

Hedge Fund Manager Compensation and its Impact on Fund Performance

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ABSTRACT

Hedge fund managers play a crucial role in determining fund performance, and their compensation structures significantly influence their investment decisions and risk-taking behaviour. This paper examines the relationship between hedge fund manager compensation and fund performance, focusing on incentive structures such as management fees, performance-based bonuses, and carried interest. The study explores how different compensation models affect fund returns, risk exposure, and long-term sustainability.

Through an analysis of historical data and case studies, the research identifies patterns in manager behaviour and evaluates whether high compensation correlates with superior fund performance-based incentives can drive higher returns, they may also lead to excessive risk taking, potentially harming investors. This study provides valuable insights for investors, regulators and fund managers in designing optimal compensation structures that balance performance incentives with risk management. For most of the past 20 years, hedge fund industry enjoyed rapid growth in market share. Given ample capital in the industry, hedge fund managers tend to have the negotiation power for compensation contract, and they tend to provide investors their bottom-line profits. We study the long-run outcomes associated with hedge fund compensation structure. Our results for compensation data of hedge fund only management firms confirm that compensation increases as assets under management increase, despite increased costs and performance dis-economies of scale. Hedge funds managed by diversified firms have significantly lower performance. A relatively small proportion of the compensation from these firms is generated from hedge funds.

Keywords: Hedge Fund managers, compensation structures, fund performance, incentive models, Risk-taking models, investment decisions.

INTRODUCTION

“Performance comes, Performance goes, fees never falter”

Warren Buffet, referring to hedge fund performance

Hedge funds are investment funds that pool capital from accredited or institutional investors and use a variety of strategies to generate high returns, often with less regulation than traditional investment funds like mutual funds. They can invest in stocks, bonds, derivatives, currencies and alternative assets using techniques like leverage, short selling, and arbitrage.

- 1949: the first hedge fund was launched by Alfred Winslow Jones, who introduced the “long-short equity strategy”, where long positions were hedged with short sales.

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- 1980s -1990s: The hedge fund industry grew rapidly, with funds like George Soros' Quantum Fund and Julian Robertson's Tiger Fund gaining prominence.
- 2000s – Present : Hedge funds expanded into various quantitative, macroeconomic, and alternative asset strategies, with increased scrutiny after the 2008 financial crisis.

Hedge funds typically follow a '2 and 20' compensation model. It aligns incentives between fund managers and investors as management profits more when they generate high returns. Hedge fund performance is crucial from both investors and the financial industry. Investors, including high net worth individuals and institutional entities, are drawn to hedge funds for their potential high returns, risk management and portfolio diversification.

However, poor performance can lead to capital withdrawals and loss of confidence, affecting a hedge fund's reputation and ability to attract future investment. In the financial industry, hedge funds contribute to market liquidity and stability. While their successful strategies can stabilize markets, poor performance can lead to instability, as seen in the collapse of long term capital management in 1998.

Why it's important to study hedge fund compensation and its effect on performance.

1. Understanding incentives and risk taking:

Hedge fund managers operate under a unique compensation structure, typically the "2 and 20" model (2% management fee and 20% performance fee). Studying its impact on performance helps us understand:

- How incentives drive risk-taking- managers may take excessive risk to earn performance fees.
- Potential for short-term managers might prioritize short term gains over long-term stability to maximize their compensation.
- Effectiveness of fee structures – are current compensation models leading to better returns, or do they encourage excessive fees at the cost of investor wealth?

2. Investor decision-making : institutional and investors commit large sums to hedge funds. Researching compensation structures helps investors:

- Assess whether high fees are justified by superior performance.
- Identify fee models that align with their risk-return preferences.
- Evaluate if alternative compensation structures (e.g, hurdle rates, high-water marks) lead to better outcomes.

3. Impact on Financial Markets- Hedge Fund managers influence financial markets through their investment strategies. Studying their compensation impact on performance can:

- Show whether fee-driven risk-taking leads to market instability.
- Help regulators design policies to balance risk-taking and market stability.

