“Discussion of ‘A Portrait of Hedge Fund Investors: Flows, Performance and Smart Money’ by Guillermo Baquero and Marno Verbeek”

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Theory and Empirics

- Market efficiency and underlying risk
- Role of the labor market and net vs. gross returns
- How do frictions in hedge fund investing influence the empirical flow-performance relationships?
- What is the potential impact of incentive fees?
- Opportunity to provide a broad perspective on the implications of hedge fund investing

Hedge Funds: Risk and Return

- Tremendous interest in hedge funds due to both flows (growth) and performance
- Capital market is basically efficient
- How does hedge fund performance relate?

----Does it reflect priced risks?

----Does it reflect violations of efficiency?—how pervasive in cross section?

Market Efficiency and Prices

- If information is costly, then prices cannot reflect all information as there would not be a competitive return to information (Grossman and Stiglitz, *AER*, 1980)
- How does information get impounded in prices?
- Role of hedge funds and active capital potentially important in markets

Price Efficiency and Hedge Funds

- Enhanced productive efficiency
- Better portfolio selections by uninformed investors
- Uninformed investors learn from information from informed investors
- Limits to arbitrage (limits to efficiency)
- Large amounts of capital and leverage
- Ability to operate across different margins

Limits on the Rents to Investors

- Predictable Rents flow to the Managers—Seeming abundance of arbitrage capital and competition in the managerial labor market (Berk and Green, *JPE*, 2004)
- Capital flows to superior managers , skills heterogeneous, and diminishing marginal returns, but no underlying persistence
- Empirical evidence is consistent with much heterogeneity and high skill levels (Berk and Green)—important theme to pursue for hedge funds (mutual fund focus earlier)

Returns and Flows

- Net vs. gross returns and performance--flow relationship--Flows chase performance (learning)
- Cross-Sectional ‘Noise”—Statistical ‘Power’ to Distinguish Superior Returns
- Selection and ‘Survivorship’ Effects
- Liquidity and Smoothing of Returns—Risks Understated

The Form of Compensation

- The compensation contract & limited managerial wealth: Incentives and signaling
- What are the empirical implications of agency and signaling theories for flows, performance (gross and net) and the form of the compensation contract?--Interesting potential cross-sectional focus from incentive fee data (risk aspects central)

Empirical Analysis motivated by Berk and Green (2004)

- I would encourage more direct focus upon trying to identify the extent of heterogeneity in skills; seems central to understanding the hedge fund business and more deeply understanding the market efficiency paradigm
- Useful for both understanding our markets and the application of the principles of financial theory

Frictions Differ for Inflows, Outflows

- Unfortunately, the TASS cross-sectional data only has net flows (not the disaggregated signs)—so the authors use a regime switching (0-1) model off the sign of the aggregated net flow
- Of course, the differing frictions are at the micro rather than aggregated level
- Suggests that the statistical relationship at the aggregate level should depend upon the scale of the aggregate net flow, not just the sign (alternative specification)

Performance and Fund Flows

- Are there ex ante identifiable performance differences among the hedge fund investors?
- If so, are there ex ante identifiable performance differences net of fees?-- Statistical power, labor market equilibrium
- If so, are the lags at which these are detected, consistent with the empirical findings concerning the dependence on horizon of the flow—performance relation

Frictions and Equilibrium Flows

- The empirics focus upon the how the flow-performance relation depends upon signed aggregate flows and horizon
- Should “equilibrium” flows depend upon these factors? Are there sufficient potential marginal investors or dis-investors who are not constrained?
- Empirical predictions of theory should reflect incorporating frictions directly into the theory