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Hedge Funds

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1

Introduction[1]

In this survey, we attempt to summarize and provide an overview of the academic research on hedge funds and commodity trading advisors (CTAs). The hedge fund industry has grown tremendously over the recent years. It is difficult to accurately estimate the true size of the hedge fund industry since the Securities and Exchange Commission (SEC) imposes restrictions on advertising for hedge funds. One of the hedge fund advisory firms, Hedge Fund Research (HFR), estimates that the total assets under management (AUM) of hedge funds have increased from USD 39 million in 1990 to about USD 972 million in 2004. During this period, the total number of hedge funds has gone up from 610 in 1990 to 7,436 in 2004. Furthermore, the allocation between different hedge fund strategies has also changed significantly during the same period. In 1990, the macro strategy dominated the industry with 71% of total assets under management while in 2004; their share was only 11%. Instead, in 2004, Equity Hedge strategy had the largest share of AUM – 29%.[2] There has also been a shift in the average

[1] N.Y. Naik is thankful to the BNP Paribas Hedge Fund Centre at the London Business School and both authors are very grateful to Maria Strömqvist for excellent research assistance. They are responsible for all errors.

[2] Source: Hedge Fund Research (HFR) – <www.hedgefundresearch.com>

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investor in hedge funds from an individual investor to an institutional investor. In the early 1990s, the typical investor was a high net-worth individual investor who invested in macro funds, which then took levered bets on currencies and other assets. Today, the typical investor is an institutional investor, for example a pension fund, which invests in hedge funds for diversification reasons, seeking investment vehicles with low correlation with other traditional asset classes such as equities and bonds.

Though hedge funds have gained popularity in the last fifteen years or so with the rise of star hedge fund managers such as George Soros and Julian Robertson, they have been in existence for more than 50 years now. The first hedge fund is believed to be started by a former Fortune magazine writer named Alfred Winslow Jones. He employed a then novel idea of taking both long and short positions in stocks to "hedge" out the market risk. Using this strategy cleverly by buying undervalued securities and selling overvalued securities, his fund returned a whopping 670% return between May 1955 and May 1965.[3] Although Jones' original fund used "long-short" strategy to hedge, today not all the hedge funds necessarily hedge. In fact, there is no universally accepted definition of hedge funds. They can now be identified by their exemption from the Investment Company Act of 1940 and the unique compensation structure.

Given the enormous growth of this industry and the limited information available on hedge funds, a need for research has emerged from both investors' and regulators' point of view. Investors need research to better understand what they are investing in and what risks they are exposed to. Research on hedge funds may also help investors recognize what diversification benefits, if any, hedge funds offer in combination with investments in equity and bonds. Regulators need research to identify if there is a need for regulation to protect investors' interests and what impact hedge funds may have on the stability of the financial markets.

The rest of the paper is outlined as follows. The first part of the paper summarizes the research on hedge fund performance, including

[3] Source: Joseph Nocera, "The Quantitative, Data-Based, Risk-Massaging Road to Riches", *New York Times*, June 5, 2005.

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comparison of risk-return characteristics of hedge funds with those of mutual funds, factors driving hedge fund returns, and persistence in hedge fund performance. The second part of the paper covers research regarding the unique contractual features and characteristics of hedge funds and their influence on the risk-return tradeoffs. The third part of the paper reviews the research on the role of hedge funds in a portfolio including the extent of diversification benefits and limitations of standard mean-variance framework for asset allocation. Finally, the last part of the paper summarizes the research on the biases in hedge fund databases.

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