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Divorce & Hedge Funds: Research Backs Up the Myth

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Investors have reason to walk when a manager splits up—and, a study shows, reason to run at the sound of wedding bells.

When a hedge fund manager starts divorce proceedings, wise investors should make like the spouse and split. Or so investment lore goes.

According to a study by three finance researchers, this is no old allocator's tale.

Hedge fund alpha during the six months surrounding a manager's split drops an average of 7.4% annualized, the researchers found. But weddings proved even more destructive to performance, cutting alpha by 8.5% for the same window.

"We show that both marriage and divorce are associated with deteriorations in fund risk-adjusted performance," wrote authors Yan Lu, Sugata Ray (both of the University of Florida), and Melvyn Teo of Singapore Management University. The scholars examined data on 26,811 hedge funds between 1994 and 2012 to investigate the impact of managers marrying and un-marrying on fund performance and strategy.

Lu, Ray, and Teo gathered the marriage and divorce data from court records and internet searches, according to the paper. It's worth noting that the study relied on a fairly small sample size of relationship milestones. Within the 18-year period covered by their return data, the authors observed 98 marriages and 76 divorces among hedge fund managers.

The study looked at myriad factors beyond absolute returns and marital status changes, including risk, volatility, liquidity, investment strategy, manager age, redemption periods, fund size, and trading patterns.

For example, after recently coupling or uncoupling, managers tended to hold onto losing stocks and sell their winners—a behavioral bias known at the disposition effect.

"Divorces, unlike marriages, appear to have a more durable impact on the hedge fund manager's susceptibility to the disposition effect," stated Lu, Ray, and Teo. Not only did this performance-hampering practice last longer, it also began in the lead-up to divorces but not marriages.

These results suggested that investor Paul Tudor Jones—who famously, if confusingly, said "one of my number one rules" is immediate redemption upon news of a manager's divorce—and his ilk have correctly balked at break-ups more than weddings. But by the time a manager has filed papers in court, thereby alerting Jones and company that it's time to flee, returns have likely already suffered.

"Unlike that of a marriage, the impact of a divorce may manifest up to two years prior to the event itself," the authors wrote, acknowledging that "these results are not surprising… especially when there are disagreements over the custody of children and the division of matrimonial assets, and the divorce is contested in court."