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Do Hedge Funds Profit from Mutual-Fund Distress?

by Joseph Chen, Samuel G. Hanson, Harrison Hong and Jeremy C. Stein

Abstract

This paper explores the question of whether hedge funds engage in frontrunning strategies that exploit the predictable trades of others. One potential opportunity for front-running arises when distressed mutual funds—those suffering large outflows of assets under management—are forced to sell stocks they own. We document two pieces of evidence that are consistent with hedge funds taking advantage of this opportunity. First, in the time series, the average returns of long/short equity hedge funds are significantly higher in those months when a larger fraction of the mutual-fund sector is in distress. Second, at the individualstock level, short interest rises in advance of sales by distressed mutual funds.

Keywords: Investment Funds; Profit; Strategy; Forecasting and Prediction; Investment Return; Opportunities; Asset Management; Sales;

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