Available online at www.sciencedirect.com

Borsa İstanbul Review

Borsa İstanbul Review 13 (2013) 30−52

http://www.elsevier.com/journals/borsa-istanbul-review/2214-8450

The performance of hedge fund indices

Yigit Atilgan [a,*], Turan G. Bali [b,1], K. Ozgur Demirtas [a,2]

[a] *School of Management, Sabanci University, Orhanli, Tuzla 34956, Istanbul, Turkey*

[b] *McDonough School of Business, Georgetown University, Washington, DC 20057, United States*

Abstract

This paper investigates the performance of various strategy-specific and composite hedge fund indices. Given the flexible and nonlinear investment mandates of hedge funds, various risk metrics that take factors such as extreme events and losses with respect to previous peaks are considered. Our analysis compares the risk-adjusted performances of hedge fund indices among themselves, with respect to the overall equity market and over time. Special attention is given to the distinction between investable and non-investable hedge fund indices. We find that the risk-adjusted performances of most hedge fund indices deteriorate over time. Although many hedge fund indices outperform a broad equity index in the full sample period, most hedge fund indices have highly negative returns during market downturns which sheds suspicion over the diversification benefits of investing hedge funds. We also find that non-investable indices are superior performers with respect to their investable counterparts. Finally, the comparison of performance among various indices has little dependence on which particular risk metric is used.
Copyright © 2013, Borsa İstanbul Anonim Şirketi. Production and hosting by Elsevier B.V. All rights reserved.

1. Introduction

Hedge funds are private pools of capital in the sense that ownership claims in a hedge fund are not traded in organized exchanges and fund investors benefit from appreciations in the market value of a hedge fund's asset portfolio. Hedge funds present investment opportunities which provide risk and return combinations that are different from traditional equity and fixed income investments and they also vary significantly among themselves in terms of investment strategy, risk and return characteristics. In this study, our goal is to provide a detailed account of how various strategy-specific or composite hedge fund indices have performed in the past. In addition to documenting the distributional properties of hedge fund index returns, we pay special attention to risk-adjustment. We present various risk metrics and compare the risk-adjusted performances of various hedge fund indices both among themselves and with respect to a broad equity index. We emphasize the distinction between investable and non-investable indices and also analyze how hedge fund performance has changed over time with a special focus on the recent global financial crisis.

Technological innovations have revolutionized the hedge fund industry and contributed to the heterogeneity that had been already inherent in the business. Despite this heterogeneity, it is possible to list some common traits that most hedge funds share. One of these traits is flexibility which is the main factor that differentiates hedge funds from more traditional investment vehicles such as mutual funds. The performance of mutual funds is measured with respect to a benchmark and when market benchmarks are plunging in value, it is natural to expect that mutual fund returns will also go down with these benchmarks. In contrast, hedge funds claim to focus on absolute returns by their ability to spot relative price discrepancies between multiple securities and exploit these

* Corresponding author. Tel.: +90 (216) 483 9663; fax: +90 (216) 483 9699.
E-mail addresses: yatilgan@sabanciuniv.edu (Y. Atilgan), tgb27@georgetown.edu (T.G. Bali), ozgurdemirtas@sabanciuniv.edu (K.O. Demirtas).
Peer review under responsibility of Borsa İstanbul Anonim Şirketi

[1] Tel.: +1 (202) 687 5388; fax: +1 (202) 687 4031.
[2] Tel.: +90 (216) 483 9985; fax: +90 (216) 483 9699.

2214-8450/$ - see front matter Copyright © 2013, Borsa İstanbul Anonim Şirketi. Production and hosting by Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.bir.2013.10.007

opportunities. Hedge funds can achieve this absolute return focus thanks to their expanded toolbox. Hedge funds do not face regulatory restrictions regarding the financial instruments they are allowed to trade or their portfolio compositions. Unlike traditional investment vehicles, hedge funds can use derivative instruments such as options and futures and they are able to bet on price declines by short selling securities. Moreover, hedge funds have the ability to borrow money to magnify their returns which is a practice called "leverage". The notion of leverage is a double-edge sword and increases the risks faced by hedge funds since leverage does not only magnify the gains, but also potential losses. Finally, hedge funds have fewer obligations compared to mutual funds regarding their capital adequacies.

