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Stephen Brown

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By John Kavanagh

The first item of business for an investment committee choosing a hedge fund manager should be to find out what cars they drive and the second is to reject the ones that drive sports cars.

Stephen Brown, a professor in the Department of Banking and Finance at Monash University, says trustees hire hedge fund managers to take risk but the important question is whether they are taking risk to enhance returns or taking risk for its own sake.

Brown's research, which he presented at the IMR conference at UTS last week, reveals that hedge fund managers who drive high-performance sports cars, such as Ferraris and Lamborghinis, are more likely to take the sort of risk that can be classified as "sensation-seeking behaviour", which will not produce good returns for investors.

Brown, who is also David S. Loeb emeritus professor of finance at New York University Stern School of Business, co-wrote 'Sensation Seeking, Sports Cars and Hedge Funds' with Yan Lu from the University of Central Florida, Sugata Ray from the University of Florida and Melvyn Teo from Singapore Management University.

Brown told the conference that the researchers found that hedge fund managers who drove sports cars preferred to invest in stocks with high past daily returns and which provided "intense lottery-like experiences". They are also more likely to be active traders using unconventional strategies.

"Motivated by sensation seeking, these fund managers often take substantial financial and operational risks for non-pecuniary reasons unrelated to performance," he said.

Brown and his co-authors collected US vehicle purchase records from 2006 to 2012. They matched vehicles, of which 163 were classified as high-performance sports cars, to 1144 US hedge fund managers.

They found that the sports car owners delivered returns that were 1.8 percentage points a year more volatile than the returns of the non-sports car driving peers. "This represents a 16.6 per cent increase in volatility over that of drivers who shun sports cars," Brown says.

They did this without generating higher returns. Risk-adjusted returns were lower for managers with sports cars, compared with other managers. The sports car owners had an annualised Sharpe ratio that was 0.34 lower (or 40 per cent) than other car owners.

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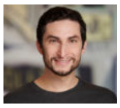
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The study also found that sports car owners were more likely to terminate their funds and be subject to regulatory action and civil and criminal proceedings.

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