

Fooling the Savvy Investor? Secrecy and Hedge Fund Performance

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Abstract

If a qualified investor has a choice between investing in a secretive fund and a transparent fund with the same investment objective, which should she choose? Prior work suggests that the secretive fund is better. Hedge fund managers generally use their discretion for the benefit of their investors (Agarwal, Daniel and Naik, 2009, Agarwal, Jiang, Tang and Yang, 2013). In this study we identify a subset of hedge funds managers, which appear to use their discretion to feign skill. Using a proprietary dataset obtained from a fund of funds, we document that hedge funds that are more secretive vis a vis their own investors earn somewhat higher returns than their investment-objective-matched peers during up markets, consistent with earlier papers documenting skill-based performance, but significantly worse returns during down markets. This evidence suggests that at least part of the superior performance that secretive funds appear to generate is in fact compensation for loading on additional risk factor(s) as compared to their objective-matched peers.

Keywords: Hedge funds, Risk premia, Disclosure, Transparency

JEL codes: G01, G11, G23, G32

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1 Introduction

Hedge funds in the U.S. are exempt from many disclosure requirements funds under the rationale that the savvy and sophisticated clientele permitted to invest in hedge funds is well qualified to evaluate funds' governance and investment strategies without the interference of government regulation.⁵

While the greater secrecy afforded hedge funds allows them to pursue proprietary investment strategies with less risk that other investors might mimic and free ride on their strategies, there is a natural tension between secrecy and the ability of a hedge fund's investors to monitor the managers, who in the absence of monitoring may deviate from strategies which are optimal for the investors.

Prior research provides evidence that managers often use their discretion for the benefit of their investors. Agarwal, Daniel and Naik (2009) find that hedge fund returns are higher when managers have more discretion as proxied by the length of lockup, notice and redemption periods. Aragon, Hertznel and Shi (2013) and Agarwal, Jiang, Tang and Yang (2013) provide evidence that managers use their discretion to delay the reporting of fund holdings to the U.S. Securities and Exchange Commission (SEC) for the benefit of their investors, generating higher abnormal returns during period when they keep their holdings secret.⁶

⁵Investment Company Act of 1940 carves out an exception from some disclosure requirements for investment companies which only accept funds from "accredited investors". Accredited investors are those income greater than \$200,000 (or \$300,000 with a spouse a net worth greater than \$1 million (<https://www.investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors>). Senate Report No. 293, 104th Cong., 2d. Sess. 10 (1996) and Staff Report to the United States Securities and Exchange Commission, September 2003, "Implications of the Growth of Hedge Funds" comment on the reasoning for this exception.

⁶Section 13F of the Securities Exchange Act of 1934 require investment companies with more that \$100 million in assets to report holdings on a quarterly basis. Managers may request to delay disclosure of the holdings for up to a year

Table 3. (continued)

Panel B: April 2008 to March 2009 ("bad" period)

	(1)	(2)	(3)	(4)	(5)	(6)
Secrecy	-10.49*** (3.70)	-10.21*** (3.84)	-8.25** (3.47)	-8.51** (3.73)	-7.70** (3.43)	-13.97*** (5.26)
Illiquidity			-22.22*** (3.69)	-18.71*** (4.00)	-17.80*** (4.09)	-14.68*** (5.06)
Concentration			-5.46 (3.48)	-3.62 (3.91)	-3.10 (3.86)	-2.16 (4.13)
Complexity			3.72 (3.93)	0.15 (4.31)	-0.16 (4.27)	-4.08 (4.95)
Leverage			-4.22 (3.61)	-6.39 (4.10)	-6.29 (4.11)	-7.17 (4.62)
ln(AUM _{t-1})			0.46 (1.57)	0.42 (1.55)	0.83 (1.64)	1.60 (1.84)
Flow _t			-1.15*** (0.15)	-1.16*** (0.15)	-1.17*** (0.15)	-1.27*** (0.17)
13F filing					-4.93 (4.13)	-7.23 (4.66)
Month FE		Yes	Yes	Yes	Yes	Yes
Strategy FE				Yes	Yes	Yes
Same Secrecy in 2007 and 2009						Yes
Observations	1,574	1,574	1,560	1,560	1,560	1,103
Number of funds	140	140	138	138	138	94
Adjusted R ²	0.00351	0.237	0.318	0.322	0.323	0.346

Table 4. Hedge fund risk-adjusted performance

This table reports the results of estimating the following specification during the period between April 2006 and March 2007 in Panel A and between April 2008 and March 2009 in Panel B:

$$R_{it} - rf_t = c + \alpha^H \text{SecH}_i + d_{st} + \varepsilon_{it}$$

where $R_{it} - rf_t$ is the excess return of fund i in month t ; SecH_i is an indicator variables that equals 1 if a fund is rated as secretive, and 0 otherwise. Columns 1 and 2 include strategy-month fixed effects to control for strategy-specific loadings on any factors. Columns 3 and 4 include substrategy-month fixed effects to control for substrategy-specific loadings on any factors. Specifications 2 and 4 estimate the results using only the funds that have the same secrecy in both periods (i.e. April 2006 to March 2007 and April 2008 to March 2009). Standard errors are clustered at the fund level and are reported below the coefficients. * indicates 10% significance; ** 5% significance; *** 1% significance.

