

Julian Holler

Hedge Funds and Financial Markets

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Geld – Banken – Börsen

Herausgegeben von
Prof. Dr. Wolfgang Bessler

Mit der Schriftenreihe Geld – Banken – Börsen wird der zunehmenden Bedeutung der kapitalmarktorientierten Sichtweise innerhalb der Betriebswirtschaftslehre Rechnung getragen. In diese Reihe sollen Dissertationen und Habilitationen aufgenommen werden, die aktuelle Fragestellungen in den Themengebieten Finanzierung und Geldanlage sowie Finanzmärkte und Finanzinstitutionen behandeln und sich durch neue, für Theorie und Praxis relevante Forschungsergebnisse auszeichnen.

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Hedge Funds and Financial Markets

An Asset Management and Corporate
Governance Perspective

With a foreword by Prof. Dr. Wolfgang Bessler



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Foreword

During the last decade, hedge funds have become one of the most important institutional investors in global financial markets. Although their activities have been viewed critically by regulators, politicians, and the public, this negative perspective is often based more on myth than on thorough economic analysis and empirical facts. Most people lack the necessary information and understanding of the role that hedge funds play in financial markets. Blaming them for the financial crisis or other market turbulences is often based on specific conjectures and not on rigorous research. Interestingly, most of the regulations proposed by German politicians, restricting hedge fund activities have not yet been implemented due to weak support from other countries.

In contrast to public opinion, most academic studies suggest that hedge funds as a new asset class have important implications for professional portfolio managers and for asset allocation decisions in that hedge funds widen the spectrum of new investment opportunities. The most compelling evidence is the relatively high percentage that U.S. university endowments allocate to hedge funds and other alternative asset classes due to their interesting risk-return and correlation properties. Thus, from the perspectives of both the asset management industry and academics, there is evidence that hedge funds may improve asset allocation decisions. From an empirical point of view, this question requires an in-depths analysis with up-to-date and rigorous statistical methods. In the first part of the dissertation, Julian Holler takes on this challenge and provides interesting and convincing empirical results on the contribution of hedge funds in optimal asset allocation decisions. Using Bayesian statistics Julian Holler's empirical findings clearly reveal that the efficient frontier is shifted upwards when hedge funds are included in optimal portfolios. Interestingly, and in contrast to common belief, this is observed particularly for low risk portfolios in downward market periods when risk reduction is most important. Thus, due to their sophisticated investment strategies that may even generate profits in bear markets, hedge funds offer investors protection in declining markets. With these insights, Julian Holler provides an important contribution to the current academic literature on asset management and asset allocation decisions that also has important implications for portfolio managers.

When considering hedge funds and financial markets in a broader context, corporate governance, in addition to asset management, is the other important area in which hedge funds have become intensively involved. In fact, hedge funds have emerged as one of the most active investors in financial markets who use their investments to exercise significant influence on management through different venues. However, whether hedge fund activities result in higher market valuations of companies is an empirical question. Although most

research for the U.S. suggests that hedge funds use their influence to increase shareholder value, these conclusions may not hold for other countries or time periods. Therefore, Julian Holler investigates whether hedge funds activities targeting German companies result in an outperformance and whether these results hold in upward and downward market environments. Surprisingly, there is an extremely high level of hedge fund activity in corporate governance in Germany. Julian Holler's analysis reveals that this is due to a control vacuum that resulted from the German banks selling their equity stakes in German companies at the beginning of the last decade. This behavior was particularly related to the provision of tax incentives by the German government which was designed to reduce the power and influence of the German banks in German companies. While this strategy was successful, the consequence is that the hedge funds now fulfill the function that banks had provided before. With his comprehensive empirical analysis Julian Holler offers very interesting new insights and makes a significant contribution to the current literature. As reported in other studies, hedge fund activities result in an outperformance of target companies in bull markets. The novel and exciting insight is that this result reverses during a bear market environment when target companies underperform. One very clear and convincing conclusion from Julian Holler's research is that hedge funds do not create shareholder value in the long run but mostly exploit short-term opportunities in overly optimistic market environments by forcing companies to distribute additional cash to shareholders with dividend increases and share buybacks.

Overall, Julian Holler provides an extensive and excellent review of the literature on hedge funds in asset management and corporate governance that reflects his exceptional understanding of asset management, corporate finance, and the functioning of financial markets. He also provides convincing empirical results and insights by using state-of-the-art statistical methodology and a large data sample. The conclusions are thoughtfully derived and - after having read this dissertation very carefully - the reader may be able to solve the puzzle why hedge funds contribute to optimal asset allocation while at the same time they do not enhance shareholder value with activists strategies. I am convinced that this dissertation is of high value to researchers and practitioners alike. It should be a "must" for regulators and politicians who want to gain a thorough understanding of hedge fund activities and their role in financial markets.