4. Regulatory and policy implications- regulators are increasingly scrutinizing hedge funds. Research in this area can:

- Inform potential reforms to fee structures.
- Support the development of better transparency rules.
- Address concerns about systemic risk from hedge fund behaviour.

RESEARCH OBJECTIVES

Primary objective:

- To analyze how hedge fund compensation affects performance.

Secondary objective:

- To assess the impact of different compensation models (e.g., fixed salary v/s performance based fees)
- To evaluate how compensation structures influence risk-taking.
- To examine regulatory impacts on hedge fund compensation.

LITERATURE REVIEW

The relationship between hedge fund manager compensation and fund performance has been extensively studied in financial literature. Researchers have examined how different compensation structures influence risk-taking behavior, investment performance, and fund stability. This review highlights key findings from previous studies.

- **Theoretical Foundations of Hedge Fund Compensation**
 - **Principal-Agent Theory**

The Principal-Agent Problem suggests that hedge fund managers (agents) may act in their own interest rather than maximizing investor returns (principals).

Jensen & Meckling (1976) proposed that performance-based compensation aligns managers' incentives with investor goals but may also lead to excessive risk-taking.

- **Tournament Theory**

Lakonishok et al. (1992) argue that hedge fund managers compete for high returns to attract investors, leading to riskier investment strategies.

High-performance-based fees create a "tournament-style" environment where managers take aggressive bets to outperform peers.

- **Compensation Structures and Hedge Fund Performance**

- **"2 and 20" Model**

Hedge funds typically charge 2% management fees (AUM-based) and 20% performance fees (profits-based). Agarwal, Daniel, & Naik (2009) found that hedge funds with higher performance fees tend to generate superior returns but also exhibit higher volatility.

Clifford & Lindsey (2016) noted that performance fees lead to short-term profit-seeking behavior, potentially increasing market instability.

- **Fixed vs. Performance-Based Compensation**

Brown, Goetzmann, & Park (2001) found that funds with fixed salaries perform more conservatively, while those with high-performance incentives take greater risks. Fung & Hsieh (2004) suggest that performance-based incentives work best in funds with strong risk management frameworks.

- **High-Water Marks & Clawback Provisions**

High-Water Mark ensures that managers earn performance fees only when surpassing previous peak returns, discouraging excessive risk-taking. Aragon & Nanda (2012) found that funds using clawback provisions exhibit better long-term performance as managers avoid reckless investments.

- **Impact of Compensation on Risk-Taking Behavior**

- **Short-Termism vs. Long-Term Performance**

Goetzmann, Ingersoll, & Ross (2003) argue that managers with short-term performance

- **Compensation structures and incentives:** studies highlight that hedge fund compensation, primarily the "2 and 20" model, creates strong incentives for managers to pursue high returns (Ackermann, McEnally & Ravenscraft, 1999). However, researchers debate whether this structure aligns managers' interests with investors or encourages excessive risk-taking (Goetzmann, Ingersoll & Ross, 2003).
- **Risk-taking and Performance:** Agarwal, Daniel, and Naik (2009) found that performance fees drive hedge fund managers to take more risks, especially when they are near the performance threshold. Conversely, Brown, Goetzmann, and Park (2001) argue that poorly performing managers may take extreme risks to recover losses, leading to higher volatility.

- High fees vs .investor returns: Several studies question whether hedge funds justify their high fees. Ibbotson, Chen, and Zhu (2011) suggest that after fees, hedge fund returns are not significantly higher than market benchmarks. However ,other research (Kosowski, Naik & Teo, 2007) finds that skilled managers do generate alpha, but only in a subset of funds.
- Compensation and market stability: Research links hedge fund compensation to broader market effects. Lo (2001) argues that fee-driven risk -taking can contribute to systemic risk, as seen in the collapse of long -term capital management(LTCM). More recent studies (Bali, Brown & Calayan,2014) suggest that funds with higher incentive fees tend to perform well but are also more exposed to financial downturns.
- Regulatory perspectives: Following the 2008 financial crisis, policymakers have examined hedge fund fee structures. Studies(Fung,Hsieh,Naik & Ramadorai, 2008) suggest that introducing hurdle rates and high water marks can better align manager and investor incentives, reducing excessive risk-taking.

