



# Can hedge funds time global equity markets? Evidence from emerging markets



Adam L. Aiken<sup>a,\*</sup>, Osman Kilic<sup>b</sup>, Sean Reid<sup>c</sup>

<sup>a</sup> Department of Finance, Elon University, United States

<sup>b</sup> Department of Finance, Quinnipiac University, United States

<sup>c</sup> Department of Finance, Ithaca College, United States

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## ABSTRACT

This paper examines the ability of global hedge funds to time a particularly volatile asset class — emerging market equities. In particular, we study whether or not these funds can either time emerging markets as a whole, or time their exposures to different regions. Using both pooled and calendar-time approaches, we generally find no evidence of overall timing ability. However, we do find some evidence of period-specific timing ability during the financial crisis and subsequent recovery.

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## 1. Introduction

Lightly regulated and operating with broad investment mandates, hedge funds have many potential sources of returns. For example, hedge funds may engage in strategies as common as long-only stock selection, or they may make more complex investments related to illiquid securities or option-like payoffs (e.g., Ackermann, McEnally, & Ravenscraft, 1999; Agarwal & Naik, 2000, 2004; Aragon, 2007; Liang, 1999). This paper investigates one important source of performance — the ability of hedge funds to time different markets. In particular, we focus on the ability of hedge funds to time different emerging markets in changing market environments.

The ability of a manager to market time can be thought of as a valuable option. A convex relationship between a manager's beta and the market is an indication of successful timing (Aragon & Ferson, 2006; Merton, 1981; Henriksson & Merton, 1981). In other words, a manager wants high exposure when the market is increasing and low (or, ideally, zero or negative) exposure when the market is decreasing. As with any option, the value of market timing increases as the volatility of the underlying asset increases. Because financial markets in emerging market countries are still developing, volatility tends to be significantly higher than the volatility found in more developed markets (Bekaert & Harvey, 1997). Greater volatility could lead to more profitable market

timing opportunities, making emerging markets an ideal environment to test the hypothesis that hedge fund managers add value for their investors through timing.

The growth and volatility found in emerging markets have not escaped the attention of hedge fund managers.<sup>1</sup> As of the end of September 2012, the hedge fund database HFR reports hedge fund capital in emerging markets to be \$127.8 billion, with a record number of 1085 active hedge funds.<sup>2</sup> These markets can experience abrupt changes, though. For example, 2013 was more difficult for managers, as one large hedge fund, Brevan Howard, closed their emerging markets strategy following poor performance.<sup>3</sup> Not all hedge fund managers are able to profit from the volatility of the asset class.

There are also important cross-sectional differences in the performance of different emerging equity markets. These variations could

<sup>1</sup> There is no universally accepted definition of an emerging market. Emerging markets are those economies that are not as fully developed as those in the United States, Canada, Western Europe, and Japan. The emerging markets that have attracted the most attention in the press and from investors are Brazil, Russia, India and China (the so-called "BRIC" economies). While the BRIC emerging markets capture a large portion of media coverage and foreign investment, emerging market opportunities exist throughout Latin America (e.g., Argentina and Chile), Eastern Europe (e.g., Poland, Hungary, the Czech Republic and Turkey), the Middle East (e.g., Egypt and Jordan), and Asia (e.g., Thailand, the Philippines, and Indonesia).

<sup>2</sup> See "Emerging Markets Hedge Fund Capital Surpasses Record Level", HFR 2012, [http://www.hedgefundresearch.com/pdf/pr\\_20121130.pdf](http://www.hedgefundresearch.com/pdf/pr_20121130.pdf).

<sup>3</sup> "Brevan Howard shuts \$2bn emerging market fund", Financial Times, 2/2/14.

\* Corresponding author at: Elon University Koury Business Center 2075 Campus Box Elon, NC 27244, United States.

provide additional opportunities for market timing across countries and regions. For example, many South American markets lost more than 20% in 2013, while Greek equities rose 53% and Malaysia and Taiwan had single digit increases. There were also substantial performance differences during the financial crisis. In October of 2008, the MSCI Emerging Asia index lost 24%, while the Emerging Eastern Europe Index lost 35%. Two months later, in December of 2008, Emerging Asia was up 11%, while Emerging Europe lost roughly 4%.<sup>4</sup> Cross-sectional variation in returns could allow hedge funds to profit by selecting the best performing market in a given period.

We use several empirical strategies to test for timing ability in emerging markets.<sup>5</sup> First, we use the original Henriksson and Merton (1981) model to test whether or not hedge funds have the ability to time their broad exposure to emerging markets. We find little evidence of overall market timing ability during our sample period (1996–2013). We also include several regional emerging market indices in our return models to examine whether timing ability varies by geography. We find some evidence of timing ability in the Latin American region, but nothing for the other geographic areas. Our last model uses a multiple market framework that allows us to test for the ability to time across different factors (Aragon, 2003). Specifically, we test if hedge funds can select the best performing region in a given month. To our knowledge, this is the first paper that explicitly examines the ability of hedge fund managers to time across specific geographic regions. However, we again find little evidence of average timing ability. Finally, we ask whether the timing ability of hedge funds is different during the financial crisis and its immediate aftermath. This time we do find evidence of timing ability, as our results suggest that hedge funds have lower exposure during the crisis relative to their exposure as markets improved.

