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Hedge fund politics and portfolios

Luke DeVault[a], Richard Sias[b,*]

[a] Department of Finance, Clemson University, Clemson, SC 29634 USA
[b] Department of Finance, Eller College of Management, University of Arizona, Tucson, AZ 85721 USA

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ABSTRACT

Consistent with the well-documented relation between political orientation and psychological traits, hedge funds' political orientations are related to their portfolio decisions. Relative to politically conservative hedge funds, politically liberal hedge funds exhibit a preference for smaller stocks, less mature companies, volatile stocks, unprofitable companies, non-dividend paying companies, and lottery-type securities. Politically liberal hedge funds are also more likely to enter new positions or fully exit existing positions, and make larger adjustments to their U.S. equity market exposure. Our results suggest that psychological characteristics can influence the portfolio decisions of even those at the very top of the financial sophistication ladder.

1. Introduction

Although it is well known that both institutional and individual investors' equity portfolios exhibit substantial heterogeneity, we have little understanding of what drives these differences.[1] One promising stream of research suggests that psychological characteristics—related to genetics or life experience—can help explain cross-sectional variation in portfolio and security selection decisions. Because research suggests that the role of psychological factors in financial decision making declines with investor sophistication, it is not surprising that most of the evidence linking psychological characteristics and investors' decisions is limited to relatively unsophisticated individual investors.[2] Nonetheless, a few recent studies suggest that psychological characteristics influence the decisions of some mutual funds and smaller, presumably less sophisticated, institutional investors. As Shu et al. (2012) point out in their examination of religious beliefs and mutual fund behavior, the link between professional money management and psychological characteristics is surprising because the competitiveness of the money management industry means that professional investors have a strong incentive to focus on performance maximizing strategies and such strategies should be invariant to managers' psychological characteristics.

It is well recognized, of course, that even if psychological characteristics influence the trading decisions of some investor groups, the asset pricing implications will be negligible as long as there is a sufficiently funded group of investors willing to exploit those whose decisions are influenced by non-performance related factors (e.g., Friedman, 1953; Fama, 1965). Because hedge funds are widely viewed as the most sophisticated investor class, they are the most likely candidate for this role.[3] Consistent with this view, a number of recent studies suggest that hedge funds are better informed than other institutional investors (e.g., Sias et al., 2016; Cao et al., 2015a, b).

In addition, the incentives for maximizing performance are stronger for hedge funds than other institutions for at least two reasons. First, unlike most other institutional investors, hedge funds have performance-related incentive fees (historically 20% of profits). Second, hedge funds have the most sophisticated investor base—primarily consisting of pension funds, foundations, and very wealthy individuals.[4] Getmansky et al. (2004) summarize the view

* Corresponding author.
E-mail addresses: ldevaul@clemson.edu (L. DeVault), sias@email.arizona.edu (R. Sias).

[1] See, for example, Cesarini et al., 2010, Campbell, 2006, and Curcuru et al., 2009 for additional discussion.

[2] We review this literature in the next section.

[3] It appears widely accepted that hedge funds are viewed as the most sophisticated investor group. For instance, Stein (2009) points out that, "Hedge funds are commonly thought of as the prototypical sophisticated investors…" Similarly, Brunnermeier and Nagel (2004) claim, "Hedge funds are among the most sophisticated investors—probably closer to the ideal of 'rational arbitrageurs' than any other class of investors."

[4] A broad literature argues that hedge funds have the most sophisticated client base. For instance, Baquero (2005) note that hedge fund clients are limited to quali-

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of hedge funds and market efficiency captured in the literature, "And if this self-correcting mechanism of the Efficient Markets Hypothesis is at work among any group of investors in the financial community, it surely must be at work among hedge-fund managers, which consists of a highly trained, highly motivated, and highly competitive group of sophisticated investment professionals."

This study investigates whether psychological characteristics impact hedge funds' security selection and portfolio decisions. The question is important for at least three reasons. First, hedge funds have grown to become an important force in equity markets, accounting for 10% of the average stock's ownership and one-third of NYSE trading volume (Cao et al., 2015b). Second, as noted above, an extensive literature suggests that the effect of psychological characteristics declines with investor sophistication. Although there is nascent evidence that the investment decisions of some institutional investors (mutual funds and smaller institutional investors) are influenced by psychological characteristics, there is effectively no evidence of a systematic relation between hedge funds' decisions and psychological characteristics.[5] Given hedge funds are viewed as the most sophisticated investor class, our tests examine whether the impact of psychological characteristics runs to the very top of the financial sophistication ladder. Third, evidence that hedge fund managers' decisions are influenced by psychological characteristics implies that we cannot be assured that even the most sophisticated investors are immune to these influences and will therefore correct mispricing caused by other, less sophisticated, investors.