Prof. Dr. Wolfgang Bessler

Preface

The present study has been completed while I was a research assistant at the Center for Banking and Finance at the Justus-Liebig-University Gießen and has been accepted as a dissertation at the Justus-Liebig-University Gießen in July 2011. Completing a dissertation project over a time period of more than five years requires the support of many people. Therefore, I would like to thank those who supported and encouraged my academic work.

First of all, I thank my dissertation supervisor Prof. Dr. Wolfgang Bessler. He constantly provided me with new insights and shaped my thinking on the way financial markets work while I was working on the manuscript of this dissertation and other research projects. He was also very helpful in organizing funding that allowed me to participate in numerous international conferences and several Ph.D. seminars. Special thanks go to Prof. Dr. Volbert Alexander who was the second member of my dissertation committee and reviewed my manuscript.

The quality of my academic work was also greatly improved by the interaction with several other people. In particular, I would like to thank my former colleagues at the Center for Banking and Finance at the Justus-Liebig-University Gießen: Christoph Becker, Dr. Claudia Bittelmeyer, Ute Gartzén, Philipp Kurmann, Dr. Andreas Kurth, Dr. Peter Lückhoff, Martin Seim, Dr. Mathias Stanzel, Daniil Wagner and Jan Zimmermann. Our discussions challenged my thinking and provided me with new insights. I also thank Stephanie Waskönig for editing my manuscript.

Finally, completing a dissertation also requires a lot of time. Therefore, I also want to thank my family and my friends who supported me during this time period. I thank my parents Petra Holler and Dr. Jens-Peter Holler for their continuous support and Dr. Volker Hustedt for many interesting discussions. Finally, I want to thank my wife Dr. Claudia Pötzl who had to dispense with a lot of my time and still provided me with the support needed to complete the present study.

Julian Holler

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Abbreviations

| | |
|---------|---|
| AG | Aktiengesellschaft |
| AktG | Aktiengesetz |
| Bafin | Bundesanstalt für Finanzdienstleistungsaufsicht |
| BHAR | Buy-and-Hold Abnormal Return |
| BilMoG | Bilanzrechtsmodernisierungsgesetz |
| bn. | billion |
| CalTime | Calendar Time |
| CAR | Cumulative Abnormal Return |
| CDS | Credit Default Swap |
| CEO | Chief Executive Officer |
| CISDM | Center for International Securities and Derivatives Markets |
| CSFB | Credit Suisse First Boston |
| CTA | Commodity Trading Advisor |
| e.g. | for example |
| ESOP | Employee Stock Ownership Plan |
| EU | European Union |
| EUR | Euro |
| FTSE | Financial Times Stock Exchange |
| FX | Foreign Exchange |
| GCT | Generalized Calendar Time |
| GmbH | Gesellschaft mit beschränkter Haftung |

| | | |
|---------|---|-------------------------------|
| GSCI | Goldman | Sachs Commodity Index |
| HFR | Hedge | Fund Research |
| HML | High | Minus Low (Book-to-Market) |
| i.e. | that | is |
| IAS | International | Accounting Standards |
| IFRS | International | Financial Reporting Standards |
| IMF | International | Monetary Fund |
| IPO | Initial | Public Offering |
| ISE | International | Security Exchange |
| KapAEG | Kapitalaufnahmeerleichterungs | gesetz |
| KonTraG | Gesetz zur Kontrolle und Transparenz im Unternehmensbereich | |
| LBO | Leverage | d Buyout |
| m | million | |
| M&A | Mergers | & Acquisitions |
| MBS | Mortgage | Backed Securities |
| MifID | Markets in Financial Instruments Directive | |
| MTF | Multilateral | Trading Facility |
| NAREIT | National Association of Real Estate Investment Trusts | |
| NBER | National | Bureau of Economic Research |
| OLS | Ordinary | Least Squares |
| OTC | Over-the-Counter | |
| p | page | |

| | | |
|---------|-----------------|---|
| p.a. | per | annum |
| PIPE | Private | Investment in Public Equity |
| R&D | Research | & Development |
| Reg NMS | | Regulation National Market System |
| REIT | Real | Estate Investment Trust |
| S&P | Standar | d & Poors |
| SE | Societas | Europaea |
| SEC | Securities | and Exchange Commission |
| SEO | Seasone | d Equity Offering |
| SMB | Small-Minus-Big | (Market Capitalization) |
| SOES | Small | Order Execution System |
| TIPS | Treasury | Inflation Protected Security |
| U.S. | United | States |
| UK | United | Kingdom |
| USD | U.S. | Dollar |
| US-GAAP | | U.S. Generally Accepted Accounting Principles |
| VaR | Value | at Risk |
| vs. | versus | |
| WpHG | Wertpapier | handelsgesetz |
| WpÜG | Wertpapier | übernahmegesetz |