

Hedge Funds Non-Transparency: Skill of Risk-Taking?

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June 2014

This policy brief raises the issue of whether the secretive nature of hedge funds allows funds to misbehave and take excess risks that may in turn be contagious for the whole economy. We use a novel dataset and a new methodology to argue that at least part of the excess performance of more secretive funds during the pre-crisis period was indeed due to higher risks taken.

Hedge Funds – the Secretive Investment Vehicles

In the modern era of delegated portfolio management, hedge funds constitute some of the most interesting and complicated investment vehicles, with a global industry size of over US\$2.5 trillion and an overall number of funds of about 10,000 (according to Hedge Fund Research, Inc). The industry grew dramatically during the early 2000s, often providing investors with returns superior to those available in other financial sectors.

The natural question arising is then what exactly made hedge funds enjoy these superior returns. Historically, hedge funds have operated in a relatively secretive way that did not require them to disclose the details about their operations to regulators. Some have argued that it is this secretive nature of hedge funds that has allowed fund managers to employ superior trading strategies and effectively preserve the managerial know-how (in terms of stock-picking skill, market timing or faster trading technology) from being potentially replicated by others.

At the same time the secretive nature of hedge funds might simply allow the fund managers to hide the excessive risks their strategies are exposed to, thereby earning superior returns during relatively good periods (when risky strategies earn the risk premium), but having drastic collapses during relatively bad periods (when these risks realize).

Distinguishing between these two major explanations of superior performance is critically important for potential policy implications regarding hedge funds transparency and disclosure. If the secretive nature of hedge funds attracts more skillful managers that employ proprietary know-how strategies and invests into acquiring more information about the instruments they trade (i.e. generate so called "alpha"), more disclosure would not be necessarily good. This, since it would allow other funds or investors to free-ride on these more skillful managers, reducing their competitive advantage and incentives for providing superior performance. If on the other hand, secrecy allows hedge funds to misbehave and take more systematic risk than they claim they take (i.e. they have a higher "beta"), then there may be a rationale for increasing disclosure

requirements, so that investors understand what they are being compensated for in the form of superior returns.

Is There More Risk in Secretive Hedge Funds?

The traditional approach to distinguishing between high-alpha and high-beta funds involves adopting a certain model of risk, i.e. selecting a set of observable risk factors that hedge funds may load on, and then adjusting their raw performance using the estimated exposures to these different factors. This would yield alpha – the risk-adjusted return – that can in turn be used as a measure of managerial skill.

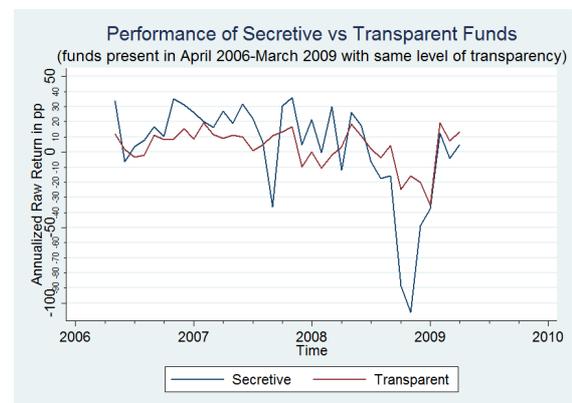
In Gorovyy et al. (2014), we argue that the above methodological approach may sometimes be misleading in evaluating managerial performance. Indeed, in the absence of the true model (e.g. not knowing all factors or not being able to observe them) such alpha would be overestimated as long as these omitted or unobserved factors are earning positive returns during the estimation period (and underestimated, respectively, if the returns are negative). For practical purposes this means that if hedge funds load on unobservable factors, which during the estimation period happen to crash rarely, but deliver a positive return most of the time, we would erroneously attribute funds' superior returns to managerial skill and not risk.

