

Hedge fund risk appetite: A Prospect theory perspective

Abstract

The paper examines the incentives and risk attitudes prevalent in the hedge fund industry. It considers the implications that fee structures hold for a fund manager's risk preferences under a prospect theory framework. In contrast to expected utility theory, prospect theory agents are thought to be loss averse in relation to a reference point and risk seeking when underperforming against their reference point. This paper argues that the incentive structure created by hedge fund fees is best described by Prospect theory. The performance fee, employed in hedge fund compensation, is calculated on the fund return achieved in excess to a stated benchmark. The benchmark, or hurdle rate, thus serves as the pivotal reference point in fund manager's decision making. The paper provides a theoretical analysis of how incentives are distorted by changes in compensation when hedge fund managers follow prospect theory utility maximisation.

The paper secondly proposes the inclusion of a social benchmark when evaluating a fund manager's decision making. The hedge fund industry is highly competitive and investors have the ability to withdraw funds from underperforming managers and allocate it to their rivals. It is also often the case that fund managers use peer benchmarks to evaluate returns. This implies that hedge funds do not solely use the hurdle rate as their reference point, but also value their relative standing against other fund managers. If this hypothesis holds true, prospect theory predicts that trailing managers could increase the risk of their portfolio in fear of underperforming against their peers. Both propositions are derived in a Prospect theory framework to illustrate the risks and incentives promoted by the hedge fund compensation structure.