Faculty and student interviews

FACULTY INTERVIEW: Vikas Agarwal

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Taught an elective seminar on Hedge Funds

What is your research focus?

My focus is on institutional investors and how their compensation influences their performance, their risk-taking behaviour–how to characterise these risks, whether performance persists over time–and what the implications are for investors and the overall markets. While I do research on various types of institutional investors, my name is associated with hedge funds. I started doing research on hedge funds when I was doing my PhD in Finance at the London Business School. Initially, my supervisor, Narayan Naik, was working on market microstructure and I was looking at mutual funds. What happened is that an alumnus of the school, Patrick Fauchier, who had co-founded a successful Funds of Hedge Funds group wanted to foster research on hedge funds and provided the data to me. I teamed up with my supervisor and we did a lot of the early work on hedge funds. While exploring various facets of hedge funds has kept me busy over the last 15 years, I have also researched mutual funds.

So the link to the elective seminar is pretty obvious…

Yes, I trust I was picked for this course because of my expertise in the area of hedge funds. The course is totally focused on hedge funds and reviews the extant literature with a view to give participants a solid grounding in the area and help those who are interested to work in the field to build on this to research their own ideas. The review is structured into five chapters: biases in hedge fund databases; performance evaluation; performance persistence; implicit and explicit managerial incentives; conflicts of interests and agency issues. The topics covered include risk-return characteristics of hedge funds, risk management and asset allocation involving hedge funds, performance evaluation and persistence in performance, managerial incentives arising from compensation contracts, performance and information content of portfolio holdings, institutional investment and intermediation through funds of hedge funds, conflicts of interest and agency issues, and biases in commercial hedge fund databases.

Have you had the opportunity to teach a course like this before?

Yes and no. I have developed a course on hedge fund and trading strategies for graduate students at Georgia State University and I have been teaching it for the last three years. There are similarities with the course I assembled for the PhD programme, but of course the treatment at the Master's level is not as academically rigorous and while I sometime discuss research articles with Master's students, the emphasis is on their practical implications rather than their technical aspects.

What was your experience of teaching this PhD in Finance course?

This has been fantastic. A lot of the participants are professionally involved in money management–there was even a hedge fund manager in the class–so this was an informed audience with a solid interest for the material. They were not shy to ask questions, which was particularly well suited to my teaching style, and also there was something for me to learn in the type of questions they asked; this was really a two-way street. The concept of the programme is unique and intriguing and I did not know what to expect. I have presented to practitioners a lot, but I have never taught a course like this to professionals. What was great was that participants asked deep questions from a practitioner's point of view; too often the questions aired at industry presentations focus on short-term performance and do not fully exploit the potential of ideas. In class discussions, there was a great blend of academic curiosity and business acumen and it seemed participants were really able to understand and absorb the information, something that after-class informal discussions with participants confirmed. We also had a lot of 'philosophical' discussions about things like the refereeing process, formatting articles for publishing, etc. I was happy to answer these questions and share my own experiences, because I think these professionals should publish their research in good journals.

Speaking of articles and good journals, you presented a working paper in the programme's research workshop, the current issue of the *Journal of Finance* carries one of your articles and another one is forthcoming in *Management Science*, can you tell us more about these papers?
The paper I presented looks at firms that simultaneously manage hedge funds and funds of hedge funds to determine whether this is associated with value creation and/or agency problems. With both types of vehicles under one roof, the fund(s) of funds may make suboptimal investments into the firm's hedge funds, but at the same time selecting third party funds might improve a firm's hedge fund management skills and/or the experience of hedge fund management may make the firm better at selection.

So the study examines simultaneously managed hedge funds and funds of hedge funds, and compares them against their counterparts. We find evidence in favour of value creation in both types of vehicles when hedge fund firms start funds of funds and we find that agency problems dominate when funds of funds start hedge funds. We also observe that fund of fund creation by hedge funds is correlated with the original fund closing to new investment. Together, these findings suggest that successful hedge fund firms diversify into funds of funds to deliver superior performance and to generate additional revenues for themselves in the form of second layer of fees. Fund of fund firms diversifying into the hedge fund business experience sub-par performance and their forays into the new arena tend to be short lived.

The article in the *Journal of Finance* is on the confidential filings of hedge funds and was covered in the course, it looks at the unintended consequences of disclosure and why institutions avoid disclosure and what can be learned from disclosure. We tried to determine whether institutions were hiding positions for window-dressing purposes or to preserve private information against the risk of front-running. To do so, we looked at the quarter end equity holdings of hedge funds that are disclosed with a delay through amendments to SEC Form 13F (funds can request the confidential treatment of certain holdings, omitting those off their original filings and filing amendments at the expiry of the confidentiality period. Delayed disclosure is allowed when it is "necessary or appropriate in the public interest or for the protection of investors."). The evidence we found is consistent with funds holding and withholding private information to reduce the price impact of disclosure: confidential holdings are disproportionately associated with information sensitive events such as mergers and acquisitions or investments in stocks with greater information asymmetry, i.e., smaller capitalisation and lesser analyst coverage; holdings exhibit superior performance up to 12 months, and tend to take longer to build.

Finally, the paper forthcoming in *Management Science* analyses the biases related to self-reporting in hedge fund databases. We do so by matching Form 13F information to five databases of self-reporting hedge funds between 1980 and 2008. We find that funds initiate self-reporting after positive abnormal returns that do not persist into the reporting period. Termination of self-reporting is followed by both return deterioration and outflows from the funds. Also, the propensity to self-report is consistent with the trade-offs between the benefits (e.g., access to prospective investors) and costs (e.g., partial loss of trading secrecy and flexibility in selective marketing). Finally, we find that the returns of self-reporting funds are higher than those of comparable but non-reporting funds, although the difference is not significant using alternative choices of performance measures.

What advice could you give to PhD students looking to identify a suitable topic for their research work assuming they are targeting publication?
This is something I discussed in the classroom and informally at breaks. I basically told participants that they had to think outside the box because there is a lot of research going on out there. To be able to really stand out, you have to address interesting questions. Identify questions that are relevant and grounded in theory first and then find out how these can be addressed. The other piece of advice I gave participants was to look at their competitive advantages and play to their strengths; focusing on one's skills and expertise also creates barriers to entry. Collecting one's own unique dataset is also one way to come up with radically new approaches. Do not aim for marginal improvements on existing work, think big and out of the box.