Skin in the Game vs. Skimming the Game
Ozik & Sadka

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AGENDA

- Bottom line: Great paper!

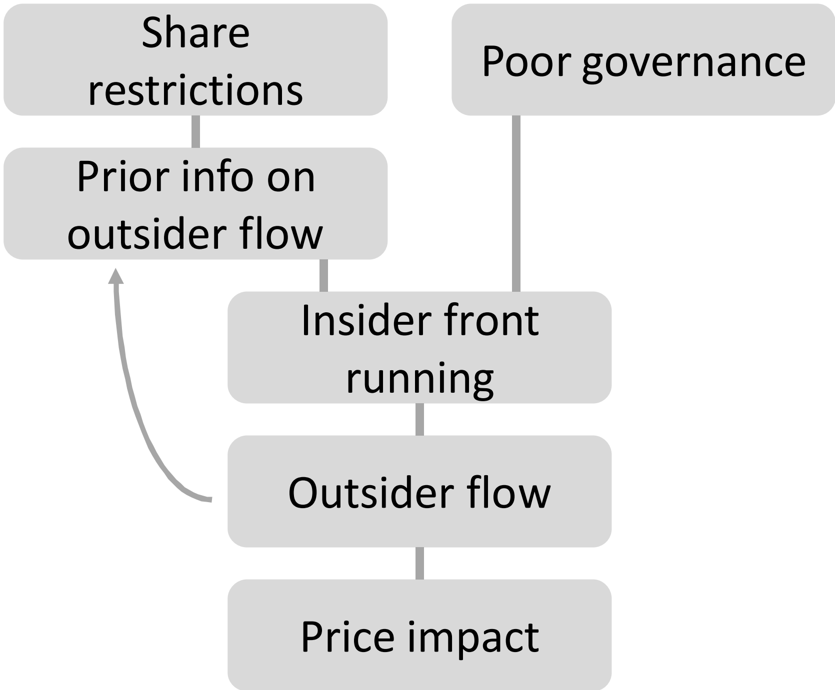
- Summary
- Comments
  - Some additional empirics
  - Minor issues
- Hedge fund misbehavior
  - Current literature
  - Future research

COMMENTS

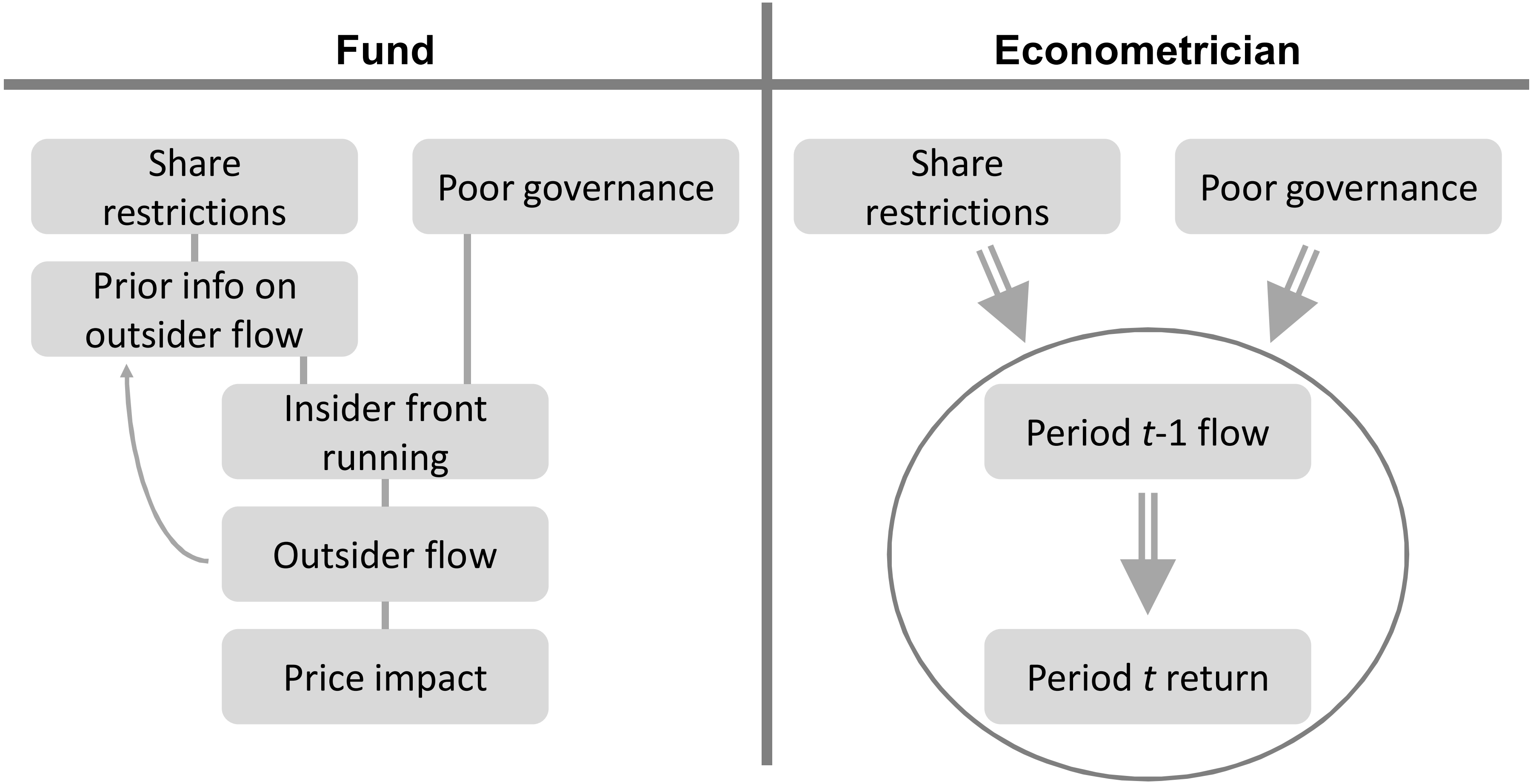
SUMMARY

- Smart money in hedge funds?
- Portfolios based on past flows
  - Positive return spread
  - “Short term smart money”
- Spread only present in restricted funds
  - Share restriction create information asymmetry regarding flows
  - Fund insiders front run price impact of outsider flow
- Spread stronger in funds with poor investor protection
  - Supports the idea of front running
- Robustness checks
  - Support initial results

