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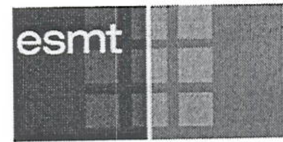


Press release

Berlin, June 1, 2010

"Serious Concerns" over hedge fund risks, concludes new research

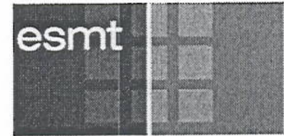
As regulation of the hedge fund industry moves closer, and negotiations begin over the character of the Directive on Alternative Investment Fund Managers (AIFM), new research highlights serious worry over hedge funds and the risks to investors

- **Results raise serious concerns about investors' ability to make the right investment choices – meaning that increasing investor protection and curbing unnecessary risks should be a priority for regulators**
- **Investors naïvely chase performance at all costs, irrespective of the risk of different hedge fund investment styles**
- **Style volatility, and investors' inability to time switching in and out of different investment styles, exposes them to unforeseen risk**
- **Research raises concern about the efficient allocation of capital and implications for hedge fund regulation**

New research from the European School of Management & Technology (ESMT), in collaboration with the Rotterdam School of Management, highlights a worrying disconnect in the behaviour of investors in hedge funds and the subsequent performance of their investments, typically resulting in poor or volatile performance and exposure to unnecessary risk. In a study of hedge fund performance according to investment style, covering 1,543 hedge funds over 10 years, ESMT's research raises disturbing questions about the way that hedge fund investors invest and their willingness to actively chase performance at all costs, irrespective of the potential level of risk to which they are exposed. As a result, the authors of the research take the view that greater regulation is necessary to protect investors and that the provisions of the controversial Alternative Investment Fund Managers (Directive) ought to be welcomed.

The research reveals that investors systematically reward investment styles that have performed well over the previous three quarters, effectively substituting different investment styles for one another regardless of whether they are taking on higher levels of risk. This results in the top performing investment style attracting nearly $300 million more capital than the investment style that performs most poorly. A differential of 1 per cent in the performance of a given style attracts a further $9 million of investor funds. However, the volatility of hedge fund styles means that high performing investment styles often go on to underperform other investment styles in subsequent quarters.

The importance of ESMT's research is that it is the first of its kind to show correlated investment behaviour based on *style*. Previous studies have not separated style-based investing from those investors rewarding the performance of individual funds or managers. ESMT calculates that approximately 13 per cent of total net asset growth can be attributed to "style-based investing", and 20 per cent of the capital that is committed to the hedge fund sector.



The ramifications of style-based investment are significant, with the research suggesting that focusing on investment styles results in a potential inefficient allocation of capital across the hedge fund sector. The danger is that as increasing amounts of capital chase given styles (potentially attracting more managers into that style in turn), momentum investment starts to take hold, forcing up the price of overheated securities.

Guillermo Baquero, Assistant Professor at the European School of Management & Technology (ESMT) and an author of the research comments:
"We have a two-fold issue here: whether investors' naivety is leaving them overly exposed to risk they are not properly evaluating, and whether the growth of the hedge fund industry combined with that naivety means the sector poses a threat to financial stability. The fact that investors appear unable to recognise the risks of different styles and chase performance at all costs could leave them vulnerable and unprotected. This is exacerbated at the individual fund level by the opacity and lack of regulation of the sector, which already means that there are significant discrepancies in the level and quality of information reported.

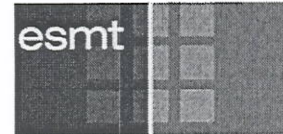
"Now is the time to discuss deep, substantial and effective regulation that will genuinely be of use to investors and protect our financial system for the future."

The fact that previously winning investment styles are subject to subsequent weak performance leads ESMT to conclude that a problem may lie within the simple movement of money itself. On a pure cash-flow weighted model, subsequent investor returns are more adversely affected than those recorded when style investment returns are equally weighted. In short, it is clear that the *wall* of cash being committed to a particular winning style only exacerbates later poor performance. This suggests that hedge fund strategies are not easily scalable and opportunities to profit rapidly diminish as more investor capital is committed.

Guillermo Baquero comments:
"Given that the minimum investment thresholds for hedge fund investing have come down substantially in recent years, expanding the market and opening it up to retail investors, it is important to consider the level of risk hedge funds – and misinformed capital flows – may pose.

"We already know from the financial crisis that hedge funds were previously making increasingly directional bets in a rising market, which forced them into a situation of having to painfully unwind their positions. This in turn exerted huge downward pressure on already fragile markets. If naïve investment combines with an increasingly expanding industry, systemic risk may yet be posed in the future by the larger funds. We need financial reform that will anticipate the threats of the future, as well as deal with those of the past. Increasing regulation and investor communication around hedge funds will help considerably in making overall investment much smarter."

'Winning' and 'losing' hedge fund styles: performance does not persist



ESMT's research firstly reveals that there is no relationship between current and subsequent performance of a given investment style, and secondly calculates the impact on investor returns.

Looking at the two top performing and two worst performing investment styles in each quarter over the study's 10-year time horizon reveals considerable volatility in the relative performance of different investment styles. For example, one of the most volatile investment strategies, Dedicated Short Bias, came first or second for 39% of the period surveyed. But this same strategy gave the worst or second worst returns for 55% of the time.

