

Capacity Constraints, Fund Flows and Hedge Fund Alpha: Asia Pacific Evidence – A Pitch

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Keywords: Capacity constraints; Fund flows; Hedge fund alpha

JFL: G11, G12, G15

1. Introduction

Referring to the template developed by Faff (2014), this pitch letter is developed using an academic research topic from the finance discipline. I am midway into my PhD programme at the Massey University Manawatu Campus, New Zealand and the template had offered me heaps of detailed guidance. It has helped me to refine my ideas, save time and resources and communicate my research better and consequently the paper has improved and for my second paper that I am currently writing. It also helped to distinguish my Master research from a PhD research.

When I started my PhD, I had no idea at all how I should tackle the journey. For many months, I was uncertain of what I should do my PhD on, I was a lost soul. I read and read through top quality journals, top conferences etc to find out the hot topics, in the end I chose hedge funds. My supervisors gave me lots guidance in framing my topic and at the same time giving me freedom to develop my own thoughts and my PhD. As I was making “call” on the key papers, I discovered the gap that I could potentially fulfil and how I could motivate my paper. Having chosen my topic, next comes the data worry. Hedge fund data is incredibly expensive. Typically in the empirical literature in studies on hedge funds, three databases is used. I was lucky as been awarded the Massey University Research Fund in 2013 to buy EurekaHedge and the school research fund for Lipper TASS. The econometric packages: STATA and Excel to run the data were a lesser headache as I had some control. Their drop down features made it user friendly for me.

The remainder of this letter is organised as follows. In Section 2, I give a brief commentary on my pitch. In Section 3, I offer a few key personal reflections on the pitch exercise, while Section 4 concludes.

2. Brief Commentary on the Pitch

The completed pitch is displayed in Table 1 and deals with Asia Pacific focused hedge funds whereby the key research question is “Do Asia Pacific focused hedge funds face capacity constraints in generating alpha?” Hedge fund markets are not as widely researched as other financial markets giving me opportunities or the real “pitch”. The identified key papers are Fung, Hsieh, Naik, and Ramadorai, (2008) and Naik, Ramadorai, and Stromqvist, (2007). The settings of both of these papers are different. Naik et al. (2007) for instance address this question at the level of hedge fund strategies. They used self-constructed value-weighted and equally-weighted strategy indices and their results suggest that alpha equilibrium will be zero. The remainder of Table 1 provides “answers” to the fields from Faff’s (2014) template, that is, Idea, Data, Tools, What’s New, So What, Contribution and Other Considerations. Because of the clarity of template layout, I have inserted it as it is as I do not think I can do a better job.

Table: Example of Faff’s (2014) “3-2-1” Pitching Template – Completed Pitch on “Hedge Fund” Topic

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| Pitcher’s Name | Mui Kuen Yuen |
| (A) Working Title | Capacity Constraints, Fund Flows and Hedge Fund Alpha: Asia Pacific Evidence |
| (B) Basic Research Question | Do Asia Pacific focused hedge funds face capacity constraints in generating alpha? |
| (C) Key paper(s) | Fung, W., Hsieh, D., Naik, N., and Ramadorai, T. (2008). Hedge funds: Performance, risk, and capital formation. <i>The Journal of Finance</i> , LXIII(4):1777-1803. Naik, N. Y., Ramadorai, T., and Stromqvist, M. (2007). Capacity constraints and hedge fund strategy returns. <i>European Financial Management</i> , 13(2):239-256. |
| (D) Motivation/Puzzle | Referring to the Berk and Green’s (2004) rational model of active portfolio management, as the amount of capital invested in the hedge fund industry increased significantly, the expected consequence of this development is a decrease in hedge fund alpha. Hedge fund managers might be forced to invest into the less profitable strategies or less attractive investments or diversify in to strategies where they have limited knowledge and experience. |
| THREE | Three core aspects |
| (E) Idea? | “Core” idea: While it has been widely documented in the mutual fund literature and economics that managers/ firms will face decreasing returns to scale over time, the Asia Pacific focused funds are on average smaller in size, at a different stage in the life cycle/capital market development and dominated by long/short strategies. Central hypothesis(es): Hedge fund alpha exists in Asia-Pacific focused funds. As the fund flows increase, Asia Pacific focused funds will face capacity |

