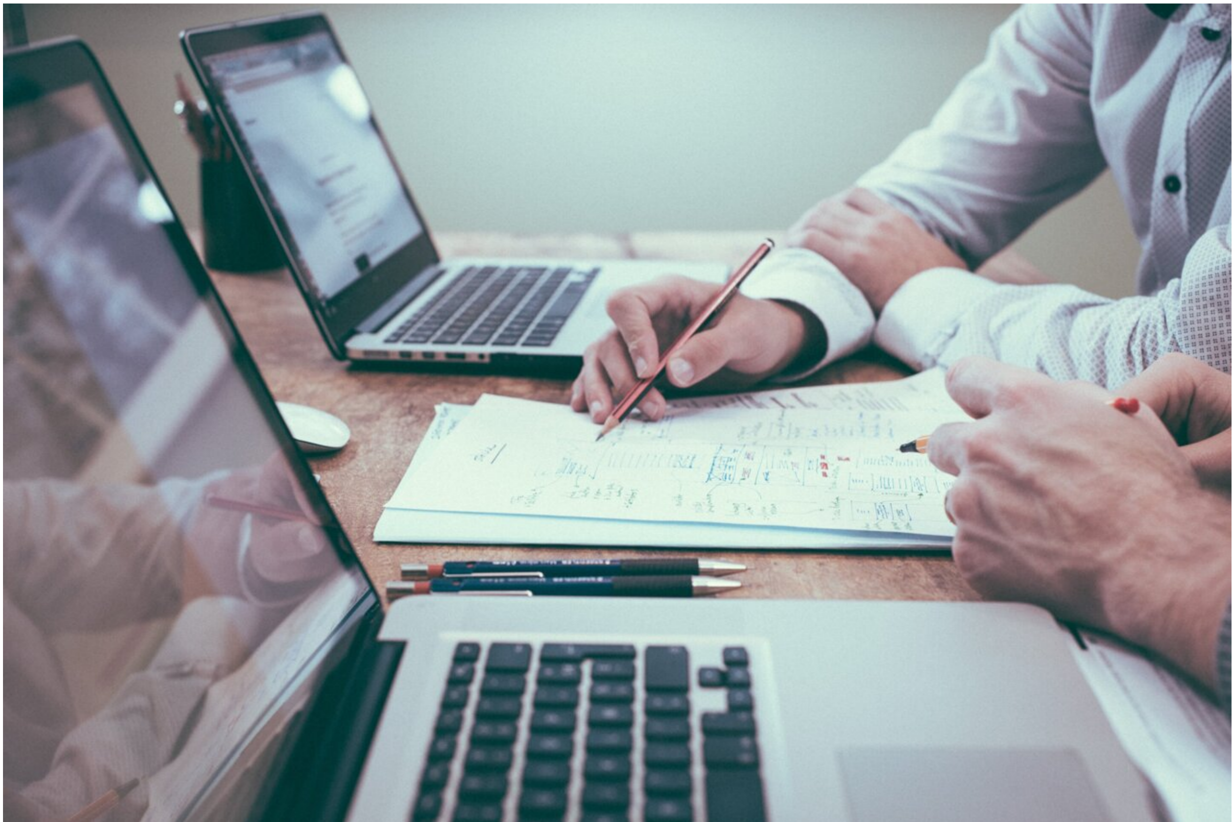

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In at least one way, asset classes in capital markets are not unlike consumer products. As they compete for investor cash, trend cycles often come into play. The movement of demand toward the "hot"

investment vehicle of the moment also affects supply, according to the inexorable logic of markets. Similar to fashion brands fast-tracking production of sought-after items, the cyclic proliferation of certain asset classes raises quality concerns.

Lin Sun, assistant professor of finance at the Donald G. Costello College of Business at George Mason University, recently published a paper in *Review of Finance* that compares hedge funds formed in high-demand, or "hot," markets to those produced in a "cold" market climate.

Sun explains, "Hedge funds often use more complex strategies to achieve higher returns. However, when overall stock market returns are already robust—for example, in years like 2017, when the S&P 500 saw an annual return exceeding 20%—there's less incentive to invest in hedge funds, because outperforming such high returns becomes more challenging. Plus, hedge fund investors face higher management and performance fees."

Sun and her co-authors Zheng Sun and Lu Zheng (of University of California, Irvine) first sought to establish the supply-demand connection for hedge funds. Using data for more than 8,000 hedge funds from the Thomas Reuters Lipper Hedge Fund Database, from January 1994-December 2021, the researchers found that, indeed, "hot" markets spawned more new hedge funds than "cold" ones.

To be more precise, about 30 more funds were started in an average "hot" month, compared to an equivalent "cold" month. This result held true regardless of the investment strategy—long/short equity hedge, fund of funds, etc.—used by the funds in question.

The researchers found that the temperature of the market that gave rise to a hedge fund was generally linked to its future performance. Funds that came into being during "hot" markets underperformed their cold-

market peers by 2.28–2.76% per annum, after adjusting for risk factors, averaged through the funds' lifetime. The professors concluded that, all told, investors were losing out on $6-$7.5 million by buying into hot-market hedge funds (assuming a typical fund with $50 million assets under management).

Moreover, hot-market funds were much more likely to fold within their first few years. Their incidence of forced closure (i.e. investors demanding their money back) was particularly high—up to 35.7% above cold-market peer funds.

Next, the researchers investigated possible explanations for these disparate results. Because hot-market funds did not perform better when cold-market conditions set in (that is, if they managed to survive that long), the story appeared to have little to do with the fund manager's efforts.

That is because in cold markets, fund managers are especially incentivized to chase higher returns, since investors who defect during these periods are harder to replace. If the problem boiled down to lazy managers, it should have been at least somewhat responsive to this change in market temperature.

At the same time, Sun and her co-authors found evidence of a "dumb-money effect" for hot-market funds whereby past flows failed to predict future returns. Also, the returns that were achieved by hot-market funds were derived more from conventional risk exposures than the exotic risks (e.g. derivatives) that are the unique specialty of this asset class. Both of the above factors suggest that investors who are drawn to hot-market funds are less sophisticated, which helps explain the initial success of flawed new funds in high-demand conditions.

"Another factor is manager quality," Sun summarizes. "In cold markets,

there's less capital flowing into the hedge fund sector but increased competition. Only the most experienced and skilled managers with proven track records are able to attract sufficient investor capital to launch a new fund."

Sun says her findings demonstrate the need for more nuanced thinking about this rapidly growing asset class. For example, hedge fund investors are automatically associated with "smart money," an assumption recently invoked by industry representatives successfully lobbying the courts to strike down an SEC disclosure rule.

"Hedge fund investors are typically more sophisticated than ordinary investors," Sun says. "But there are cross-sessional variations. In hot markets, new investors entering the sector are often less experienced, or 'green' investors."

Industry incentive structures are supposed to ensure managers do right by both the "smart" and "dumb money." But Sun points out that the motivations of fund managers are not always straightforward.

"You may assume that a hedge fund manager would want to control the fund's size so as to maximize returns and, consequently, performance fees. However, research indicates that managers sometimes focus more on the fund's size than performance. If you increase the total assets under management, you boost the company's fee income. In a hot market, companies have this incentive to launch more funds and attract as much capital as possible," Sun concludes.

More information: Lin Sun et al, The start matters: time-varying investor demand, hedge fund inceptions, and performance, *Review of Finance* (2023). DOI: 10.1093/rof/rfad031

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