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Fund Performance Indicators The SEC May Be Watching


Law360, New York (May 02, 2014, 1:51 PM ET) -- According to recent reports, the U.S. Securities and Exchange Commission has set up a dedicated unit focused on private investment funds, including private equity and hedge funds.[1] The SEC's focus on private investment funds may relate to two factors.

First, increased reporting requirements for private investment managers have provided the SEC with additional data to track hedge funds and private equity funds.[2] Second, the SEC has recently focused on data-driven efforts to detect potential performance reporting issues, whether in corporate accounting or investment returns. For example, the SEC itself has indicated that steadily outperforming indices by 3 percent may elevate SEC scrutiny of hedge funds.[3]

In this article, we present an overview of recent economic research on potential performance manipulation by private investment managers. This research provides a window into the statistical indicators that the SEC may use in screening for potential reporting issues.

However, as we describe below, this research is in its infancy. There are competing hypotheses, and the findings are limited to the available data and its quality. Fund managers and their advisers can monitor regulatory risk by understanding the signals that regulators may be monitoring, determining whether a fund stands out on any metrics, and understanding why it does.

What the Literature Says: Private Equity Fund Valuations

As a result of investing in illiquid assets that lack secondary market prices, private equity funds are a natural target of regulatory concern. Economic researchers have therefore focused on whether there are any systematic biases in the net asset values (NAVs) reported by private equity managers.

Jenkinson, Sousa and Stucke (2013) examined private equity reporting and found reported NAVs were consistently better during the fourth quarter for buyout funds.[4] This could be consistent with funds' assets being valued more conservatively in the rest of the year.

Fundraising activities also seem to have an effect on NAVs. When general partners are promoting follow-on funds, the funds' NAVs are found to be higher on average. This increase was found to gradually unwind over subsequent years.

There are various explanations for this performance pattern. One is self-selection bias: all else equal and considering the fundraising schedules, GPs are more likely to begin follow-on fundraising when the existing funds' valuations are higher. Brown, Gredil and Kaplan (2014) find that any increase in reported NAV associated with fundraising may be transparent to investors, as these GPs have greater difficulty subsequently raising funds.[5]

What the Literature Says: Hedge Fund Performance

Research on hedge fund performance has been more extensive due to greater data availability through hedge fund reporting databases. Recent findings have focused on statistical patterns in reported returns and whether statistical anomalies relate to potential wrongdoing.

Bollen and Poole (2009) noted a discontinuity in the distribution of monthly hedge fund returns.[6] Specifically, the likelihood of reporting a slightly negative return appears to be significantly lower than the likelihood of reporting a slightly positive return. The researchers hypothesize this statistical pattern relates to manipulation of reported investment returns. As possible corroboration of their hypothesis, they find the discontinuity is absent from audited three-month results. Similarly, Agarwal, Daniel and Naik (2011) find that hedge fund returns tend to be higher at the end of year.[7]

Jorion and Schwarz (2014) offer explanations for those statistical anomalies that are unrelated to potential misreporting. One explanation relates to how hedge funds accrue for performance fees with high water marks.[8] Because performance fees are assessed only on positive returns, and high water marks affect fee accrual after losses are incurred, there is a tendency for net returns to exhibit the aforementioned discontinuity in the distribution of returns around zero.[9] Consistent with this explanation, Jorion and Schwarz (2014) show that the discontinuity in hedge fund returns is much less pronounced in funds with lower incentive fees.

Bollen and Poole (2012) extended their research into possible hedge fund return manipulation by comparing information on the set of funds subject to SEC enforcement actions and lawsuits with information on those funds' characteristics, to obtain statistical indicators of potential reporting violations.[10], [11]

They find a number of indicators that are more pronounced among the sample of funds with alleged wrongdoing as compared to the remaining sample. Such indicators include repeated returns, infrequent negative returns and performance that does not correlate with that of other hedge funds with similar investment styles.

Jorion and Schwarz (2014) point out that such indicators are not necessarily related to wrongdoing. For example, repeated positive returns may be associated with infrequent updates to the prices of illiquid assets or with how the value of a held-to-maturity fixed-income instrument is booked.

Investments in fixed-income securities, whose yields do not go below zero, may explain infrequent observations of small losses. Where a fund may have low correlation with benchmark indices, individual analysis is required to discern whether such low correlation simply relates to fundamental differences in fund investment strategies.

