The Secondary Market For Hedge Funds

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What Do We Know About Hedge Funds?

- Returns can be explained by linear (S&P 500, SMB, HML, Yield Spreads) and nonlinear (out of the money puts on the S&P 500, lookback straddle options) factors. (Fung and Hsieh (2001, 2002, 2004), Agarwal and Naik (2004)).

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- Liquidity restrictions in hedge funds (withdrawal restrictions and minimum investment periods) are associated with high alphas. (Aragon (2006)).
- Hedge fund flows behave rationally, chasing high past alpha. Alpha-chasing generates declines in future alpha (capacity constraints). Fung, Hsieh, Naik, Ramadorai (2007).

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- So Hedge Funds were (and are) privately offered to qualified (wealthy) investors, and lately, to institutional investors. But little public disclosure of ownership structure.
- This makes information about their ownership hard to find.

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  - Fees: do high management and incentive fees scare investors away?

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- Anonymous bargaining is conducted by both parties engaging in unilateral negotiations with Hedgebay.

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- Almost all completed transactions are conducted between pre-existing investors of the funds.
- Every completed transaction in the data thus far is initiated by sellers of funds.
- Transactions are primarily in funds that are closed to new investments, or in share classes that are not available for purchase.

Data

- 935 transactions from 220 funds, August 1998 to July 2007. 66 ‘disaster’ transactions, occurring during/after fund frauds (Bayou), or highly publicized liquidations (Amaranth, Absolute Capital). 869 non-disaster transactions in well-known names. Focus on these.
- Transactions are matched (by name and management company) to the consolidated TASS, HFR, CISDM and MSCI database, for administrative information, returns, and AUMs of funds around the time of transactions.
- Hedgebay acquired information directly from funds in several cases in which this information was not available from the consolidated database.
- Final set (when past 12 months’ return data is required) includes 380 non-disaster transactions from 95 funds.
- When return data for 48 months surrounding a transaction is required, 239 transactions from 47 funds.

Disaster Transactions

Years	Transactions Number	Funds Number	AMT Mean $MM	PREM Mean %
1998	0	0	0	0
1999	0	0	0	0
2000	0	0	0	0
2001	0	0	0	0
2002	1	1	1.479	-50.000
2003	5	3	1.039	-65.000
2004	8	4	1.133	-67.072
2005	12	8	2.279	-49.485
2006	19	8	6.224	-31.075
2007	21	14	3.951	-56.167
Overall	66	23	3.702	-49.626

Non-Disaster Transactions

Years	Transactions Number	Funds Number	AMT Mean $MM	PREM Mean %	TOTPAY Mean %
1998	12	6	0.566	0.000	0.528
1999	51	14	0.591	0.000	0.408
2000	92	30	1.131	-0.060	0.382
2001	120	47	1.350	1.318	1.886
2002	86	29	1.260	1.937	2.603
2003	124	49	2.497	1.716	2.328
2004	109	48	3.298	1.353	1.989
2005	120	61	2.838	0.578	1.173
2006	104	54	3.747	-0.450	0.006
2007	51	31	3.846	0.086	0.478
Overall	869	202	2.309	0.813	1.362

Comparison With Hedge Fund Universe

	SAMPLE	UNIVERSE	[2.5%,97.5%]
NUMBER	124	10666	
MININV ($MM)	1.747	3.476	[1.414,5.498]
LOCK (%)	31.710	31.110	[30.239,31.986]
REDEMP (Months)	1.583	1.159	[1.146,1.182]
REDFREQ (Months)	2.756	2.408	[2.357,2.466]
MGMTFEE (%)	1.540	1.434	[1.422,1.448]
INCFEE (%)	19.839	16.993	[16.896,17.154]
OFFSHORE (%)	83.704	57.610	[56.676,58.542]

Aggregate Relationships

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- Variables: *SP500,ILLIQI,VIXDIFF,CEFPREM,SENTIMENT,HFRET,HFFLOW* and *d(CREDITSPREAD)*
- Simple univariate regressions to detect relationships:

$$\begin{aligned} AVGTOTPAY_t &= a + bMKTCOVARIATE_t + u_t, \qquad (1) \\ AVGTOTPAY_t &= \frac{1}{N_t}\sum_{i=1}^{N_t} TOTPAY_{i,t} \end{aligned}$$

Aggregate Relationships

	AVGTOTPAY(t)							
Intercept	<u>**0.938**</u>	<u>**1.067**</u>	<u>**0.785**</u>	<u>**2.238**</u>	<u>**1.167**</u>	<u>**0.941**</u>	<u>**0.901**</u>	<u>**0.930**</u>
SP500(t)	-0.065							
ILLIQI(t)		-0.063						
VIXDIFF(t)			0.145					
CEFPREM(t)				<u>**0.590**</u>				
SENT(t)					<u>**-0.477**</u>			
HFRET(t)						-0.021		
HFFLOW(t)							0.028	
d(CREDITSPREAD(t))								-0.166
AVGTOTPAY AR(1)	0.593	0.586	0.617	0.586	0.586	0.593	0.593	0.593
Regressor AR(1)	0.040	-0.214	0.103	0.906	0.860	0.180	0.153	0.361
Adjusted R-squared	-0.006	-0.008	0.011	0.340	0.219	-0.009	-0.009	0.018
N	104	89	101	89	89	104	104	104

