Executive Briefing

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Motivating managers: How incentives and discretion play into hedge fund performance

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There are problems in the delegated portfolio management of both mutual funds and hedge funds. These include potential conflicts of interest and misuse of managerial freedom to make decisions. However, investors can alleviate such problems either by offering incentives to the fund manager that better align the interests of the manager with those of the investors or by closely monitoring the manager's decision-making. But do these solutions actually work? Do they motivate managers and alleviate potential agency problems? Do higher managerial incentives and greater managerial discretion lead to better performance in the hedge fund industry?

Two approaches

Interestingly, mutual funds and hedge funds approach these challenges differently. Hedge fund investors address conflicts of interest by linking incentive fee pay to performance and requiring a co-investment by the manager. Mutual fund investors typically lack such arrangements. However they seem to take the potential problem of managerial abuse more seriously by relying on regulation, disclosure, and risk limits (determined by comparison to benchmarks) to mitigate abuse of a manager's decision-making freedom. By contrast, hedge fund investors recognize the benefits of managerial discretion in making decisions. These investors accept restraints to capital withdrawal, thereby providing the manager with greater investment flexibility.

Other studies have explored the potential problems arising from managerial incentives and discretion—particularly in the context of corporations, where top executives are awarded stock options as incentives to improve the firm's performance. However, the causality, or the driver, of the solution remains unclear. Does the granting of stock options follow better performance, or does superior performance result from executives being awarded stock options?

Several factors underlie this ambiguity. Top executives in corporate firms are able to influence the pay-setting process and can issue stocks and options prior to the release of good news. This ability compounds the problem of attributing performance to managerial incentives. Also, if stock options end up deeply out of the money (in other words have no intrinsic value), executives can lobby to reset the strike price of existing options or issue additional at–the-money options (where the strike price is exactly at the prevailing price of the underlying stock).

Why hedge funds?

The hedge fund industry provides an interesting setting for investigating how performance relates to managerial incentives and discretion. With hedge funds, a manager's compensation contract is set at the fund's inception and does not change during the life of the fund. The manager proposes whether to include hurdle rate and/or high-water mark provisions as well as the performance-based incentive fee rate. Investors then decide to allocate money to the fund after reviewing these provisions, well aware that the manager will be unable to change these provisions in the future. Therefore, it is easier to determine if higher incentives influence better future performance with hedge funds than with mutual funds.

Other measures for controlling managerial discretion also are chosen at the inception of the fund, such as the duration of the lockup, notice, and redemption periods. At the end of the lockup period, which is the minimum time commitment for investing capital, an investor who wishes to withdraw funds must give advance notice (the notice period), then wait an additional amount of time to receive the money (the redemption period). Thus the longer these periods are, the greater the manager's freedom to pursue different investment strategies. For example, managers with greater flexibility can invest in opportunities that may take more time to become profitable. They also can avoid engaging in asset fire sales, such as selling securities during adverse market conditions.

Therefore, a better understanding of the relationship between performance and managerial incentives and discretion could shed light on the effectiveness of contracts in the asset management industry. Insights could help investors improve their contracting and capital allocation process as well as increase the enterprise value for fund managers. Furthermore, given the recent trend of more accessibility of hedge funds to retail investors, an exploration of these relationships would be of great interest to regulators.

A more accurate calculation

In exploring these issues we've developed more accurate measures of incentives than those previously used for hedge funds such as the incentive fee rate, which fails to capture managerial incentives. For example, two different managers who charge the same incentive fee rate may face different dollar incentives, depending on the timing and magnitude of investors' capital flows, the fund's return history, and other contractual features. To overcome such limitations we recognize that the incentive fee contract is a call option written by the investors on the assets under management—where the strike price is determined by the net asset value (NAV), at which different investors enter the fund, as well as the hurdle rate and high-water mark provisions in the contract. Using this approach, we are able to empirically quantify the delta (the amount by which an option's price will change for a corresponding change in price by the underlying entity) of the manager's call option/incentive fee contract. We refer to this measure as the manager's option delta.

The manager earns an incentive fee from the investors' assets as well as the entire return on any co-investment in the fund. Therefore, we estimate the total delta—the overall pay-performance sensitivity measure—as the total expected dollar increase in the manager's compensation for a 1% increase in the fund's NAV. The total delta measure combines the delta from investors' assets (including the manager's option delta) and the delta from the manager's co-investment.

Unfortunately, data on the manager's investment in the fund often are unavailable. But discussions with industry practitioners suggest that managers often reinvest all of the incentive fees earned back into the fund, allowing for an approximate calculation. Therefore, following this practice, we compute the dollar amount of the incentive fee earned by the manager each year and allow for it to be reinvested in the fund. At any point in time, then, the manager's co-investment is the cumulative value of the incentive fee, reinvested with the returns earned on it. We scale this co-investment by the total assets under management and use it as our proxy, or measure, for managerial ownership.

Total delta is a better measure of a manager's incentives than simply using the incentive fee percentage. For example, funds that charge the same incentive fee show very different values of delta, both in a given year and over time, because of differences in return histories and capital flows. The correlation between the total delta and the incentive fee rate in the sample in this study is only 0.17, highlighting the limitations of using the percentage incentive fee as a proxy for managerial incentives.

So what?

This investigation has led to several interesting findings.

- First, the higher values of managerial incentives measured by total delta—and not higher incentive fee rates—are associated with higher future returns. In fact, once we control for total delta, the incentive fee rate is not useful to explain higher future returns, whereas delta continues to be a significant predictor of future returns. The finding holds true even with a smaller sample of funds that charge the same incentive fee of 20%.
- Second, when we capture incentives by using managerial ownership as well as the manager's option delta, both are positively related to performance. This finding supports industry wisdom that requires co-investment by the manager for a fund to be successful.
- Finally, the proxies for managerial discretion are always positively related to performance.

Therefore, providing flexibility to the manager should be beneficial, provided appropriate incentives are in place.

Overall, the findings of this study strongly suggest that several features of hedge fund contracts—among them, offering incentives, requiring co-investment, and providing flexibility—effectively motivate managers and alleviate potential agency problems. The results carry significant implications for contracting with asset managers as well as executives who manage corporations.

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