Skin in the Game Isn’t Enough

Stockholm (HedgeNordic) – Capital commitment by fund managers is an effective way to align the interests of managers and investors. Hedge fund managers with more “skin in the game” do outperform those with less capital commitment, but the outperformance “comes at the cost of limited entry by outside investors,” recent research shows.

According to a study by Arpit Gupta and Kunal Sachdeva published in July this year, “funds with more insider investment outperform other funds within the same family.” However, the researchers argue that “this relationship is driven by managerial decisions to invest capital in their least-scalable strategies and restrict the entry of new outsider capital into these funds.” Whereas hedge fund managers contribute substantial personal capital into their funds, which can better align incentives between managers and investors, “managers may also strategically allocate their private capital in ways that negatively affect investors.”

In the study, Arpit Gupta and Kunal Sachdeva examine three hypotheses:

- Hedge fund managers allocate their capital to less-scalable strategies;
- Managers restrict access to outside investors in these funds;
- Insider funds outperform on a risk-adjusted basis.

First, the authors find that managers invest capital in the least-scalable strategies. Second, they find that managers limit access to outside investors into these least-scalable funds, “sometimes closing access to outside investors completely.” And third, funds with higher internal investment deliver greater excess returns by taking on less leverage and less exposure to illiquid assets, which suggests that the outperformance is not attributable to hidden risks. Yet, these funds are offered on a limited basis to outside investors. According to the results, a fund with a one-standard-deviation increase in insider investment relative to the mean is associated with an additional 1.4-1.7 percent in excess return per year.

The authors also find evidence that greater “skin in the game” incentivizes managers to better manage the so-called size-performance trade-off by crowding out outside capital. Funds with higher insider investment are less likely to accept inflows following positive returns and are more likely to be closed to outside investors completely. The authors conclude that “the joint relationship between internal investment, fund flows, and performance suggests that funds better manage capacity constraints when managers have personal capital at stake, leading to superior returns at the expense of fewer managed investments.” These findings show that “hedge funds face capacity constraints in their operations, and differentially allocate capital across their funds to maximize profits, depending on the mix of inside and outside capital.”

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