Closed-End Funds and Hedge Funds

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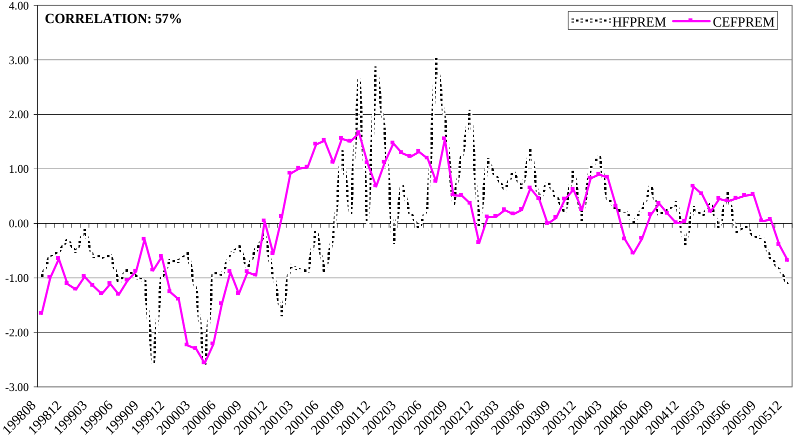
- *AVGTOTPAY* similar to *CEFPREM*. In both cases, portfolio composition determined by fund's management, investors trade claims with each other, not with the fund directly.
- Berk and Stanton (2007), and Cherkes, Sagi and Stanton (2007) model *CEFPREM* as driven up by expectations of future performance (B&S), up by expectations of the illiquidity of underlying securities (CSS), and down by the level of fees (both).

Common Determinants?



What Determines the Hedge Fund Premium?

- Regress *PREM*, *COMM*, *TOTPAY* on explanatory variables related to liquidity and past performance.

$$\begin{aligned} PREM_{it} &= \alpha_s + \beta_1 LOCK_i + \beta_2 REDEMP_i + \beta_3 MININV_i \\ &\quad + \beta_4 REDFREQ_i + \beta_5 AMT_{i,t} + \beta_6 GLMTHETA0_{i,t-1} + u_{i,t} \end{aligned} \tag{2}$$

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- Strategy-specific fixed effects in estimation, and standard errors in panel corrected for heteroskedasticity and contemporaneous cross-correlation.

Liquidity and the Premium

	PREM	TOTPAY
LOCK	0.067	0.136
REDEMP	-0.496	-0.559
MININV	0.002	0.001
REDFREQ	-0.146	-0.168
AMT	0.011	0.008
GLMTHETA0	0.016	0.018
Adjusted R-squared	0.072	0.079

Past Performance and the Premium

	PREM	TOTPAY
PERF(-12)	**<u>0.336</u>**	**<u>0.362</u>**
RM(-12)	<u>-0.107</u>	<u>-0.120</u>
STDPERF(-12)	**<u>-0.193</u>**	**<u>-0.218</u>**
MGMTFEE	**<u>-1.128</u>**	**<u>-1.220</u>**
INCFEE	-0.014	-0.008
AMT	0.013	0.009
Adjusted R-squared	0.199	0.186

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- First stage probit: z_i – 'selection' variable which is 1 if transaction occurs on Hedgebay, 0 otherwise. w_i – vector of determinants of selection. (Unconditional) exclusion restriction: *OFFSHORE*.

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- Compute inverse Mills ratio $\lambda(\mathrm{w}_i^{'}\gamma) = \frac{\phi(\mathrm{w}_i^{'}\gamma)}{\Phi(\mathrm{w}_i^{'}\gamma)}$, incorporate it into *PREM* regression as a selection bias correction:

$$PREM_{i,t} = \mathrm{x}_{i,t}^{'}\beta + \delta\lambda(\mathrm{w}_i^{'}\gamma) + \upsilon_{i,t}. \tag{5}$$

Probit Marginal Effects

	dF/dX
MININV	0.000
MGMTFEE	0.101
INCFEE	0.029
REDFREQ	0.043
REDEMP	0.286
LOCK	-0.027
STRATEGIES	
Security Selection	1.260
Global Macro	1.511
Relative Value	-0.283
Directional Traders	-0.144
Funds of Funds	-0.392
Multi-Process	1.130
Emerging Markets	0.311
Fixed Income	0.804
EXCLUSION RESTRICTION	
Offshore	0.988
N(Funds)	10,790
Observed Probability	1.149
Pseudo R-Squared	0.114
Chi2(15)	116.270
P-value(Chi2)	0.000

Selection Bias Corrected Results

	PREM	TOTPAY
TALPHA(-12)	**0.015**	**0.017**
STDPERF(-12)	-0.067	-0.078
MGMTFEE	**-1.008**	**-1.103**
INCFEE	-0.008	-0.001
LOCK	-0.102	-0.005
REDEMP	-0.180	-0.235
REDFREQ	-0.167	-0.197
AMT	0.011	0.008
GLMTHETA0	0.017	0.019
IMILLS	0.401	0.320
Adjusted R-squared	0.213	0.207

Does the Hedge Fund Premium Anticipate Future Performance?

