Skin or Skim? Inside Investment and Hedge Fund Performance

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Executive Summary

Delegated asset managers are commonly thought of as being compensated only through fees imposed on outside investors. However, access to profitable, but limited, internal investment opportunities can also be a form of compensation for managers. Consider the hedge fund industry, which manages over $3 trillion in assets, of which $400 billion can be attributed to investments from insiders and related parties. Return to this insider capital is an important, but previously overlooked, component of hedge fund compensation and a potential conflict of interest between managers and investors.

Arpit Gupta and Kunal Sachdeva outline a framework in which managers face capacity constraints in their funds, choose to endogenously create new funds with different strategies, and can allocate internal capital across various funds under their control. When managers have more personal capital committed, they internalize the fact that raising additional capital is dilutive to existing investors in the sense that it causes the strategy to operate closer to its capacity constraint, lowering the returns for all existing investors. A key prediction from their model is that higher inside investment better aligns incentives between managers and investors and induces managers to limit the size of their fund, resulting in higher alphas even in equilibrium.

The researchers document the extent of inside investment in fund families across the universe of hedge funds using novel regulatory data from the SEC's Form ADV. They find that inside investment – as measured either by percentage or gross investment – remains a predictor of excess returns even when comparing different funds within firms. An investor moving to another fund in the family with a standard deviation rise in inside investment would see a rise in excess return of 1.26 percent annually. This indicates that inside investment is an important, and previously neglected, cross-sectional predictor of hedge fund returns.

The researchers also find that high inside investment funds have different fund flow-performance and return predictability characteristics relative to funds largely catering to outside investors. In response to positive excess returns, they do not accept as much capital as outsider funds and experience greater persistence of high excess returns. The relationship of internal investment, fund flows, and performance suggests that funds better manage capacity constraints when managers have personal capital at stake, leading to superior performance.

These findings also argue against a signaling-based explanation of the results, since inflows are lower – not higher – among high inside investment funds. Some high-investment funds are explicitly closed to outside investors and return 2-4 percent higher alpha yearly, suggesting that explicit rationing of capital by insiders can explain how insider funds operate at a smaller scale, consistent with the model explanation that insider fund managers internalize the costs of fund expansion.

The results contribute to ongoing debates regarding the presence of managerial alpha and financial rents. Many observers are puzzled at the apparently outsize rents earned by financial intermediaries such as hedge funds, even in the wake of apparently strong competition and the role of fund inflows in diminishing returns. In turn, these managerial rents have driven top-end wealth and income inequality (see Kaplan and Rauh, 2013). The researchers suggest a possible reconciliation of these facts can come from considering that fund managers have the option not only of earning management and performance fees, but also the possibility of deploying their own capital in funds they manage.