Alpha or beta in the eye of the beholder: What drives hedge fund flows?

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A B S T R A C T

Capital Asset Pricing Model (CAPM) alpha explains hedge fund flows better than alphas from more sophisticated models. This suggests that investors pool together sophisticated model alpha with returns from exposures to traditional (except for the market) and exotic risks. We decompose performance into traditional and exotic risk components and find that while investors chase both components, they place greater relative emphasis on returns associated with exotic risk exposures that can only be obtained through hedge funds. However, we find little evidence of persistence in performance from traditional or exotic risks, which cautions against investors’ practice of seeking out risk exposures following periods of recent success.

1. Introduction

The last 20 years have witnessed considerable advances in our understanding of the unique risks that hedge funds seek out to achieve returns. While traditionally all returns unrelated to the market have been interpreted as manager skill (alpha), investors have begun to recognize the return implications of other traditional risks (such as

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size and value) as well as more exotic risks (such as momentum and option-like investments) generally only available through hedge funds. Despite the large literature on hedge fund performance and a plethora of risk models put forth by academics, it remains unclear how investors evaluate performance. In this article, we take a revealed preference approach as in Berk and van Binsbergen (2016) and Barber et al. (2016) to address three research questions. First, which risk model do investors use to evaluate hedge fund performance? Second, do investors respond differently to the returns due to traditional risks and the returns attributable to exotic risks? Finally, are investors’ capital allocation decisions justified by funds’ future alphas and returns due to traditional and exotic risks?

We begin our empirical analysis by conducting a flow-performance horse race to infer which risk model hedge fund investors use when allocating capital. Given the significant model uncertainty associated with evaluating hedge fund performance, we measure risk-adjusted performance using a range of single and multi-factor models including the CAPM, the Carhart (1997) four-factor model, the Carhart model augmented with the option-based factors of Agarwal and Naik (2004), the trend-following seven-factor model of Fung and Hsieh (2004), and a 12-factor combined model which also includes an emerging market factor.

We find that CAPM consistently wins the race, with hedge fund flows being better explained by CAPM alpha than alphas from more sophisticated models. CAPM alpha also weakly dominates raw returns in explaining hedge fund investors’ capital allocation decisions. The success of CAPM alpha in explaining hedge fund flows is consistent with recent evidence for mutual funds (Berk and van Binsbergen, 2016; Barber et al., 2016). However, hedge funds offer a much wider range of risk exposures than mutual funds, and hedge fund investors are viewed as more sophisticated than mutual fund clientele and pay substantial performance-based fees.2

CAPM’s success is surprising and helps motivate the rest of our analysis. In particular, this finding suggests that hedge fund investors only control for general aggregate market risk when evaluating fund performance. That is, they pool together manager skill (sophisticated model alpha) with the returns associated with traditional risk exposures other than the aggregate equity market, and exotic risk exposures.3 Investors appear either indifferent to the nature of risks inherent in certain hedge fund strategies, or they actively seek out these risks following periods of recent success. To determine whether hedge fund investors are indifferent to non-market risks or actively seek them out, we decompose fund performance into components related to manager skill and returns associated with traditional and exotic risk exposures.

Our evidence suggests that investors do seek out non-market risks, and they distinguish between hedge fund returns arising from conventional risk exposures that may be obtained more cheaply through mutual funds, and exotic risk exposures that can only be obtained through hedge fund investments. While investor flows respond to all three return components, they place greater relative emphasis on the returns arising from exotic rather than traditional risk exposures. For example, using the Fung and Hsieh (2004) model we find a one percent increase in lagged hedge fund returns attributable to exotic risk exposures leads to a 9.5% increase in inflows, compared to 5.5% for a one percent increase in lagged returns due to traditional risk exposures. This evidence suggests that investors credit hedge fund managers not only for their skill to produce alpha, but also for their ability to deliver returns through taking opportune exposures to exotic risk factors and to a lesser extent traditional risk factors.

Implicit in hedge fund investors’ strategy of allocating capital based on past return components is that these sources of return should persist in the future. Our final set of tests explores whether hedge fund investors’ flow response to three return components is justified by the data. To that end, we evaluate the persistence over time for hedge fund alpha, returns attributable to traditional risk exposures, and returns arising from exotic risk exposures. We find mixed evidence for persistence in alphas and little evidence of persistence in returns due to either traditional risks or exotic risks. We further explore the relatively weak persistence in fund returns due to traditional or exotic risks by separately examining the persistence in factor returns and betas. We find that while hedge fund risk exposures (betas) do significantly persist, the factor returns themselves do not exhibit evidence of persistence.

Taken together, our findings suggest that hedge fund investors’ emphasis on CAPM alpha when allocating capital does not reflect a lack of awareness of non-market risks, but rather a specific tendency to chase recent returns associated with both traditional and exotic risk exposures. Since these components of hedge fund performance fail to persist, our evidence suggests that this investor practice is suboptimal. Exotic risk exposures may well earn a premium on average, and our evidence does not imply that investing in exotic risks is misguided. However, our finding of lack of persistence in returns due to risk exposures suggest that investors should not select exposures based on their contributions to funds’ recent performance.

Our evidence indicates that investors would benefit from using more sophisticated models that adjust for traditional as well as exotic risks when evaluating fund performance.

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2 Berk and van Binsbergen (2016) argue that CAPM’s success in explaining mutual fund flows suggests it necessarily also explains flows into other investments such as hedge funds. Although this may be true in a complete, frictionless market, there are a number of institutional impediments that prevent flows from revealing the “true” underlying risk model, such as the inability to short bad fund managers. We interpret our findings as shedding light on how hedge fund investors evaluate performance rather than revealing the true hedge fund risk model. We discuss this issue further in Section 3.

3 Exotic risks are also referred to as “advanced,” “alternative,” or “smart” beta in the literature (e.g., Carhart et al., 2014). In our taxonomy, we separate premium-bearing risks into those that are generally available through liquid, low-cost, and transparent investment vehicles such as index mutual funds or exchange-traded funds (traditional beta) from those that can typically only be obtained through hedge funds (exotic beta). We also use the shorthand of referring to sources of risk other than the aggregate US stock market as “non-market” risks, although the size and book-to-market factors may also capture aspects of market risk.
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