Review of the Academic Hedge Fund Literature

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Hedge Funds: Insights in Performance Measurement, Risk Analysis, and Portfolio Allocation

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Content of Chapter 13

1. Performance persistence: do winners repeat?
   - Three ways to measure (2×2 table, binomial, regression).
2. Factor Modeling
   - Difficult to identify sources of returns.
3. Portfolio diversification
   - Strong selling point is low correlation.
4. Survival, mortality, survivorship bias
   - Mortality rates and survivorship bias can be high, but factors leading to long life have been identified.

Three Main Points

- Little evidence of persistence.
  - Persistence often due to losers continuing to lose (Brown, Goetzmann, and Ibbotson 1999, Agarwal and Naik 2000).
  - Some short-term persistence, little long-term persistence.
- Difficult to identify sources of returns.
  - Important b/c no transparency: eliminate funds with similar strategies.
  - Novel factors work best: returns on option or volatility portfolios (Agarawal and Naik 2004).
- Hedge funds tend to die off quickly.
  - Yearly attrition as high as 30% for some styles (Getmansky, Lo, and Mei 2004)
  - Biased upward because of voluntary reporting (Liang, 2000).

Main Conclusion

- Hedge funds can provide great portfolio diversification and downside protection, low volatility, and good returns.

- Long-term performers and survivors, however, are difficult to identify and a lack of transparency must be endured.