This paper contributes to the literature on hedge fund performance and, more specifically, to work on the ability of hedge funds to time different markets or factors. Chen and Liang (2007) investigate whether a sample of 221 self-styled market timing hedge funds are able to time U.S. equity markets and find evidence of timing at both the aggregate and fund-levels. While we do not find overall timing ability in our sample, Chen and Liang (2007) also find, like us, that hedge fund timing ability is stronger in bear markets. Using a larger sample of hedge funds, Chen (2007) finds that fund managers are able to time their “focus market” (e.g. equity, bond, or currency markets). Chincarini and Nakao (2011) use a similar framework to study the ability of hedge funds to time the Fama-French factors. They find that a small subset of equity hedge funds do appear to be able to time their size, value, and market exposures in the U.S. stock market.

Several recent papers are particularly related to our work. Caglayan and Ulutas (2014) study emerging market and global macro hedge funds and find that hedge funds following a directional strategy can time emerging market securities. Cao and Jayasuriya (2011) also test for timing ability in emerging markets, but they find no evidence of skill. Kotkatvuori-Örnberg, Nikkinen, and Peltomäki (2011) study the performance of emerging market hedge funds with a specific geographic focus and find some evidence of manager skill. However, they do not use a formal model of timing ability. Eling and Faust (2010) compare the performance of mutual funds and hedge funds in emerging markets. They find that hedge funds have larger alpha estimates than mutual funds when investing in emerging markets and that hedge funds shift their allocations more over time. Finally, like us, Cave, Hubner, and Sougne (2012) argue that the financial crisis (July 2007–December 2008) is an excellent “laboratory” to test for market timing ability. Using weekly return data for a smaller subset of the hedge fund universe and a multi-factor model based on Treynor and Mazuy (1966), they find positive market-timing ability for U.S. equity markets, but negative timing ability in emerging markets.

There is also a growing literature on state-dependent performance by professional money managers. For example, Glode (2011) develops a model in which mutual funds will perform better during bad states of the economy, since this is when investors will be most willing to pay for good performance. This framework potentially rationalizes the use of active management even if alphas are negative on average. Kacperczyk, Van Nieuwerburgh, and Veldkap (2014) suggest that tests of managerial ability should focus more on market timing during recessions. However, Sun, Wang, and Zheng (2009) find that actively-managed mutual funds outperform during recessions through their stock-picking ability. Kosowski (2011) also finds positive risk-adjusted performance by mutual funds during recessions. Schaub and Schmid (2013) investigate hedge fund performance during the financial crisis (July 2007–December 2008) and find that funds with illiquid portfolios perform worse.

The current literature contains mixed evidence on hedge fund market timing ability. We contribute to this work by supporting the claim that the average hedge fund does not add value for their investors through market timing. In particular, we find this result in markets where possessing market timing skill would be especially valuable. Like prior work, our study also asks if hedge funds are able to time different factor exposures, beyond just a single equity market. However, the existing literature does not test for the ability to time across different regions and successfully forecast the best performing market. While emerging market equities are relatively illiquid compared to more developed markets, they are still publicly traded stocks and skillful managers could have the ability to shift allocations across regions as opportunities dictate. Finally, by explicitly examining a variety of timing measures during the crisis and subsequent market recovery, our work suggests that hedge funds were able to forecast markets in a period when this ability would be especially valuable to investors. As recent literature indicates, active management may be more successful during difficult market environments.

## 2. Data

Our hedge fund data is from the Hedge Fund Research (HFR) database, a large commercial vendor of hedge fund return and characteristic data. We use monthly returns from 1996 through 2013 from both the live and dead databases in order to eliminate the survivorship bias.<sup>6</sup> We further eliminate back-filled returns to mitigate the backfill bias (Aggarwal & Jorion, 2010; Fung & Hsieh, 2000; Joenväärä, Kosowski, & Tolonen, 2014).<sup>7</sup> We only include funds with USD-denominated, after-fee returns in order to eliminate the influence of exchange rates on returns. Finally, all returns are trimmed at the 0.5% and 99.5% levels to eliminate outliers and errors. By starting with individual fund data and using these screens, rather than relying on hedge fund return indices, we believe that we are better able to control for some of the biases inherent in the commercially-available hedge fund data.

We only want to include hedge funds that are potential emerging equity market timers in our sample. Including funds that do not engage in this strategy would add noise to our results. We begin by restricting our initial pool of funds to only include those with one of the following stated regional investment focuses: Asia: Asia ex-Japan, Europe: Russia/Eastern Europe, Other: Multiple Emerging Markets, Other: Africa, Americas: Latin America, Other: Middle East, Asia: Asia w/Japan, Europe: Pan-European, Other: Global. We believe that these investment objectives provide us with a set of funds that are potential emerging market equity timers.

After this initial regional restriction, we narrow our sample along two more dimensions. We first restrict our attention to funds in the

<sup>6</sup> Because of how we define our sample, our first hedge fund returns are actually in May of 1996.

<sup>7</sup> A backfilled return is defined by a return observation that is dated prior to when the fund was added to the database, indicating that the hedge fund waited before reporting their performance.

<sup>4</sup> Source: MSCI Indices. Returns are in USD and include dividends.

<sup>5</sup> We note that all of our tests are done on an after-fee basis. Therefore, we are really testing for the ability of managers to add-value for their investors.

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