Another common feature of hedge funds is that the regulatory and tax framework surrounding them is not stringent. Many hedge funds are registered in off-shore tax havens around the world and there is not much transparency regarding their operations. For hedge funds, transparency is an undesired attribute because funds that take strategic positions or short sell particular securities would not want their trades to be known by outsiders. On the other hand, fraud risk becomes substantial in a lightly regulated industry since investors are unable to monitor the hedge funds using conventional methods. Even if the investors are suspicious about fraud, they cannot just take their money and leave the crime scene due to restrictions for redeeming capital in the hedge fund business.

This brings us to the issue of illiquidity. Hedge funds are not liquid investments. Even the wealthiest institutions and individuals need to wait for specific dates or time windows before they can subscribe to hedge funds since most funds do not let investors in on an ongoing basis. More importantly, investors cannot redeem their invested capital from the hedge funds whenever they desire. There are lock-up periods which correspond to minimum amounts of time that an investor is required to keep his or her money invested in a hedge fund before the investor is allowed to withdraw capital. Even when the investors are allowed to redeem their money, there are certain conditions that need to be satisfied. Redemption periods are often set at the end of fiscal quarters but they can even be less frequent. Moreover, an advance notice up to three months should be given to the hedge fund before the redemption. The rationale behind the illiquidity of hedge fund investments is that these provisions enable hedge fund managers to invest freely in illiquid assets. Illiquid assets may turn out to be very profitable investments but they may require a long-horizon focus because it may take time before the profits can be realized. Many valuable investment opportunities in financial markets are not compatible with the idea that hedge funds should maintain continuous liquidity for their clients. In a liquid world, hedge funds would have had to maintain cash reserves as liquidity buffers and since cash generally earns lower expected returns compared to riskier investments, this would hurt a hedge fund's overall performance. Another drawback of liquidity is related to the adverse impact of early withdrawers on existing fund investors because potential asset sales could spur additional transaction costs which would be borne by existing clients.

The expensive fee structure underlying hedge funds is also a common feature. Hedge funds charge their clients an annual operating fee typically about 2% of assets under management just like mutual funds, but on top of this, hedge funds also impose additional performance or incentive fees that are generally about 20% of fund returns. This "2 plus 20" formula is common in the industry and it is possible to encounter performance fees that are even higher and reach half the gains generated by the hedge fund. This type of fee structure may not always justify the returns generated by fund managers even if the gross returns are higher than the ones generated by traditional money management vehicles. The rationale behind this fee structure is that hedge funds try to attract the brightest minds and the best talent to their businesses by compensating their managers based heavily on their success. The drawback is that this type of reward system is asymmetric and fund managers receive a portion of the profits but they do not share the portfolio losses. As a result, hedge fund managers may take too many risks in their investment decisions. A protection against extravagant fund fees is the high water mark system which means that hedge fund managers can charge performance fees only after the hedge fund surpasses its historical peak.

Mutual funds can be passively or actively managed, but hedge fund managers are active by definition. Hedge funds are in the business of chasing after arbitrage opportunities. In today's financial markets where arbitrage opportunities are short-lived and fleeting, the notion of buy-and-hold is incompatible with the nature of hedge funds. Therefore, portfolio turnover is very high for many hedge funds and trading costs such as bid-ask spreads, commissions paid to the brokers and stock borrowing costs can amount to about 5% of portfolio value on average. The performance of hedge funds can be either beta or alpha driven. A beta driven hedge fund exposes itself to some market or macroeconomic risk and hopes to get compensated for this risk. For hedge funds, on top of traditional sources of beta such as equity market and bond market performance, there are also alternative sources of alpha such as liquidity, volatility, corporate event risk and commodity market performance. Alpha represents the abnormal returns earned by hedge funds that cannot be explained by risk exposures. In the hedge fund business, alpha comes from either the regulatory flexibility awarded to hedge funds or the fund manager's ability to pick the right securities to invest in at the right times. The competitive advantage of hedge funds comes from the ability to collect and analyze information more efficiently, the valuable human resources that possess special insights, the low cost access to financial markets and superior trade execution.

Many investors prefer to park their money in hedge funds because they believe that they are delegating the management of their savings to truly skilled professionals. Modern financial markets present many complex opportunities to talented players to realize returns. Hedge funds have the required resources such as human capital and computer power to exploit

Download English Version:

https://daneshyari.com/en/article/7342238

Download Persian Version:

https://daneshyari.com/article/7342238

Daneshyari.com