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Flows: The ‘Invisible Hands’ on Hedge Fund Management

Midwest Finance Association 2012 Annual Meetings Paper

49 Pages

Posted: 19 Sep 2011

Last revised: 4 Jan 2012

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Date Written: September 16, 2011

Abstract

Hedge funds feature special compensation structure compared to traditional investments. Previous studies mainly focus on the provisions and incentive structure of hedge fund contract, such as 2/2'8 hurdle rates, and high-water mark. We develop an algorithm to empirically estimate the monthly fees, fund flows and gross asset values of individual hedge funds.

We find that management fee is a major component in the dollar amount of hedge fund total fees, and fund flow is more important in determining the change in fund size compared to net returns, especially when fund is shrinking in size. We also find that best paid hedge funds concentrate in the largest hedge fund quintile. Large funds tend to perform better, earn more, and rely less on management fee for their managers' compensation. Further, we find that fund flow is an important determinant of hedge fund managerial incentives. Together with the "visible" hands of hedge fund management, i.e. the provisions of hedge fund incentive contracts, the "invisible" hands – fund flows enable investors to effectively impact hedge fund managerial compensation and incentives.

Keywords: Hedge Fund, Fund Flow, Fee Structure, Managerial Incentives, Gross Return

JEL Classification: G20

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