- Unconditional specification:

$$\overline{FUTPERF}_{i,t+1,t+24} = \alpha_s + \beta_1 \overline{PASTPERF}_{i,t-1,t-24} + \beta_2 TOTPAY_{i,t} + \beta_3 AMT_{i,t} + \beta_4 GLMTHETA0_{i,t-1} + \beta_5 IMILLS_i + e_{i,t} \quad (6)$$

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- Conditional on level of $TOTPAY$:

$$\overline{FUTPERF}_{i,t+1,t+24} = \alpha + \beta_1 \overline{PASTPERF}_{i,t-1,t-24} + \beta_2 HITOTPAY_{i,t} + \beta_3 LOTOTPAY_{i,t} + \beta_4 AMT_{i,t} + \beta_5 GLMTHETA0_{i,t-1} + \beta_6 IMILLS_i + e_{i,t} \quad (7)$$

$$\begin{aligned} HITOTPAY_{i,t} &= TOTPAY_{i,t} * I_{\{TOTPAY_{i,t} > median(TOTPAY_{i,t})\}}, \\ LOTOTPAY_{i,t} &= TOTPAY_{i,t} * I_{\{TOTPAY_{i,t} <= median(TOTPAY_{i,t})\}} \end{aligned}$$

Future Performance and the Premium: Unconditional

	PERF(+24)	ALPHA(+24)			TALPHA(+24)		
	Raw Returns	Market Model	Fama-French	Fung-Hsieh	Market Model	Fama-French	Fung-Hsieh
TOTPAY	-0.009	-0.052	-0.058	-0.082	-0.136	-0.129	-0.186
AMT	-0.001	-0.001	-0.003	-0.004	**-0.011**	-0.011	-0.007
PERFMEAS(-24)	**-0.135**	-0.099	-0.080	-0.122	**0.474**	**0.485**	**0.337**
IMILLS	0.046	**-0.241**	**-1.071**	-0.259	-1.828	-3.028	-2.005
GLMTHETA0	0.003	0.011	0.028	-0.018	0.239	**0.298**	0.058
Adjusted R-squared	-0.019	0.012	0.146	-0.001	0.352	0.457	0.245

Future Performance and the Premium: Conditional

	PERF(+24)	ALPHA(+24)			TALPHA(+24)		
	Raw Returns	Market Model	Fama-French	Raw Returns	Market Model	Fama-French	Raw Returns
HITOTPAY	-0.015	**<u>-0.067</u>**	<u>-0.072</u>	**<u>-0.102</u>**	-0.174	-0.151	<u>-0.228</u>
LOTOTPAY	0.067	**<u>0.117</u>**	**<u>0.092</u>**	**<u>0.136</u>**	**<u>0.257</u>**	0.086	0.215
AMT	-0.001	-0.002	<u>-0.004</u>	<u>-0.005</u>	**<u>-0.015</u>**	<u>-0.013</u>	<u>-0.011</u>
PERFMEAS(-24)	**<u>-0.151</u>**	**<u>-0.126</u>**	-0.113	-0.160	**<u>0.453</u>**	**<u>0.474</u>**	**<u>0.312</u>**
IMILLS	0.080	**<u>-0.180</u>**	**<u>-1.028</u>**	-0.158	-1.781	<u>-2.995</u>	-1.955
GLMTHETA0	-0.002	0.002	0.019	-0.029	0.217	<u>0.286</u>	0.041
Adjusted R-squared	-0.012	0.078	0.179	0.039	0.362	0.457	0.255

Conclusion

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- The tradeoff between expectations of future performance and fees seems to be the primary driver.
- The asymmetry between high and low transactions premia and their relationship with future performance could be coming from market segmentation, or from conditioning on macro variables.
- The high correlation between the hedge fund premium and the closed-end fund premium suggests that there may be some deeper structure underlying different markets for managed investments.

Conclusion

- It appears that the hedge fund premium is well-explained by several rational determinants.
- The tradeoff between expectations of future performance and fees seems to be the primary driver.
- The asymmetry between high and low transactions premia and their relationship with future performance could be coming from market segmentation, or from conditioning on macro variables.
- The high correlation between the hedge fund premium and the closed-end fund premium suggests that there may be some deeper structure underlying different markets for managed investments.
- Now working on the 'book' of all indications of interest on Hedgebay ($>$1,000 funds, $>$7 years). A rich set of possible questions to be answered using those data.