redpoint Investment Management

Does your fund manager drive the 'right' car?

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It can be easy to make assumptions about someone by the way they dress or the car they drive. They say you should never judge a book by its cover, but when you only have a fleeting moment to make a judgement it may be the only data point available to us. But in the world of investment management, an industry which is fuelled by seemingly endless amounts of data, does the car an investment manager drive actually tell us anything about their investing abilities?

In a recent article published in the prestigious Journal of Finance, Stephen Brown[1], Yan Lu, Sugata Ray and Melvyn Teo, investigate a link between performance car ownership and hedge fund returns. They link a multitude of hedge fund characteristics with the type of car the lead staff drive. Through a barrage of statistical tests that seek to remove any confounding variables (e.g. fund size, fund type, leverage, etc.) the authors find some striking results.

It's the journey, not the destination

The authors looked at fund returns, fund flow, portfolio risk, management and performance fees, high water marks, lock up periods, redemption periods and leverage. They found no distinguishable statistical[2] or economic difference between performance car owners and non-performance car owners for all of these attributes apart from one, the variability of returns. This in turn impacts the important risk-return performance metrics, the Sharpe ratio, defined as the ratio of portfolio return less cash return compared to portfolio volatility. The Sharpe ratio was found to be statistically and economically lower for sports car owners, as is the information ratio, defined as portfolio excess return versus portfolio tracking error. It seems that hedge funds run by performance car owners tend to have similar long term outcomes but with more variability along the way.

I feel the need, the need for speed

Performance car ownership is linked by the authors to the psychological trait called *sensation seeking*, more commonly called thrill seeking. The conjecture is that sensation seekers are willing to accept riskier activities simply for the sake of the experience. The implication is they run their money in a similar way to other hedge fund managers, but with a proclivity for riskier portfolios. This is indeed supported by the performance analysis. The authors go further however to see if the hedge fund businesses are also run in a riskier way. They find that performance car owners are statistically more likely to wind-up their hedge fund, be subject to regulatory action and lawsuits, and carry more operational risk. They also appear to engage in riskier trading behaviour. US equity hedge funds (at least) managed by performance car owners have higher fund turnover, more frequent trading, more holdings in smaller companies, a higher active share[3], and favour stocks with high recent returns.

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[1] Brown is affiliated with Monash Business School and New York University, Lu is at University of Central Florida, Ray is at University of Alabama and Teo is at Singapore Management University

[2] In lay terms, a statistical difference occurs when the difference between two outcomes (e.g. the average portfolio return of sports car owners compared to non-sports car owners) is so great, that the probability the difference was observed by chance is improbably low, when taking into account the variability of the data. There is always a small possibility you are wrong. You'd be forgiven for thinking a coin is loaded if it turns up heads ten times in a row. This is an improbable outcome, a 1 in 1,000 chance, but it can occur.

[3] Active share is the fraction of the fund that differs from the S&P 500 index

Birds of a feather

The paper tests and re-tests the hypothesis in a number of ways. For example they perform the analysis on high vs low torque cars, high vs low horsepower cars, 'sports' vs non-sports cars. They look into investor motivation and find that sensation seeking investors tend to be attracted to sensation seeking hedge funds, that non-sensation seeking incentives tend to encourage non-sensation type activity. There are also some robustness tests to see whether gender, personal wealth, age, previous success and other factors might explain the results. They find no statistical link between these.

So the message from the article is, if you have a long time to invest it doesn't matter what car your fund manager drives. However, if your timeframe is shorter you may think a little differently. In short, if you're looking for thrills, go ahead and chase the overtly successful fund manager with the red Ferrari. On the other hand, if it's risk adjusted returns you're after, make sure your manager drives a dull boring car.

The article's full reference is:

Brown, Stephen, Yan Lu, Sugata Ray and Melvyn Teo, 2018, Sensation Seeking and Hedge Funds, *Journal of Finance*, 77(6), pp. 2871-2914.

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