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Strategic behavior within families of hedge funds ☆

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ABSTRACT

The paper investigates the strategic behavior of hedge fund families. It focuses on decisions to start and liquidate family-member funds. Hedge fund families tend to liquidate funds that underperform compared to other member funds, and to replace them by new ones. By choosing a launch time after a short period of superior performance by their member funds, families extend the spillover to new funds. Hedge fund families seem to be more experienced in promoting their funds and attracting fund inflow than in generating superior performance. This results in higher dollar compensation earned by managers within multi-fund families than in stand-alone funds.

1. Introduction

The number of hedge funds and the assets under their management has grown exponentially during the last decade, and has accordingly attracted increasing attention from researchers. Historically, individual hedge funds have been treated as independent investment vehicles with strategies determined solely by their portfolio managers. Individual hedge funds, however, are not always independent of each other, but may be controlled by the same investment company, taking the form of a family[1] of funds. According to the ALTVEST database used in this study, some 70% of all hedge funds belong to such families. For these funds, long-term decisions such as fund origination, liquidation, closure to further investments, fund promotion and fund marketing (by listing in commercial hedge fund databases) can be made strategically by these over-arching investment companies.

Hedge fund investors, however, are considered to be sophisticated. It should be relatively difficult to manipulate their beliefs about family quality and future hedge fund profitability via any kind of strategic behavior by investment companies. Thus the empirical results of this paper are surprising, and indicate that hedge fund companies do behave strategically, and that this behavior is financially beneficial for their managers.

Although the strategic behavior of hedge fund families has not been extensively studied in the literature, there is abundant evidence concerning the strategic behavior of mutual fund families. See, e.g., Khorana and Servaes (1999) for origination decisions, Zhao (2004) for decisions to close funds for investments, Nanda et al. (2004) for strategic fund promotion, and Gaspar et al. (2006) for cross-fund subsidization. This paper concentrates on two major decisions by hedge fund families – fund origination and fund liquidation – since these primarily affect the opportunity set of investors. The analysis of other family-related decisions is postponed for future research.

Decisions concerning the founding of new hedge funds have not received much attention in the existing literature. I am aware of only one paper, Boyson (2008), in which the performance difference between funds from large and small families is addressed. The author tries to relate the decision to originate a hedge fund to the increasing market share of the company.

Hedge fund survival, on the contrary, has been extensively studied in the literature (see Liang, 2000; Gregoriou, 2002; Park, 2006). The authors relate the probability of a hedge fund's liquidation to its performance and risk, and to different organizational factors, such as incentive fees and lockup periods. Alas, this research seems to disregard the fact that liquidation decisions may be taken

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[1] The terms "family" and "investment company" will be used interchangeably throughout this paper.

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strategically by investment companies operating several funds; and, moreover, that they can be linked to the origination decision.

This paper fills this gap and inspects more closely the determinants of the birth and death of family held hedge funds, while accounting for the possible strategic decisions by investment companies. The empirical evidence suggests that investment companies tend to liquidate funds that underperform relative to the company average. By doing so, they not only improve the average family performance, but also ensure that only those funds that are able to generate high fee income operate within the family. Hedge funds with fewer assets under management, lower fees, and lower value relative to the high-water mark than the family average are more likely to be liquidated. At the same time, investment companies do not simply liquidate the black sheep of the family; they also tend to replace poorly performing funds with new ones.

Trying to capitalize on the good past performance of family-member funds, investment companies are more likely to start new funds when other member funds perform well. Notably, the families choose the fund launch time strategically, after a short period of superior performance by other family-member funds. Investment companies seem to optimize the launch time to encourage a money inflow to the new funds. The launching decision in itself should thus not be interpreted as a signal of outstanding family quality that will persist in the future.

Additionally, I find evidence of the presence of economies of scale in hedge fund families, similar to mutual fund families. Larger families, and families that have opened funds in the past, are more likely to start new ones. At the same time, hedge fund families appear to be much more specialized than mutual fund families, and the probability of starting a new fund with a particular style increases with the number of funds with the same style already launched within the family.