Panel A: April 2006 to March 2007 ("good" period)

		Model-free Risk Adjustment			
		Strategy-specific loadings		Substrategy-specific loadings	
		(1)	(2)	(3)	(4)
Secrecy	High	2.69*	7.23***	2.38	4.42**
		(1.52)	(1.78)	(1.60)	(1.75)
Same Secrecy in 2007 and 2009			Yes		Yes
Observations		1,663	989	1,663	989
Number of funds		150	91	150	91
Adjusted R ²		0.229	0.241	0.320	0.317

Panel B: April 2008 to March 2009 ("bad" period)

		Model-free Risk Adjustment			
		Strategy-specific loadings		Substrategy-specific loadings	
		(1)	(2)	(3)	(4)
Secrecy	High	-8.21**	-18.55***	-5.22	-10.71**
		(4.09)	(5.37)	(3.57)	(5.25)
Same Secrecy in 2007 and 2009			Yes		Yes
Observations		1,574	1,151	1,574	1,151
Number of funds		140	98	140	98
Adjusted R ²		0.309	0.317	0.415	0.417

Table 5. Hedge fund flow-to-performance sensitivity

This table reports the results of estimating the following specification for the periods from April 2006 to March 2007 and from April 2008 to March 2009:

$$\text{NetFlow}_{it+3} = c + \alpha^H \text{SecH}_{it} + g^L \text{SecL}_{it} * (R_{it} - rf_t) + g^H \text{SecH}_{it} * (R_{it} - rf_t) + X_{it}'d + d_s + \epsilon_{it}$$

where NetFlow_{it+3} is the net quarterly flow to the fund from month t to $t+3$, $R_{it}-rf_t$ is the quarterly excess return of fund i from month $t-3$ to t ; SecL_{it} (SecH_{it}) is an indicator variables that equals 1 if a fund is rated as low- (highly) secretive, and 0 otherwise; X_{it} are fund-level controls (log of assets under management, measured at $t-3$ annual volatility, measured from $t-15$ to $t-3$, and median percentage net flows for funds in the same strategy, from t to $t+3$), and d_s are strategy fixed effects. Specifications 4 and 8 additionally include indicator variables for illiquidity, as well as their interactions with performance. Specifications 1 to 4 estimate the model for months from April 2006 to March 2007 ("good" period); specifications 5 to 8 estimate the model for months from April 2008 to March 2009 ("bad" period). Specifications 3, 4, 7, and 8 estimate the results using only the funds that have the same level of secrecy in both periods (i.e. April 2006 to March 2007 and April 2008 to March 2009). Standard errors are clustered at the fund level and are reported below the coefficients. * indicates 10% significance; ** 5% significance; *** 1% significance.

	April 2006 to March 2007 ("good" period)				April 2008 to March 2009 ("bad" period)			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Net Performance	0.0728*** (0.0118)				0.0434*** (0.00703)			
SecL*Net Performance		0.122*** (0.0194)	0.115** (0.0454)	0.165*** (0.0261)		0.0555*** (0.0203)	0.0703*** (0.0240)	0.0973*** (0.0275)
SecH*Net Performance		0.0492*** (0.0114)	0.0411 (0.0407)	-4.88e-05 (0.0238)		0.0431*** (0.00723)	0.0607*** (0.0167)	0.0588*** (0.0171)
SecH		2.226 (2.519)	2.258 (2.563)	8.837* (4.907)		-3.666 (2.519)	-3.418 (2.395)	-4.632 (3.049)
Median Strategy Flow	0.591** (0.229)	0.579** (0.227)	0.576** (0.228)	0.356 (0.277)	0.845*** (0.0628)	0.848*** (0.0639)	0.847*** (0.0639)	0.831*** (0.0655)
lnAUM	-1.835** (0.871)	-1.873** (0.879)	-1.869** (0.904)	-2.036** (0.889)	-0.637 (0.634)	-0.502 (0.588)	-0.449 (0.587)	-0.525 (0.611)
Annual volatility	-0.0709 (0.0672)	-0.0740 (0.0673)	-0.0741 (0.0727)	-0.227** (0.113)	-0.0380 (0.0548)	-0.0214 (0.0550)	-0.0244 (0.0579)	-0.0135 (0.0615)
Strategy FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Illiquidity and Illiquidity*Net Performance controls			Yes	Yes			Yes	Yes
Same Secrecy in 2007 and 2009				Yes				Yes
Observations	1,113	1,113	1,113	652	1,273	1,273	1,273	1,063
Number of funds	113	113	113	66	114	114	114	92
Adjusted R ²	0.129	0.140	0.139	0.179	1,273	0.437	0.437	0.417