Labor Market Helps Discipline Hedge Fund Managers

Stockholm (HedgeNordic) – With hedge fund managers seemingly having limited downside and fairly unlimited upside when running their strategies, one may fail to identify measures encouraging managers to reduce unjustified risk-aversion and act in the best interest of their investors. A recent study, however, finds evidence that the labor market helps discipline fund managers through the impact of fund liquidations on their careers.

Using data on 1,948 professionals who at one point in their careers worked for a hedge fund, a working paper titled "Career Risk and Market Discipline in Asset Management" evaluates whether fund managers are exposed to the risk of permanent career setbacks after their funds are liquidated following a period of underperformance. The data used in the study covers employment histories from 1963 to 2016. According to the researchers conducting the study, "hedge funds are particularly well suited to investigating how careers are affected by liquidations, as these are not rare events, especially in the wake of unsatisfactory performance." The likelihood of someone working for a hedge fund to switch employers rises by 20 percentage points in the two years after liquidations, data shows.

The study finds that higher-ranking managers are more likely to suffer a career slowdown after the liquidation of their funds, with top executives (e.g., CEO, CFO, CIO) suffering an estimated compensation loss of around $200,000 on average regardless of the reasons triggering liquidations (either due to poor performance or other reasons). More interestingly, however, high-ranking managers of funds liquidated after two years of underperformance incur an estimated compensation loss that is $664,000 larger than the loss suffered by managers of funds closed after a period of reasonable performance. "Where preceded by normal performance, fund liquidation is not associated with a career setback" or significant compensation loss for high-ranking managers, the study concludes.

"Our results reveal a new facet of market discipline in asset management, operating via the managerial labor market. This labor market discipline is complementary to contractual incentives within the firm," the authors argue.

The complete study can be downloaded here.

Picture © Vibe Images—shutterstock