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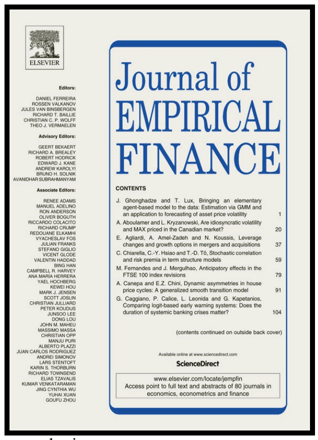

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Systemic Risk and Cross-Sectional Hedge Fund Returns

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Abstract

This paper examines the cross-sectional relation between hedge fund returns and systemic risk. Measuring the systemic risk of an individual hedge fund by using the marginal expected shortfall (MES), we find evidence for a positive and statistically significant relation between systemic risk and hedge fund returns. The risk-adjusted return of a hedge fund portfolio with a high systemic risk is 0.64% per month higher than for one with a low systemic risk during 1994–2012, while negative performance is observed during crisis periods. The relation between systemic risk and hedge fund returns holds for both live and defunct funds. Moreover, the relation holds even after controlling for a large set of fund characteristics. Hence, systemic risk is a powerful determinant of cross-sectional variations in hedge fund returns. Our results imply that the positive relation between hedge fund returns and systemic risk is due to compensation for the realized losses during systemic events.

Keywords: hedge fund, systemic risk, cross-section of expected returns
JEL Classification: G10, G11, G23, G28, C13

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