Hedge fund performance can also be temporarily affected by actual transactions. Ben-David et al. (2013) found that stocks that are more heavily owned by hedge funds exhibit abnormally higher prices during the last trading date of quarter ends; however, these price increases reverse on the next quarter's first trading day.[12] Such unusual price changes are more pronounced for less liquid stocks.

Because such price changes are relatively small and short-lived, they are unlikely to have an impact on fund manager performance compensation. Also, even if a particular hedge fund invests in an illiquid stock with such unusual quarter-end price spikes, the fund manager may not necessarily be causing the increase, as many other funds often invest in the same stock.

Conclusions

The emerging literature on private equity and hedge fund returns provides potential quantitative signals that may attract a regulator's focus. It is worth noting that economic research has focused on large samples across thousands of observations. One should be careful, therefore, in applying such research to a single fund.

In our experience, inferences about potential reporting issues do not easily translate from large samples to an individual fund, where understanding case-specific facts and circumstances is required to explain patterns in observed fund performance.

As noted above, the literature on private investment manager reporting issues is in its infancy, and there remains a debate regarding whether statistical findings consistent with manipulation can be explained by reasons unrelated to wrongdoing.

Even taking the academic findings at face value, it is always easier to find statistical anomalies in large samples than to prove them for any individual fund. Identifying such benign reasons may require an individualized analysis by a fund, examining not only any patterns in its reported performance but also reconciling those patterns to that fund's specific investment strategies.

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[1] Bruce Karpati, "Private Equity Enforcement Concerns" (speech, Private Equity International Conference, New York, N.Y., Jan. 23, 2013), SEC, http://www.sec.gov/News/Speech/Detail/Speech/1365171492120#.U0sQIGBOVO9); Greg Roumeliotis and Sarah N. Lynch, "Exclusive: SEC forms squad to examine private funds - sources," Reuters, April 7, 2014, http://www.reuters.com/article/2014/04/07/us-sec-privatefunds-idUSBREA360M420140407.

[2] For example, certain investment advisers are required to file Form ADV (providing fund details such

as assets under management and a narrative brochure, written in layman's terms, that describes the nature of the fund and its business) while funds of sufficient size are required to file Form PF (providing for the collection of risk exposure information) pursuant to the requirements of the Dodd-Frank Act.

[3] Robert Khuzami, "Oversight of the Securities and Exchange Commission's Operations, Activities, Challenges and FY2012 Budget Request," (testimony, before the House Committee on Financial Services, 112th Congress, March 10, 2011), http://financialservices.house.gov/uploadedfiles/112-14.pdf.

[4] Tim Jenkinson, Miguel Sousa and Rüdiger Stucke, "How Fair are the Valuations of Private Equity Funds?" working paper (2013).

[5] Gregory W. Brown, Oleg R. Gredil, and Steven N. Kaplan, "Do Private Equity Funds Game Returns?" working paper (2014).

[6] Nicolas P. B. Bollen and Veronika K. Pool, "Do Hedge Fund Managers Misreport Returns? Evidence from the Pooled Distribution," The Journal of Finance 64, no. 5 (October 2009): 2257-2288.

[7] Vikas Agarwal, Naveen D. Daniel, and Narayan Y. Naik, "Do Hedge Funds Manage Their Reported Returns?" The Review of Financial Studies 24, issue 10 (2011): 3281-3320.

[8] Philippe Jorion and Christopher Schwarz, "Are Hedge Fund Managers Systematically Misreporting? Or Not?" Journal of Financial Economics 111, issue 2 (2014): 311-327.

[9] This is not dissimilar from past research offering benign explanations for the distribution of corporate earnings around zero: taxes affect positive earnings more than they affect negative earnings. William H. Beaver, Maureen F. McNichols, and Karen K. Nelson, "An Alternative Interpretation of the Discontinuity in Earnings Distributions," Review of Accounting Studies 12 (2007): 525-556.

[10] Nicolas P. B. Bollen and Veronika K. Pool, "Suspicious Patterns in Hedge Fund Returns and the Risk of Fraud," The Review of Financial Studies 25, no. 9 (September 2012): 2673-2702. The authors categorize as performance violations allegations related to misappropriation, overvaluation, misrepresentation and Ponzi schemes.

[11] Because this research is based on allegations, not admissions of wrongdoing, it may be identifying indicators that the SEC has used to screen funds for further scrutiny rather than indicators of wrongdoing itself.

[12] Itzhak Ben-David, Francesco A. Franzoni, Augustin Landier, and Rabih Moussawi. "Do Hedge Funds Manipulate Stock Prices?" Journal of Finance 68, issue 6 (2013): 2383-2434.