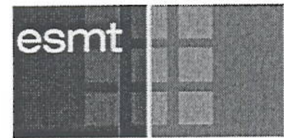
(fig.1) Quarterly Frequency and persistence of investment performance by style

('Winners' refers to the investment style that performed the most strongly, or second most strongly. 'Losers' refers to the investment style that performed the most poorly, or second most poorly)

Top performing or 'winning' investment style % of top-ranking performance over 10 years	Worst performing or 'losing' investment style % of bottom-ranking performance over 10 years	Momentum or reversal in quarterly returns (initial & subsequent performance: the diff. between 'winners' and 'losers')	
1 **Emerging markets (45%)**	1 Dedicated short bias (55%)	Initial quarter's performance	+9.0%
2 Dedicated short bias (39%)	2 Managed futures (41%)	Subsequent Q1	+0.4%
3 Managed futures (30%)	3 Emerging markets (36%)	Subsequent Q2	-1.6%
4 Global Macro (27%)	4 Long/short equity (21%)	Subsequent Q3	+1.2%
5 Long/short equity (25%)	5 Equity market neutral (11%) 5 Global macro (11%)	Subsequent Q4	-1.1%
6 Convertible arbitrage (11%) 6 Equity market neutral (11%)	6 Fixed income arbitrage (9%) 6 Convertible arbitrage (9%)		
7 Event driven (7%)	7 Event driven (7%)		
8 Fixed income arbitrage (5%)			

While strategies like emerging markets, dedicated short bias, and managed futures are particularly well-known for their volatility, ESMT's research reveals that the volatility of hedge fund returns is true *across* the spectrum. When analysing the performance of different styles in the immediately following quarter, the research found that half of investment categories typically went on to outperform the winning style from the previous quarter. When comparing winners and losers over several subsequent quarters, the research finds that relative performance even reverses – with the losers increasingly outperforming the previous winners.

What is more, investors are also highly likely to reward very extreme movements in style, often associated with the riskiest areas of hedge fund investment. ESMT's research reveals that if a particular style moves from bottom to top



performer in a given quarter, it is rewarded with 6 per cent of investor inflows, and 12 per cent of capital over the following three quarters. Also, investors react strongly to sequences of relative performance.

Guillermo Baquero explains:
"Naturally, investors will be drawn to investments that demonstrate more favourable returns, yet our research acts as a cautionary tale about falling into the age-old trap of trusting to past performance. Despite the perception that hedge fund investors are more sophisticated, our research suggests that this is not the case and that investors are overly reliant on yesterday's performance. This is particularly worrying at a style level as investors are, in effect, moving in and out of strategies irrespective of whether they are exposing themselves to higher or inappropriate levels of risk for their needs. Evidence of an uninformed supply of capital flooding the market raises serious questions both about the level of risk to which investors are personally exposed, and the potential level of risk brought to financial markets as a whole".

"Chasing the winners": investors fail to anticipate future performance

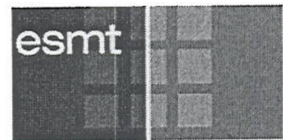
ESMT's research then goes on to track aggregate dollar flows from investors as a result of their rewarding (or punishing) different investment styles. The research finds that investor inflows are more heavily weighted to the particular styles with the highest index returns in the previous three quarters.

However, the research clearly reveals that money flows fail to anticipate future performance. By the fourth quarter, poor performing investment styles – that had received net negative inflows of investor capital – increasingly outperform. In short, investors are unable to time their investments effectively.

(FIG.2) STYLE-DRIVEN DOLLAR FLOWS: CASH-FLOW WEIGHTED RETURNS

	Styles with net positive inflows	**Styles with net negative inflows**	**Difference (between positive and negative inflows)**
Lagged quarter (-2)	*+3.6%*	*+0.3%*	*+3.3%*
Lagged quarter (-1)	*+3.9%*	*+0.2%*	*+3.7%*
Initial quarter (0)	+3.0%	+0.5%	+2.5%
Subsequent Q1	+2.1%	+2.2%	**-0.1%**
Subsequent Q2	+1.6%	+3.3%	**-1.7%**
Subsequent Q3	+2.4%	+2.1%	+0.3%
Subsequent Q4	+2.0%	+2.9%	**-0.9%**

ESMT's research concludes that investors' inability to time their capital effectively means they either misread the information they consume on given investment styles, or that the information to which they are exposed is not representative enough to act as a useful benchmark.



Guillermo Baquero concludes:

"These results raise serious concerns about investors' ability to make the right allocation choices and suggest that increasing investor protection and curbing unnecessary risks and speculative activity of hedge funds should be a priority for regulators. In line with these results, the proposed new rules by European member states on tighter restrictions for hedge funds are a milestone. The new rules would include registration requirements, compensation guidelines and compel managers to regularly disclose the use of leverage, short sales and derivatives.

"Whilst no-one would wish to reduce hedge funds to a mere offshoot of the mutual fund sector, the industry needs to take responsibility for its increasing size, role, and attraction for much more mainstream investors. Cross-border marketing restrictions or "third country" rules remain controversial, particularly with the UK and US. Yet, overcoming the inconsistencies in cross-border regulatory regimes is vital to frame the regulatory debate on hedge funds correctly and effectively and to ensure the full protection of investors."

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About ESMT
ESMT European School of Management and Technology was founded in October 2002 by 25 leading global companies and institutions. The international business school offers Full-time MBA and Executive MBA programs, as well as executive education in the form of open enrollment and customized programs. The School also features in-house research-oriented consulting services. ESMT is a private university based in Berlin, Germany, with an additional location in Schloss Gracht near Cologne.