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| | <p>constraints in generating the alpha.</p> <p>Theoretical “tension”: theory of rational portfolio management versus the literatures supporting emerging markets.</p> |
| (F) Data? | <p>(1)Country/setting: Asia Pacific focused funds. Some of the reasons already mentioned are the stage of capital market development, strategies dominance (e.g. short selling is only recently permitted in China) and inclusion of retail investors other than institutional investors. Unit of analysis: post fee returns. Sampling: monthly returns</p> <p>(2) Expected sample size: approx. 3000 Asia Pacific focused funds. Analysis: Cross sectional and time series analysis. Sample period: January 1994 – December 2013</p> <p>(3) Data source(s): Eureka hedge, Lipper TASS and Morningstar (hedge fund data) and others from Datastream, Hsieh data library. Timeframe: 3 months. Funding/grants?: Massey University Research Grant and the School research fund.</p> <p>(4) Standard data</p> <p>(5) Will there be any problem with data? There are lots of biases in hedge fund data such as selection bias, backfill bias, voluntary reporting etc and various approaches have been chosen to minimise these biases such as using three databases, use data from 1994 onwards, etc.</p> <p>(6) Will your test variables exhibit adequate (“meaningful”) variation to give a good power? Yes, as we augmented the factor models used in the prior literature specific to our setting.</p> |
| (G) Tools | <p>Basic empirical framework: Time series regression and cross sectional regression. Augment the factor model with factors relevant to Asia Pacific focused funds: MSCI emerging markets Asia index, MSCI Pacific excluding Japan index, MSCI Japan index and JP Morgan emerging markets bond Asia index.</p> <p>Econometric software needed/appropriate for job?: Stata and Excel. Prefer to do filtering of data in Excel before transfer to Stata.</p> <p>Knowledge of implementation of appropriate statistical/econometrical tests? Yes lots of experimenting, re-reading and advice from supervisors.</p> <p>Compatibility of data with planned empirical framework?: Yes, we are building on the prior literature and covers a long time period including the latest financial crisis.</p> |
| TWO | Two key questions |
| (H) What’s New? | We focus on hedge funds that invest in the Asia Pacific only which are usually smaller in size and where the capital market development is potentially different. There could also be differences in proximity of location. |
| (I) So What? | The answer to this question is important as it gives important implications for investors such as universities, pension funds, endowments, wealthy individuals and retail investors seeking diversification opportunities in this region. |
| ONE | One bottom line |
| (J) Contribution? | Primary source of contribution: Add to the literature on portfolio diversification, rational model of portfolio management and hedge fund alpha and performance |
| (K) Other considerations | Some of the considerations include the accuracy in constructing the model, competing papers and completing the three essays on time. |

3. Personal Reflections on the Pitch Exercise

Since I am not native speaker of English, writing is incredibly hard. It seemed or thought that I was able to express myself more easily than on paper. Some aspects of the pitch process that I have difficulty include: is all the relevant literature covered? Is the research question answerable? Is the contribution significant enough? Is the hypothesis testable? How to set up the model to test the hypothesis correctly?

All these questions are in line with Faff (2014, p.1) which said that “starting” is a major challenge to doing research. Nevertheless, I made a start on the pitch template sometimes only writing one sentence. I followed the approach of the “cocktail glass” by Faff (2014) and that provided tremendous support. At first, I started off with Asia Pacific hedge funds. But this was deemed too broad and unfocused. So I narrower it down to exactly what aspect of Asia Pacific hedge funds that I wanted to study. During my monthly meetings with my supervisors, I usually start off with what I have done and report any results and my supervisors will offer their comments. If they agree, then I know I am on the right track. On the other hand, if they said what about these, I take that as constructive criticism and improve from there. There is no “wrong” answer according to Faff (2014) but a better way and PhD is a journey.

Relating to the above, I find that understanding the key papers are very important as that will helped you identified the gap. These will lead to answers to your contribution and the what’s new and so what questions. Thorough literature review is money worthwhile spent as well as solid econometrics knowledge. The pitch template was very useful, it helped me to organize my ideas and write them concisely not only for myself but for my supervisors, classmates, seminar audience.

4. Conclusion

This letter states my preliminary pitch for my PhD paper on capacity constraints due to increasing capital inflows in the Asia Pacific. It is still in development phrase and there is ongoing polishing work. The Faff (2014) pitch template gave me clear guidelines to embark on my PhD journey with confidence and for future projects to come!

References:

Faff, R. W. (2014). Pitching Research. Available at SSRN: <http://ssrn.com/abstract=2462059>.

Fung, W., Hsieh, D., Naik, N., and Ramadorai, T. (2008). Hedge funds: Performance, risk, and capital formation. *The Journal of Finance*, LXIII(4):1777-1803.

Naik, N. Y., Ramadorai, T., and Stromqvist, M. (2007). Capacity constraints and hedge fund strategy returns. *European Financial Management*, 13(2):239-256.