Comment on “Hedge Funds: Risk and Return”
and on “Why Do Hedge Funds Stop Reporting Their Performance”
Atanu Saha

Hans Stoll
Owen School
Vanderbilt University
Hedge funds are a hot topic

Search for key words, “hedge fund” in the title:

- WSJ 200 articles in last 12 months
- Amazon 266 books
- SSRN 89 working papers
Hedge funds under attack

- High fees
- Fee structure creates adverse incentive
- High risk
  - Leverage
  - Peso problem
- Low transparency
  - Inadequate disclosure
  - Moving target – changing investments
- Excessive trading may roil markets. Role of prime broker.
- Fraud
- Shadowy world of short selling
- Returns of hedge funds are overstated – this paper
Hedge funds: the pluses

- Unique investment strategy
  - Long/short
  - Arbitrage, event trading
  - Statistical trading
  - Managed futures

- Low correlation with market

- Trading strategy has a payoff akin to a straddle (Hsieh and Fung)

- Manager incentive

- Fewer regulatory costs (but that is changing)
Hedge fund indices

- Hedge fund indices are intended to measure the return that an investor would have achieved by investing in hedge funds.

- In constructing indices, one must be aware of different biases that can arise. This paper makes clear many of the biases, although it does not establish that a particular hedge fund index has biases.

- Distinguish a database – the TASS database – and an index constructed from that database.

- How would an index constructed from the TASS database compare to published hedge fund indices?
Biases in hedge fund returns

• Backfill bias
  – Incubation bias – new funds report only if successful in past
  – Initial reporting bias – old funds decide to report only if successful

• Survivorship bias – measure historical return only of survivors

• Superior fund bias – superior funds don’t report

• Hedge fund database bias – different services survey different funds
Estimating survivorship bias

• Compare return of funds that survived until 2004 to return of all funds. Average difference 1996-2003 = 4.42%

• Comments
  – What about risk? If risk of funds that survived is less than that of all funds, expected return for survivors would be less than that of all funds, which causes understatement of bias.
  – What is the effect of viewing survivorship bias from 2004? Is the bias the same if funds that survived until 2003 are examined?
  – Returns of funds are weighted equally. If funds that are doing poorly have fewer assets, equal weighting overstates survivor bias.

• What would be a good hedge fund index? Is the portfolio of live + defunct funds that is used to gauge survivor bias, a good hedge fund index?
Hedge funds versus mutual funds

Does the performance of hedge funds vs mutual funds seem reasonable?

Hedge Fund vs Mutual Fund Returns
Why don’t hedge funds report their performance?

- **Never report**
  - Don’t need to because they have plenty of investors
  - Don’t report to A because they are already reporting to B

- **Stopped reporting**
  - No desire to report because they have attracted sufficient funds
  - Fund closed to new investment
  - Fund liquidated
  - Fund merged or changed name

- In the second paper, find that funds which stopped reporting had poor returns, not superior returns. They are also young and small. This is not surprising. Implications for an index? Should an index be limited to funds above a minimum size and age?
Interesting issue for future research: Why do hedge funds start reporting their performance?

- What is hedge fund performance in the first year of reporting? Has backfill bias been fully removed? Are returns of funds in their first year the same as returns of funds that have been reporting?

- What factors determine initiation of reporting?
Other issues addressed

- Non-normality of hedge fund returns

- Persistence of hedge fund returns
  - Paper 1: little persistence in performance
  - Paper 2: may be able to predict which funds will stop reporting

- Cross-section variability of hedge fund returns
  - Higher for hedge funds than mutual funds
  - Danger of picking a bad fund or a bad strategy

- Risk and return of hedge funds. Learned about risk and about return but not whether return more than offsets risk. Alpha? Beta?
Implications of the research

• For hedge fund indices: must correct for biases

• For hedge fund performance: not clear in this research whether performance is superior or inferior, adjusted for risk.

• For investors: Beware and be skeptical.

• For regulators: Should all hedge funds be required to report returns like mutual funds? Regulation is appropriate (1) to control systemic risk and (2) to protect investors.

• For the industry: As an alternative to more regulation, standardize reporting procedures for hedge funds.