To tackle this issue, we offer a different approach and suggest that during relatively good times high-alpha and high-beta explanations may be observationally equivalent, but during relatively bad times, they are not. In particular, if during bad times the risks that funds have been loading on realize, we would observe relatively worse performance of funds that loaded more on such factors, *ceteris paribus*. Thus, in order to distinguish between high-alpha and high-beta

funds, we need to look precisely at periods when we would be comfortable assuming that such unobserved factors are likely to crash.

In order to implement this idea, we use a novel proprietary dataset obtained from a fund-of-funds – that is, a hedge fund that invests in other hedge funds, and, hence, has a lot of information about these other hedge funds – and spans April 2006 to March 2009, to directly measure the secrecy level of a fund that is missing in public hedge-fund databases. This qualitative measure describes the willingness of the hedge-fund manager to disclose information about its positions, trades and immediate returns to fund investors. It is based on formal and informal interactions of the fund-of-funds with hedge funds it invests in, such as internal reports, meetings with managers and phone calls.

Figure 1. Performance of Secretive vs. Transparent Funds



Source: Author's own calculations.

First of all, we document that secretive funds significantly outperform transparent funds during the relatively good times, as suggested, for example, by the period between April 2006 and March 2007 – a growth period according to NBER, and a period of rapid rise of the U.S. stock market indices. In particular, we find that the most secretive funds earned on average about 5% in annualized terms more than the most transparent funds during this period, even when we control for differential

risk exposure of different strategies over time and various hedge-fund control variables.

In order to understand whether this superior performance of more secretive funds is due to managerial skill, or some other factors that may not be observable or not known in the model, we need to see what happened to these funds during the relatively bad period of time, i.e. during the period when we would feel comfortable assuming that risk factors on which hedge funds may have loaded did indeed realize. Although we may have in mind some of the omitted factors being potentially related to rare events and tail risk (as also supported by loadings on strategies associated with option-based returns as in Agarwal and Naik, 2004), they may well represent other risks that were likely to realize during the crisis period. We therefore label April 2008 to March 2009 as the "bad" period – a recession period according to NBER, highlighted by the bankruptcy filing by Lehman Brothers in September 2008 and some of the largest drops of stock market indices in history.

As we see from the graph in figure 1, the performance comparison between secretive and transparent funds largely reversed during this bad period. In particular, also supported by our more saturated regression results, transparent funds outperformed the secretive ones during the crisis by the magnitude of about 10-15% in annualized terms, depending on the exact specification. This explicit consideration of the bad period allows us to conclude that at least a part of the performance differential between secretive and transparent funds during good times can be attributed to a higher risk-taking by secretive funds, which earned a premium during good times but faced these realized risks during bad times.

Potential Policy Implications

As a response to the recent financial crisis, many developed economies have passed

regulatory reforms considerably increasing the required disclosure levels, suggesting that the secretive nature of alternative investment vehicles has been considered to be something undesirable (e.g. for contagious effects on the economy, or the ex-post bailouts of the "too-big-to-fail" financial institutions). The examples of such policies include the U.S. Dodd-Frank Wall Street Reform Act passed in July 2010, the European Union Alternative Investment Fund Managers Directive 2011/61/EU that entered into force in July 2013, and the Regulation Guide 240 issued by the Australian Securities and Investments Commission in September 2012.

However, given that hedge funds receive money from relatively sophisticated and wealthy investors (i.e. generally having at least \$1 million in net worth), whether more risk in hedge funds strategies is good or bad for them in particular, and the society in general becomes a somewhat debatable question. More importantly, the essence of many of the hedge-fund strategies lies in the so-called dynamic trading – with asset positions and risk exposures being adjusted daily or even more frequently. In such an environment, reporting these positions to the regulatory authorities even on a monthly basis may not adequately describe the exact risks taken by the hedge funds.

More relevant questions, on the other hand, may be about whether investors correctly perceive the exact risks faced by the fund, how large the degree of asymmetric information is within the hedge fund industry, and whether any action may be needed to correct it. These remain open questions and we hope that future research will address them.

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References

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