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The performance and diversification benefits of funds of hedge funds

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Abstract

We examine the performance and diversification potential of 332 funds of hedge funds (FOHFs) for the period from January 1990 to May 2003. Consistent with prior studies, we find that FOHFs appear to underperform the hedge fund index on a risk-adjusted basis. However, FOHFs have characteristics that offset their apparent underperformance. Their returns do not suffer from negative skewness that is a feature of many hedge fund strategies. Relative to the hedge fund index, we find that FOHFs have lower correlations with stock indices in both bull and bear markets, making them a better diversification tool in equity portfolios. For bond portfolios, however, FOHFs have no diversification advantage over hedge fund indexing.

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1. Introduction

The growth in funds of hedge funds (FOHFs), which are vehicles offering pooled investments in hedge funds, has been phenomenal in recent years. The number of FOHFs increased by 40% between 2001 and 2003,¹ and now comprise almost one-third of the \$650 billion

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¹ Financial Times, 29 October 2003.

invested in hedge funds. The boom in hedge fund investment has been matched by a burgeoning academic literature on hedge fund performance. FOHFs have received less attention, and have mainly been studied as a sub-strategy of the hedge fund universe. They are, however, quite different entities from hedge funds, and we argue that they should be examined separately, for a number of reasons. First, relative to hedge-fund managers, FOHF managers require a different set of skills. They are portfolio managers, and like active mutual funds must try to ‘pick winners’. In order to do this, they sometimes go to extraordinary lengths. According to *The Economist*, FOHF managers “...not only tour the world assessing funds, but also might hire private investigators and delve into the private lives of hedge-fund managers (might that impending divorce be a distraction?).”² The FOHF industry claims several other advantages vis-à-vis investing directly in hedge funds. As well as diversification, FOHF managers claim ongoing monitoring of hedge funds, access to good funds that are closed to new investors, lower minimum investments and more flexible redemption policies. For these services, FOHFs charge a management fee and usually a cut of performance.³

Second, FOHFs are available to a wider range of potential investors than hedge funds. While most regulation around the world restricts direct investment in hedge funds to institutions and high net-worth individuals, recent changes to regulations in many countries have opened investment in FOHFs to retail investors.⁴ Indeed, one of the claimed benefits of FOHFs is that small and moderately wealthy investors are able to participate in hedge funds without the risks associated with investing in only one or two. For this reason, FOHFs should be subject to greater academic and regulatory scrutiny than hedge funds. Third, being portfolios of hedge funds, FOHFs may have different risk and return characteristics from hedge funds, and these characteristics are not well understood. Prior studies have concluded that the ‘double fee structure’ inherent in funds of funds (that is, the FOHF as well as the underlying hedge funds charge fees) offsets any diversification benefit, and that funds of funds underperform hedge funds on a risk-adjusted basis (Amin and Kat, 2003; Brown et al., 1999, 2002; Kat and Lu, 2002).

Using data for 332 FOHFs for the period from January 1990 to May 2003, we find, in common with prior research, that FOHFs on average underperform hedge funds. There are, however, several features of FOHF returns that offset their apparent poor performance vis-à-vis hedge funds. FOHFs do not suffer from negative skewness to the extent that hedge funds do. While it has been found that combining hedge funds into portfolios does not reduce the negative skewness that tends to be a feature of hedge fund return distributions (Fung and Hsieh, 2002), we show that most FOHF distributions are not negatively skewed. We also show that drawing inferences from averaging the skewness statistic across a large sample

² The Economist, 18 September 2003.

³ The most visible FOHFs fees are management fees which are usually set at 1% of the total of assets under management and performance fees which are usually set at 10% of return. This is on top of standard hedge fund fees of typically 2% of assets under management and 20% of return (Jaffer, 2003).

⁴ In the US, registered funds of funds are permitted to offer minimum investments as small as \$25,000. In the UK, funds of funds are listed on the London stock exchange, and many specifically target the retail market. Funds of funds are available to the retail public in Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Sweden and Switzerland, and in most of these countries, there is no stipulated minimum investment amount (PriceWaterhouseCoopers, 2003).

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