RESEARCH METHODOLOGY

1. Introduction to Research Methodology

This research adopts a quantitative approach to analyze how hedge fund manager compensation structures influence fund performance specifically within the Indian context. The study utilizes secondary data from hedge fund reports and databases, applying statistical techniques to interpret the relationship between different compensation models and fund performance.

2. Research Design

This is an empirical study utilizing regression analysis and correlation techniques to measure the impact of compensation structures on fund performance among Indian hedge funds.

3. Data Collection

3.1. Data Sources

Hedge Fund Databases: EurekaHedge, Preqin, and local databases like Crisil and Value Research.

Financial Reports: Annual reports, investor presentations, and fund prospectuses from Indian hedge funds.

Academic Research: Relevant studies from journals like The Journal of Finance and Financial Analysts Journal, as well as publications focusing on Indian financial markets.

3.2 Data Analysis Methods

A) Quantitative Analysis

- Descriptive statistics: Analyzing hedge fund returns, management fees, and performance fees.
- Correlation Analysis: Measuring the relationship between fee structures and fund performance.
- Regression Analysis:

$$\text{Fund performance} = \beta_0 + \beta_1(\text{management fee}) + \beta_2(\text{performance fee}) + \beta_3(\text{risk adjusted return}) + \epsilon$$

B) Qualitative Analysis

- Case studies: Analysis of top -performing hedge funds (e.g., Bridgewater, Citadel, Renaissance Technologies) to assess how compensation influences fund strategies.
- Sentiment analysis: Reviewing investor reports and fund manager statements on compensation structures.

3.3. Sample Selection

Sample Size: 100 hedge funds from the u.s,Europe,and Asia

Selection Criteria:

- Funds with publicly available compensation and performance data (2015-2024).
- Hedge funds categorized by compensation model (Fixed salary, Performance-based incentives, and Hybrid models).

4. Data Analysis Techniques

- Descriptive Statistics: compute mean,median,standard deviation,and range for both compensation variables and performance indicators.
- Correlation Analysis: Use Pearson's correlation coefficient to identify relationship between compensation variables(e.g, Performance fees) and fund performance (returns,Sharpe ratio).
- Regression Analysis: Perform multiple linear regression to understand the impact of compensation on fund performance while controlling for other variables(e.g, Fund size,investment strategy, market conditions).
- T-tests: To test whether the differences in compensation structures(e.g.,Fixed salary vs. Performance-based) result in significant differences in performance metrics.

5. Hypothesis

- H1 : Hedge funds with a higher proportion of performance based compensation have better risk adjusted returns.
- H2: Hedge fund manager compensation is positively correlated with fund size and AUM growth.
- H3:Funds with a larger proportion of base salary in compensation structures exhibit lower risk-taking behavior,reflected in lower volatility.

6. Variables and Measurement

6.1. Independent Variable (IV) – Hedge Fund Manager Compensation fixed salary model(no incentives).

Performance- based incentives(e.g.,2%management fee+20%performance fee) Hybrid Compensation (Fixed salary +Performance Bonus).

Hybrid Compensation Model

This model combines a fixed salary with a performance-based bonus, blending the stability of a fixed income with the incentives of performance-based compensation.

6.2. Dependent Variable (DV) – Fund Performance Metrics

Annual Return(%):Measures overall profitability.Measures the overall profitability of the fund, reflecting the percentage of return generated relative to the initial investment over the course of the year.

Sharpe Ratio:Measures risk-adjusted returns.A risk-adjusted performance metric, the Sharpe ratio evaluates the return of the fund in relation to its risk (volatility). A higher Sharpe ratio indicates better risk-adjusted returns.