Following several recent studies, we use individuals' political orientations (as revealed through their political contributions) as an instrument for their psychological characteristics to test if sophisticated investors' psychological characteristics influence their security selection and portfolio decisions. Specifically, more than 60 years of psychology and political science research demonstrates that political ideology is strongly related to psychological characteristics—relative to conservatives, liberals are more tolerant of ambiguity and uncertainty, more open to new experiences, have lower levels of fear, exhibit higher integrative complexity, and have lower needs for order, structure, and closure (e.g., Jost et al., 2003). Moreover, these psychological characteristics are strongly related to political ideology not only through environment (or nurture), but also through genetics (or nature), e.g., evidence reveals that both brain structure and brain processing differ between conservatives and liberals.

Given the well documented relation between political ideology and psychological characteristics, we hypothesize that politically conservative hedge funds' long equity portfolios will, on average, exhibit less weight in securities with the most subjective valuations. Specifically, we focus on six security characteristics identified in previous work—the five characteristics identified by Baker and Wurgler (2006, p. 1648) that capture the "subjectivity of their valuation" and lottery-type securities as identified by Kumar et al. (2011). Further, we hypothesize that politically liberal hedge funds, relative to politically conservative hedge funds, will exhibit greater portfolio turnover, greater willingness to enter new securities, greater willingness to completely exit existing positions, and greater willingness to adjust their exposure to U.S. equity markets.

By construction, we focus on portfolio and security characteristics with no direct link to politics.[6] That is, we do not claim political orientation is the source of causality. Rather, based on a well-established psychology and political science literature, political orientation is the instrument we use to identify the nature of hedge fund managers' psychological characteristics. Fig. 1 captures the framework for our research question. Specifically, we hypothesize that psychological characteristics (which are a function of both nature and nurture) influence both political orientation and portfolio decisions and, as a result, hedge fund managers' political orientations are related to their security selection and portfolio decisions.[7]

Our empirical tests provide the first systematic evidence that hedge fund managers' psychological characteristics influence their security selection and portfolio characteristics. On average, politically liberal hedge funds' long-equity portfolios contain a greater weight in more speculative stocks—smaller stocks, younger companies, more volatile stocks, unprofitable companies, non-dividend paying companies, and lottery-type stocks—relative to their politically conservative counterparts. Politically liberal hedge funds, on average, are also more likely to completely liquidate an equity position or enter a new equity position and exhibit a greater willingness to adjust their exposure to U.S. equity markets.

The relation between political orientation and portfolio characteristics is both statistically and economically meaningful—for our broadest tests, the effect size ranges from 12% to 24% of the standard deviation of the cross-sectional variation across hedge fund portfolios. For instance, the value-weighted mean market capitalization of securities held by politically liberal hedge funds averages 0.22 standard deviations smaller than value-weighted mean market capitalization of securities held by politically conservative hedge funds. Moreover, the evidence is stronger when more clearly isolating the variation in portfolio preferences related to psychological characteristics by using stricter definitions of political conservatism, controlling for fund characteristics (e.g., fund age), controlling for manager characteristics (e.g., manager age), or controlling for both manager and fund characteristics simultaneously. Additional tests reveal no evidence that the relation between hedge funds' political orientations and their security selection and portfolio decisions is related to hedge funds attempting to "buy" performance via political contributions.

Our results may appear surprising given the view that hedge funds use sophisticated valuation models. Nonetheless, recent work demonstrates that hedge funds' long equity portfolios exhibit a tremendous amount of cross-sectional heterogeneity. Sias et al. (2016) report, for example, that more than 95% of hedge fund pairs have less than 10% overlap in their long equity portfolios. Our results suggest that psychological factors can help explain this cross-sectional variation in hedge funds managers' security selection and portfolio decisions.

In sum, our goal is straightforward: testing whether the investor group at the top of the financial sophistication ladder—those investors who are expected to systematically correct mispricing due to less-sophisticated investors' non-performance maximizing trades—are immune to the influence of psychological characteristics. As pointed out by Cesarini et al. (2010), the relation between psychological characteristics and portfolio decisions may reflect

fied investors who, "…have sophisticated understanding of financial markets…" and pension funds with at least $25 million in assets. Similarly, Brav (2008) note that, "…hedge funds avoid the Investment Company Act of 1940 by having a relatively small number of sophisticated investors." Further, Akbas (2015) use flows to hedge funds as a measure of 'smart money' and find that smart money appears to attenuate mispricing while dumb money (flows to mutual funds) magnify mispricings.

[5] Hong and Kostovetsky (2012) examine mutual funds' political donations and portfolio political characteristics (e.g., holdings in politically sensitive industries such as tobacco). They also include a small sample of hedge funds in their study (see their Table 8). We discuss differences between their study, other related papers, and our study in the next section.

[6] For example, we do not examine corporate social responsibility or exposure to "sin" stocks.

[7] Recent studies use this same framework to examine the relation between corporate managers' political donations and corporate decisions (Hutton, 2014) or equity analysts' political donations and their forecasts (Jiang, 2016).