Altogether, hedge fund families seem to manipulate their funds strategically, to improve the average performance record. I document the existence of the spillover effect in hedge fund families, which provides an additional incentive for such behavior: capital inflow into newly originated funds within fund families increases with the past performance of other family-member funds.

The spillover to new funds within investment companies, in conjunction with investors' preference for "familiar" (already existing) companies, leads to higher inflows to new hedge funds launched within already existing companies than to funds launched as stand-alone vehicles. Remarkably, investors do not seem to be aware of the potential strategic choice of the exact time of a hedge fund start. Flows to new funds are not sensitive to the possible timing of the fund launch. They react positively to the short-term outperformance of other family-member funds, even if they do not perform persistently well.

Hedge fund families seem to be more successful in promoting their funds and attracting higher fund inflow than in generating superior performance. Hedge funds from multi-fund families are on average twice as large as their peers from single-fund families, but they deliver significantly lower returns. Their managers earn higher monetary compensation from management fees. Despite lower returns, the dollar incentive fees earned by the fund managers of newly launched funds within multi-fund companies are also higher than those earned by managers within single-fund companies. The lower returns are more than offset by the greater amount of assets under management.

The paper proceeds as follows: The main testable hypotheses are developed in Section 2. The methodological approach and the control variables are discussed in Section 3. Section 4 describes the data. Section 5 presents the empirical results. Some extensions and robustness are discussed in Section 6, and the last section concludes.

2. Hypotheses development

2.1. Liquidation of hedge funds within fund families

Investment companies receive profits (fee income) from existing hedge funds. The total income includes both the management fee income, which is proportional to the assets under management, and the incentive fee income, which depends on the cumulative fund return, and its value relative to the high-water mark.

In maximizing management fee income, investment companies are interested in higher capital inflows to their funds. Intuitively it should be much easier to attract investors into a fund if other funds within the family perform well. There is some evidence for mutual funds that the good performance of one fund within a family attracts higher inflow to other funds within the same family (Nanda et al., 2004). Similar effects can provide hedge fund investment companies with incentives to improve the average performance record of the family.

According to Massa (2003), mutual fund investors first pick a fund family, and then an individual fund in which to invest. If the decision making process of hedge fund investors is similar, hedge fund families have additional incentives to improve the average family quality by liquidating poorly performing funds, and keeping only those with high returns, which are able to attract new investors and to earn high management and incentive fees. The relative position of a hedge fund within its family should have a significant influence on the probability of the fund's liquidation.

Hypothesis 1. The relative characteristics of a hedge fund within its family are more valuable liquidation predictors than their absolute counterparts.

The crucial factors for hedge fund liquidation decisions are those that contribute to a general positive perception of the family by market participants, and those that influence the management and incentive fee income of the company. These factors include hedge fund average return and risk (Liang, 2000; Brown et al., 2001), assets under management (Getmansky, 2005), managers' incentives and flexibility (Ackermann et al., 1999), and the value relative to the high-water mark (Hodder and Jackwerth, 2007). I expect to find that hedge funds having higher than average returns, lower risk, larger assets under management, larger percentage flows, higher management and incentive fees, longer notice period prior to redemption, longer lockup periods, and higher value relative to the high-water mark than other funds within the same investment company are less likely to be liquidated.

2.2. Origination of new hedge funds within fund families

Having decided to liquidate a hedge fund, a company commits to redeem the shares of the investors. Consequently, it loses the associated management fee income. Hedge funds, however, are often liquidated when they are below the high-water mark. Such hedge funds have low potential to earn incentive fees. Since high-water marks in new funds are reset, investment companies can increase the probability of earning incentive fees and keep earning management fees, by substituting poorly performing hedge funds with new ones.

Hypothesis 2. The probability of launching a new hedge fund increases given the recent liquidation of another hedge fund within the family.

Like mutual fund families (see Khorana and Servaes, 1999), hedge fund families can capitalize on their good reputation by creating new funds. As companies that perform well may expect a