WHERE THE VALUE IS

Have hedge funds performed well because of the market or managers?

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The growth in hedge fund assets has exploded during the past fifteen years to well over $1 trillion. While aggregate performance has been strong in the past, many have questioned the source of the performance: is it coming from overall market performance or are fund managers adding value?

I focus on trying to better understand what drives the returns of the classic hedge fund style: equity market neutral strategies. If such strategies are able to exploit market inefficiencies, then these strategies should provide significant outperformance after adjusting for risk. Measures of market beta should not be significantly different from zero. Similarly, any other betas relative to various exposures or factors should not be significantly different from zero. In order to test these propositions, one needs to identify various risk factors beyond the traditional market that might explain returns.

Performance Variables

Researchers have identified various factors that relate to portfolio strategies such as:

- Going long in small stocks and short in large stocks;
- Going long in value stocks and short in growth stocks;
- And going long in stocks that have experienced large price increases and short in those that have not.

As such, investors may be better off simply replicating such long/short strategies directly rather than through hedge fund investments. While much attention has been placed on these portfolio strategies as risk factors, less attention has been placed on economic factors that may impact performance. Examination of economic factors as explanatory variables for equity market neutral hedge funds may shed light on the ability of such funds to act as a counterbalance during depressed economic times.

I create and examine the properties of four asset-based style factors based on equity market neutral market strategies. The strategies are based on rankings and monthly updates of equal-weighted portfolios of S&P 500 stocks and involve going long (short) on the highest (lowest) ranked quintile sorted on earning/price (EP), price/book (PB), price momentum (PRM) and market capitalization (MKT). I also create a number of economic-based variables. YLD captures the shape of the yield curve, PREM measures a default premium, INFCHG is an inflation change variable and VIX measures market volatility.

I then perform regression analysis on the CSFB/Tremont equity market neutral index return series (1994 to 2005) to explain what drives average equity market neutral hedge fund return performance, measured in excess of T-bill returns (EMNE). Using a classical CAPM approach, regressing EMNE on a market premium, the average equity market neutral fund has a low beta exposure (0.07) and a positive and significant alpha (0.44 or 44 basis points per month), suggesting outperformance with little market exposure. The picture is similar when the additional style factors (EP, PB, PRM and MKT) are added as well. However, once the economic factors are added (YLD, PREM, INFCHG and VIX), the alpha is negligible and no longer significant. The good news is that EMNE returns are negatively related to the shape of the yield curve and positively related to market volatility, suggesting an important counter-cyclical role for such a strategy.

Finally, I extend the analysis to other hedge fund styles, as a robustness check and to examine whether style factors and economic variables also explain returns from other styles. Among seven equity-related styles, all have significant world market premium betas. There is prevalence among the remaining six strategies to have a growth tilt and also a small-cap tilt. Most of the event-driven strategies have significant and negative VIX coefficients, suggesting lower volatility is better for these types of strategies. ∎