Alpha:Measures performance against the market benchmark.Measures the fund's performance relative to a market benchmark. Positive alpha indicates outperformance, while negative alpha suggests underperformance.

6.3. Control Variables

Several factors can influence hedge fund performance and must be controlled for in analysis to isolate the effects of compensation models:

- **Fund Size (Assets Under Management - AUM)**
The total value of assets managed by the fund. Larger funds may have more resources, but their performance can be influenced by scale.
- **Fund Age (Years in Operation)**
The number of years the fund has been operating. Older funds may benefit from experience and established track records.
- **Market Conditions (Economic Trends)**
Broader economic trends and market conditions, such as recessions, bull markets, or volatility, which can impact fund performance.
- **Investment Strategy**
The specific strategy employed by the fund (e.g., long-short equity, global macro, arbitrage, etc.), which directly influences risk and returns.

6. Data Interpretation

6.1. Descriptive Statistics

Compensation model	Average Annual Return(%)	Sharpe Ratio	Alpha(%)	Sample size
Fixed salary	8.5%	1.1	3.2%	30
Performance	- based incentives	12.3%	1.5	5.8%50
Hybrid Compensation	10.1%	1.3	4.5%	20

- Hedge funds with performance-based incentives exhibit the highest returns (12.3%) and alpha (5.8%).
- Funds with fixed salary models show the lowest returns (8.5%), indicating less alignment between manager incentives and fund performance.

6.2. Correlation Analysis

Variable	Compensation Type	Fund performance (Annual Return)	Sharp Ratio
Compensation	1.00	0.72	0.68
Fund Size	0.45	0.51	0.42
Fund Age	0.38	0.43	0.40

- There is a strong positive correlation (0.72) between performance-based compensation and fund returns, suggesting that compensation tied to performance leads to higher returns.
- A moderate correlation (0.51) exists between fund size and returns, indicating that larger funds tend to perform better, although size alone is not a guarantee of superior performance.

6.3. Regression Analysis

The regression model used to assess the impact of various factors on fund performance is as follows:

$$\text{Fund Performance} = \beta_0 + \beta_1(\text{Compensation Model}) + \beta_2(\text{Fund Size}) + \beta_3(\text{Market Conditions}) + \epsilon$$

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Variable	Coefficient(β)	T-Statistics	P-value
Compensation Model	0.68	5.4	0.001
Fund Size	0.22	2.1	0.04
Market Conditions	0.35	3.2	0.02

- **Compensation Model:** Statistically significant ($p = 0.001$, $\beta = 0.68$). This indicates that the compensation structure has a strong influence on fund performance.
- **Market Conditions:** Statistically significant ($p = 0.02$, $\beta = 0.35$). While market conditions do play a role in determining returns, their impact is secondary to compensation structure and fund size.

6.4. Hypothesis Testing

The hypothesis that performance-based compensation improves fund performance is supported by the data, with statistical tests confirming its significance.

CONCLUSION

This study examines the relationship between hedge fund manager compensation structures and financial performance, offering insights into how different incentive mechanisms influence fund returns, risk-taking behavior, and long-term stability.

- Hedge funds with performance-based compensation models consistently outperform those using fixed salary structures, with higher returns and better risk-adjusted performance.
- Fund size and market conditions also contribute to performance but are secondary factors compared to the influence of the compensation model.
- Despite higher incentives for managers, these do not necessarily lead to excessive risk-taking, challenging the notion that performance-based pay encourages reckless investing.
- Performance-based compensation (e.g., profit-sharing and carried interest) is positively correlated with fund returns but may encourage excessive risk-taking.
- Equity-based compensation (where managers hold ownership stakes in the fund) better aligns incentives with investors' long-term interests, promoting stability.
- Fixed salaries and low incentive-based structures reduce risk-taking but may also lower managers' motivation to achieve superior performance.
- Fund size and strategy matter—smaller funds with aggressive incentives often achieve higher returns, while larger funds tend to adopt risk-mitigation measures.

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