CHAIN OF EVENTS



Chain of events



GREAT PAPER

- Interesting, well motivated, well executed
- Relevant for academics
  - Hedge fund manager misbehavior
  - Pricing of poor governance
- Relevant for practitioners
  - Front running has wealth effects in favor of the insiders
- Relevant for regulators, policy makers
  - Front running looks like a wide spread phenomenon
  - Need to prevent? How to prevent?

Further Identification

- Front running should be easiest in funds where “redemption notice period” ≥ “redemption frequency”
  - E.g. monthly redeemable fund requiring notice two months in advance
- Currently use: “restricted” ~ “redemption notice period” > 0
- Should try also: “restricted” ~ “redemption notice period” ≥ “redemption frequency”?

Contemporaneous flows

- If front running, should return spread be strongest for funds experiencing large flows also during month *t*?
- Sort funds on past and contemporaneous flow → see if contemporaneous flow affects return spread
  - Mitigate endogeneity issues by including only funds with infrequent redemptions and subscriptions, and lengthy notice period

LAGGED AND CONTEMPORANEOUS FLOW

- All funds in TASS with at least 36 months of reliably reported assets
- Fung-Hsieh 7 factor alphas

		Contemporaneous flow				
		Lo	2	3	4	Hi
Lagged flow	Lo	0.2	-0.1	0.0	**0.4**	**0.3**
	2	0.1	-0.2	0.0	**0.5**	**0.5**
	3	0.2	-0.1	0.0	**0.4**	**0.5**
	4	0.1	-0.2	0.0	**0.4**	**0.9**
	Hi	0.2	-0.1	0.1	**0.3**	**0.8**
	Hi-Lo	0.0	0.0	0.1	-0.1	**0.5**

Ahoniemi, Jylhä (2011): *Flow Sensitivity of Hedge Fund Returns* (w.i.p.)

AUTOCORRELATION OF FLOWS

- We know that flows are highly autocorrelated
  - Herding
- Should autocorrelation of flows be higher for poorly governed restricted funds than well governed or unrestricted?
  - Unconditionally?
  - Conditionally?

WITHIN-QUARTER REDEMPTIONS

- TASS funds with quarterly redemption frequency exhibit surprisingly high number of within-quarter redemptions
- This could be due to
  - Front running by insiders!
  - Data errors, typos, etc. Unlikely as they are so many and large
  - Restructuring of funds, changing terms
- If just data errors, within-quarter redemptions should be independent of end-of-quarter redemptions

REDEMPTIONS

- Only funds with quarterly redemptions
  - Should have zero or positive within-quarter flows
- Pooled logit regression of likelihood of within-quarter redemption on end-of-quarter redemption
- *t* = {Mar, Jun, Sep, Dec}

	Flow *t*-1 < 0	Flow *t*-2 < 0
Constant	**-0.48**	**-0.31**
	(-16.9)	(-11.1)
Flow t < 0	**0.19**	**0.41**
	(4.5)	(9.8)

Minor issues

- Changing characteristics
  - TASS only reports the latest value of fund characteristic
  - What if characteristics have changed?
  - Can't really verify changes without facing legal actions
  - Discuss in paper?
- 3-variable interaction in cross-sectional regressions
  - Include all lower order combinations: flow × pers inv, flow × low gov, and pers inv × low gov
  - Difficult to interpret
    - "All positive" = "two negative, one positive"
    - Graph: b_{flow} = fn(pers inv, low gov); other illustrations?
- Treatment of non-USD funds
  - Run results for USD subsample for robustness

MINOR ISSUES

- Incubation
  - Front running could be very profitable at the end of incubation
  - But still, are results robust to including the first three years of fund's life?
  - Alternative incubation correction: exclude observations where "date" < "date added to TASS"
- Are results robust for excluding the last months of fund's life?
  - Business as usual or rats leaving the sinking ship?

HEDGE FUND MISBEHAVIOR

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Hedge fund misbehavior

Return misreporting
- Bollen & Pool 2009 (JF), 2008 (JFQA)
- Cassar & Gerakos 2011 (RFS)
- Jylhä 2011 (wp)

Price manipulation
- Ben-David et al. 2011 (wp)

Poor processes
- Brown et al. 2010 (wp)
- Cassar & Gerakos 2010 (AR)

Front running
- **Ozik & Sadka 2011**

Future Research

- Non-trivial amount of empirical evidence on hedge fund misbehavior
- Not too much theory or evidence on the motives and effects of these phenomena
- Future avenues:
  - More evidence of misbehavior?
  - Motives behind misbehavior?
    - Too low compensation; opportunity makes a thief; ignorance
  - Effects of misbehavior?
    - On portfolio decisions; wealth; performance measurement; asset markets; academic research
  - Prevention of misbehavior?
    - Contracts; regulation; transparency; liquidity; closed-end structure