Hedge Funds Make Better Decisions Under Pressure

Stockholm (HedgeNordic) – Hedge funds have been facing massive outflows over the past year as investors pull out their capital after last year's meagre returns. However, a new study finds that hedge fund managers display superior stock-picking skills during times of significant outflows of capital.

In a working paper published on SSRN, Xinyu Cui and Olga Kolokolova from the University of Manchester analyze the trading patterns of hedge funds facing substantial capital inflows or outflows and find that "hedge fund managers are likely to reveal their skills under pressure." The authors assume that hedge fund managers put different levels of effort into managing their fund's portfolios depending on the level of investor flows, "with strong outflows inducing higher effort."

Some hedge fund managers are buying stocks even when experiencing substantial outflows and requiring cash to meet redemptions. Xinyu Cui and Olga Kolokolova observe a remarkable "trading-against-the-flow" behaviour among hedge funds. According to the study, long positions initiated in times of large capital outflows "deliver a significant ex-post abnormal return of +0.31% per month."

Similarly, the stocks sold by hedge funds during times of large inflows exhibit no future abnormal returns. In addition, the authors find that the positive abnormal returns of the stocks bought by hedge funds decrease with the increase of fund inflows. These results indicate that "hedge funds tend to put more effort into adjusting their portfolios when facing strong outflows."

Interestingly, the "trading-against-the-flow" abnormal returns are higher for funds with shorter notice periods for redemptions and less stringent share restrictions. This group of funds is more likely to experience sudden outflows than funds with longer notice periods and, hence, might be under higher stress levels during periods of outflows. "This finding further supports our intuition that it is extra pressure associated with the outflows" that induces managers to put more effort into the day-to-day portfolio management activities.

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