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A Tale of Feedback Trading by Hedge Funds

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Abstract

This paper studies the extent of feedback trading at the factor level by hedge fund managers. We show that fund managers continuously adjust their exposure to different risk factors conditional on the recent performance of these factors. The majority of managers applies a positive feedback strategy, whereas the remaining managers use a negative feedback strategy. In addition, we find some evidence for factor timing ability, although managers appear to be more backward looking than forward looking. We show that positive feedback trading can be beneficial to fund performance in our setup. If managers applied the positive feedback strategy more aggressively, however, they could benefit more from it. As such, the "smart switching benchmark" can be used to assess the risk-adjusted performance of hedge funds.

Keywords: hedge funds, style analysis, feedback trading, time variation.

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