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Geographical focus in emerging markets and hedge fund performance

Juha Kotkatvuori-Örnberg, Jussi Nikkinen, Jarkko Peltomäki *

University of Vaasa, Department of Accounting and Finance, P.O. Box 700, FI-65101 Vaasa, Finland

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ABSTRACT

Emerging market hedge funds are an asset class which does not seem to outperform the market benchmarks. We hypothesize that the poor aggregate performance may be due to lack of focus of these funds. Our results suggest that a portfolio of emerging market hedge funds, which have geographical focuses, outperform their underlying stock markets. Hedge funds which focus on Eastern Europe appear to have the best outperformance. However, we also find that the performance of all emerging market hedge funds has reduced after the start of the 2008 Crisis.

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1. Introduction

Hedge fund investors can benefit from the skills of a hedge fund manager allowed by their free and flexible investment policies of hedge funds. When investing in emerging markets, which are both risky and challenging, investors can invest in hedge funds as well. But the study by Strömqvist (2007) presents evidence that emerging market hedge funds are not capable of outperforming their underlying benchmarks. This evidence is further supported by Peltomäki (2008) and Abugri and Dutta (2009).

The objective of our study is to further analyze the performance of emerging market hedge funds with a consideration that the term “hedge fund” is most of all a legal definition. Consequently, within the industry some funds may be more alternative investments than other funds. The “true alternatives” can possibly produce superior performance than the others. To pick outperforming funds we propose an investment style for investing in emerging market hedge funds in each geographical location by investing in funds which have reported geographical focuses.

* Corresponding author at: Department of Accounting and Finance, University of Vaasa. P.O. Box 700, FIN-65101, Vaasa, Finland. Tel.: +358 6 3248 911; fax: +358 6 324 8344.
E-mail address: jape@uwasa.fi (J. Peltomäki).

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Given the above reasoning, the purpose of our study is to focus on analyzing the aggregate performance of emerging market hedge funds with geographical focuses. The research problem of this study is two-folded: first, whether geographical portfolios of emerging market hedge funds outperform their underlying geographical focus markets. Second, whether the aggregate portfolio of focused emerging market hedge funds outperform the underlying indexes.

We argue that the investment focus is the key in finding skilled managers within the industry beyond the term "hedge fund" with the following reasoning. As emerging market hedge funds carry a relatively high market risk, it is an opportunity for less skilled managers to infiltrate in the hedge fund industry to collect high fees. A solution to select the skilled managers would be to have a signal of their expertise in some emerging market. Indeed, Chen (2007) presents evidence for market timing ability of hedge funds in their focus market. The result leads us to expect that in their focus market emerging market hedge funds would also show better performance due to their profound expertise in the market.

In fact, our approach of finding information advantage is closely associated with the local information advantage in Teo (2009) but the approach is different. Teo (2009) finds that especially for emerging market and event-driven funds local information advantage (i.e. fund operates close to its focus market) leads to better performance. We assume that market focus likewise to information advantage as does local information advantage. Our study also differs from Cao and Jayasuria (2010a), who examine the performance of individual emerging market hedge funds against their matched regional benchmarks (1 regional benchmark per fund) since they do not consider how the focus relates to the performance. In the following study, Cao and Jayasuria (2010b) study the performance of different geographical hedge fund portfolios and a global hedge fund index against their matched equity and bond benchmarks. In relation to these both studies, we consider all hedge funds that have geographical focuses as a group and we also adjust to the exposures of hedge funds to equity returns of multiple geographical focuses.

To investigate the performance of emerging market hedge funds, we use the emerging market hedge fund database obtained from the EurekaHedge. Our analysis period starts in April 2000 and ends in September 2009. The data for performance analysis includes 786 funds. Our results suggest that a portfolio of emerging market hedge funds that have geographical focuses is able to show statistically significant and positive abnormal performance unlike the portfolio of other emerging market hedge funds. Therefore, a profitable investment style for emerging market investors is to allocate their funds toward emerging market hedge funds which have a distinct geographical focus. For data vendors, we propose that creating focused country benchmarks of emerging market hedge funds could be an interesting and well motivated benchmark style given the results by Teo (2009) and our study.

The remainder if this paper is organized as follows: In Section 2 we review the literature on the market timing ability of hedge funds. Section 3 presents our hypotheses. In Section 4 we present the data used for this study followed by Section 5 for the methods used in this study. Section 6 presents our results and Section 7 concludes the study.

2. Literature review

The question whether hedge funds truly outperform their underlying benchmarks and are able to produce abnormal performance is stressed in the academic research, but is also difficult to answer. Using a robust methodology, Kosowski, Naik and Teo (2007) find that hedge funds outperform their underlying benchmarks. However, Aragon (2007) finds that the performance of hedge funds is associated with share restrictions, and thus the seemingly abnormal performance of hedge funds can be explained by illiquidity premium.

For the emerging market hedge funds, two early studies examine their performance: first, the evidence reported by Strömqvist (2007) suggests that at the broad strategy level emerging market hedge funds have not outperformed their benchmarks over the period 1994–2004. However, her results suggest that the abnormal returns of the strategy may be increasing. For the period 1994–2006, Peltomäki (2008) also examines the performance of emerging market hedge funds and confirms poor performance at the index level. However, he finds that nearly 40% of emerging market hedge funds shows statistically significant and positive abnormal returns. He also finds that higher performance among emerging market hedge funds is associated with the use of auditing services and higher management fees. Both of these studies use the Lipper TASS database.

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