NICOLE BOYSON *Assistant professor of finance, Northeastern University.*

HEDGE FUND CAREER CONCERNS

Evidence that managers' risk-taking behavior increases over time.

Several theories of reputation suggest that managers' career concerns affect their decisions, particularly their propensity to take risk. On one hand, a number of academic researchers suggest that managers will increase risk as they gain experience. For example, Avery and Chevalier (1999) argue that as managers gain experience they obtain more precise knowledge about, and confidence in, their own abilities. There is empirical support for this theory as well among mutual fund managers, security analysts, and macroeconomic forecasters (Chevalier and Ellison [1999], Hong, Kubik, and Solomon [2000], and Lamont [2002]). By contrast, other models and a large amount of labour economics literature predict that risk-taking behavior will decrease as managers age. There is theoretical and empirical support for this theory as well (Prendergast and Stole [1996] and Graham [1999]).

Perhaps the contradictory conclusions of these empirical studies relate to how well industries and firms provide incentives to overcome the effects of career concerns. This career-concerns literature, pioneered by Fama (1980), argues that principal-agent problems—which occur when the incentives of investors and fund managers are misaligned—can be mitigated by a manager's desire to keep his current job or obtain a better job. However, sometimes career concerns can work too well, resolving some agency problems while causing others (Holmstrom [1982/1999], and Holmstrom and Ricart i Costa [1986]). An alternative view is that career concerns are themselves a type of agency problem, which sometimes mitigate and sometimes exacerbate existing problems.

In order to understand the career concerns and incentives faced by hedge fund managers, I first examine the determinants of fund failure. For hedge fund managers, with a few notable exceptions, fund failure often implies exit from the industry, since building and maintaining a reputation is an important factor in attracting investors to a fund. Thus, if this analysis finds that risk-taking behavior is related to fund failure in a systematic way, it is reasonable to assume that managers will respond to the incentives created. To study the determinants of fund failure, I use a proportional hazards model which allows the specification of determinants of fund failure over time, and is a conditional model in that failure in a period is conditional upon not having failed in a prior period. The results of this analysis provide evidence that experienced managers are less likely than inexperienced managers to be terminated for risky investment strategies. I define risky investment strategies in three ways: those with high volatility, those with market exposure that differs from other fund managers, and those with tracking error that differs from other fund managers. Additionally, these more senior risk-taking managers receive significant new fund inflows. I theorize that these implicit incentives should induce managers to increase risk as their careers progress.

Given these implicit incentives, I next examine whether more experienced managers take on more risk. To perform this analysis, I use a fixed-effects regression model, which has the unique ability to track individual fund managers through time. I separately regress the risk measures for a number of manager characteristics, including experience, and find that more experienced managers do indeed take on more risk over time. These results are largely consistent with studies of mutual fund managers, despite differences in explicit compensation plans and industry structure.

Finally, this increase in risky behavior does not improve the returns of more experienced managers relative to less experienced ones. In fact, there is no statistically significant difference between the returns of managers at the beginning of their careers versus those at the middle or end of their careers. This may be due to the widely cited difficulty for managers with larger, more established funds to identify profitable investment opportunities, and is an interesting avenue for future research. ■