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Birds of a Feather—Do Hedge Fund Managers Flock Together?

Only a small portion of hedge funds' alpha can be explained by risk models. Could a change of perspective provide answers, and potential investors with a valuable addition to their due-diligence arsenal?

The spectacular growth of the hedge fund industry in recent decades has stimulated a great interest in understanding the roots of this success. In the academic literature, this question has been tackled mainly by developing increasingly rich factor models. This approach tries to explain hedge funds' stellar performance through exposure to primitive risk factors—that is to say, portfolios deliver a compensation for bearing some systematic risk, such as the market or liquidity. Despite this wealth of research, however, much remains to be understood about the determinants of hedge funds' returns. The average fund still delivers a significant abnormal return, or alpha, and the amount of variability in funds' returns that is not explained by these models remains quite sizeable.

Three authors, including SFI's Alberto Plazzi, adopt a different modeling perspective. Their study looks at hedge funds from the standpoint of a network, and asks whether personal connections that link hedge fund managers together matter when it comes to explaining performance. The authors investigate this question for the UK hedge fund industry, where mandatory filings allow a nearly ideal setting for such research. More specifically, starting in 2002 insurance, investment, and banking companies that operate in the UK (i.e., onshore) are required to report detailed information on current and past employment of their key employees. The resulting data set is maintained and made publicly available by the Financial Conduct Authority, which regulates the UK financial system, with full disclosure of company and employee names.

"Social ties, in the form of prior employment experience, may lead to similarities among funds' returns."

How might prior employment history ultimately affect hedge fund managers' investment decisions, and lead to similarities in funds' returns? Several channels come to mind. First, managers who share a common experience in an industry are likely to have been exposed to similar training. For example, managers who worked in the life insurance

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The full paper can be found at http://bit.ly/2ovoOtW.

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sector may develop an attitude with regard to risk that is different from that of employees in the banking sector. This attitude could manifest itself later, as the managers set up their funds with similar levels of risk exposure. For any given industry, having worked for the same employer is likely to exert an additional effect. Managers may have learned portable skills at their former workplace that guide their current investment strategies. To the extent that these skills allow managers to take better decisions, they have the potential to explain some of the abovementioned abnormal performance. Finally, employees may establish personal connections. These connections are likely to be stronger for managers that overlap in their prior experience—that is, managers who worked for the sample employer at the same time. Through the sharing of views and information, these personal connections may lead to correlation (coordination) in managers' trading behavior. In sum, social ties, in the form of prior employment experience, may lead to similarities among funds' returns that show up in the various components of performance: exposures to risk factors (i.e., beta), abnormal performance (i.e., alpha), and the unexplained (mean-zero) idiosyncratic component.

"Having worked in the same industry captures a significant portion of the differences in funds' risk exposures and especially alpha."

Guided by these arguments the authors show that components of the UK hedge fund market are densely linked through such ties, which are found to be important determinants of proximities in any two hedge fund pairs. In particular, having worked in the same (finance) industry and, to a greater extent, having worked for the same employer in the past capture a significant portion of the differences in funds' risk exposures and especially alpha. In contrast, social connections measured by an overlap in prior employment experience explain only differences in the idiosyncratic component of returns. Interestingly, these connections play a much greater role for funds that invest in styles that are particularly sensitive to the exchange of relevant information, such *event driven* and *merger arbitrage*. Can we conclude that social connections are ultimately responsible for similarities in hedge funds' performance? In order to draw conclusions about causality, several competing channels should be addressed. Managers may self-select and find themselves working for the same prior employer because of similar preferences or risk profiles. Alternatively, there may be other network-related conduits, such as access to local information, that are responsible for similarities in trades. Adding managers' personal characteristics or controlling for geography does not, however, dissipate the effect of prior employment connections.

"The exchange of information through social ties ultimately has a positive effect on performance."

A potentially more challenging task is to control for managers' skills. The argument here is that (past) employers may hire individuals with similar levels of skills. To account for this, the authors exploit the fact that a subset of managers in the data have previous experience in the hedge fund industry. They then use the abnormal performance in the previously managed fund as a control variable. If skilled managers tend to outperform their peers consistently over time, this should go a long way toward absorbing the effect of innate intelligence. It turns out that the results are also robust with regard to this test. The evidence that fund pairs of connected managers are closest in performance begs the intriguing question whether differences exist in the average returns to hedge funds (not pairs) that are grouped based on the extent of their connectedness. Indeed, the authors show that loading on portfolios of connected hedge funds generates a positive spread in terms of risk-adjusted performance compared to unconnected funds. They conclude that the exchange of information through social ties has ultimately a positive effect on performance.

Overall, these results have clear implications for the industry. They imply that managers' social ties should be considered when evaluating the performance of a single hedge fund or a portfolio, for example via funds of funds. They also stress that social ties should be an important aspect of investors' due diligence processes when deciding which fund to invest in.

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