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The alpha and omega of fund of hedge fund added value

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ABSTRACT

In spite of a somewhat disappointing performance throughout the crisis, investors are showing interest in hedge funds. Still, funds of hedge funds keep on experiencing outflows. Can this phenomenon be explained by the failure of fund of hedge fund managers to deliver on their promise to add value through active management, or is it symptomatic of a move toward greater disintermediation in the hedge fund industry? We introduce a return-based attribution model allowing for a full decomposition of fund of hedge fund performance. The results of our empirical study suggest that funds of hedge funds are funds of funds like others. Strategic allocation turns out to be a crucial step in the investment process, in that it not only adds value over the long-term, but most importantly, it brings resilience precisely when investors need it the most. Fund picking, on the other hand, turns out to be a double-edged sword.

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1. Introduction

Positive inflows since the third quarter of 2009 and a number of industry surveys (2010 Preqin Global Hedge Fund Investor Review) suggest that in spite of a somewhat disappointing performance throughout the crisis, and a series of high-profile scandals, investors and especially institutional investors, are still showing interest in hedge funds. Against this backdrop, funds of hedge funds, which used to be the favorite route for traditional investors to gain exposure to hedge funds strategies, keep on experiencing outflows (see e.g., Fig. 1). Can this phenomenon be explained by the failure of fund of hedge fund managers to deliver on their promise to add value through active management, or is it symptomatic of a move toward greater disintermediation in the hedge funds industry?

The debate on active vs. passive management is not a petty local quarrel. It has been agitating the investment community and challenging one of the central assumptions of economic theory, namely market efficiency, for decades. In this respect, a large body of empirical literature documents the performance of

mutual funds, and most studies do not seem to support the proposition that professional money managers succeed in adding value through active management (see Sharpe, 1966; Treynor, 1966; Jensen, 1968; Grinblatt and Titman, 1992; Hendricks et al., 1993; Elton et al., 1996; Carhart, 1997, or Blake et al., 1999, among other examples). But, despite traditional investors' significant exposure to funds of hedge funds, little attention is paid to the added value of these investment vehicles. This is all the more surprising in that funds of hedge funds invest in funds that show themselves a persistence that appears to be at best shorter term than the typical fund selection process (see Agarwal and Naik, 2000; Amenc et al., 2003; Baquero et al., 2005; Capocci et al., 2005; Capocci and Hübner, 2004; Eling, 2009; Herzberg and Mozes, 2003; Kat and Menexe, 2003; Kosowski et al., 2007; Malkiel and Saha, 2005, among other examples).

The lack of transparency that is characteristic of the hedge fund arena and that makes the performance attribution exercise particularly challenging is probably an explanation. The objective of this study is to fill in the gap. Our contribution in this article is twofold. On the one hand, we propose a performance attribution model incorporating state-space models, which makes it possible to disentangle the value stemming from strategic allocation decisions (static betas), from tactical allocation bets (dynamic betas), and from the fund selection (alpha). The merit of this performance attribution model described in Fig. 2 is therefore to allow for a full decomposition of the performance, i.e., as with

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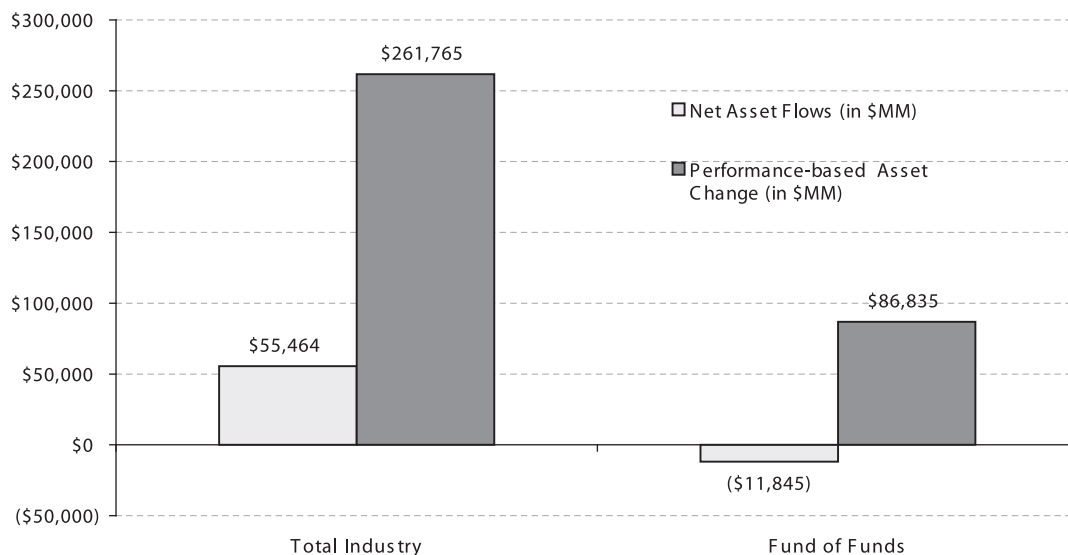


Fig. 1. Year-to-date estimated change in assets (in \$ billion), as of the end of Q4 2010. Source: HFR Global Hedge Fund Industry Report, Q4 2010, <http://www.hedgefundresearch.com>.

portfolio-based approaches (see Brinson et al., 1986, 1991)¹ but in a return-based setting. On the other hand, our observation period covers the recent financial crisis. We can therefore test the extent to which the value added by fund of hedge fund managers is regime-dependent; we can also analyze more specifically the behavior of funds of hedge funds while they experience – for the first time on record – a period of significant capital outflows. Unsurprisingly, asset allocation and risk management being two sides of the same coin, we find that the value added at the strategic allocation level is significantly positive, especially during this period of capital outflows, i.e., from July 2007 to July 2009. The results are more mixed when it comes to tactical allocation and fund picking.

The remainder of this article is organized as follows. In Section 2, we propose a performance attribution model allowing for a full decomposition of fund of hedge fund returns. We then figure out in Section 3 whether strategic allocation really matters in the case of funds of hedge funds. In Section 4, we dig further and get a better understanding of the sources of fund of hedge fund managers' added value, and assess the extent to which it varies across market regimes. We subsequently evaluate the impact of various exogenous variables on this added value in Section 5. Section 6 ends this article with some concluding remarks and suggestions for future research.

2. A performance attribution model for actively managed portfolios

Most performance studies consider strategic allocation an exogenous variable, as if fund managers have no impact on this crucial part of the investment process. They therefore consider only the value added by the fund manager through tactical allocation, and stock or fund picking. However, as evidenced in the literature, strategic allocation appears to be the main determinant of a fund's performance (see Brinson et al., 1986, 1991, or Ibbotson and Kaplan, 2000, among other examples). It is therefore inconsistent to ignore the value added at the strategic allocation level. To address this issue, we suggest extending the approach introduced in Bailey et al.

(1990) and consider that the performance (P) of a fund of hedge funds is made up of four distinct components:

- (i) the performance of an uninformed investor (N),
- (ii) the value added by the portfolio manager through the strategic allocation process (S),
- (iii) the value added by the portfolio manager through the tactical allocation process (T),
- (iv) the value added by the portfolio manager through the fund selection process (F).

By doing so, we can decompose the performance of a fund of hedge funds as follows:

$$P = N + S + T + F \quad (2.1)$$

or alternatively:

$$\begin{cases} N = R_{\text{Neutral portfolio}} \\ S = R_{\text{Strategy benchmark}} - R_{\text{Neutral portfolio}} \\ T = R_{\text{Tactical benchmark}} - R_{\text{Strategy benchmark}} \\ F = P - R_{\text{Tactical benchmark}} \end{cases} \quad (2.2)$$

Let us now develop the intuition beyond the different benchmarks involved in this decomposition. The impact of any investment decision can be measured by comparing its outcome with that of an alternative decision (i.e., *neutral portfolio*). As highlighted in Hensel et al. (1991), the results of the performance attribution process strongly depend on the choice of this alternative decision; there is, however, no consensus on its definition. One could choose the risk-free rate or the minimum risk portfolio. But it is highly questionable that this would be an appropriate benchmark for an uninformed investor. Another option would be to follow a liability-driven logic. But since investors have specific liability constraints such a benchmark would not fit them all equally; notwithstanding the fact that designing a liability matching portfolio is not straightforward when it is made up of alternative strategies. We thus take another route and opt for the equilibrium logic, by selecting the market portfolio, or more specifically, a composite index as *neutral portfolio*. We use to this end an equally weighted index based on the meta-database presented in Section 3.

The strategic allocation of a fund of hedge funds reflects the long-term bets made by the portfolio manager. We assume in

¹ The portfolio-based approach is also applied to the hedge fund world (see Lo, 2008). It is however practically difficult to implement it on a large sample of funds of hedge funds given the lack of transparency provided by many funds.

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