ALTERNATIVE INVESTING

Do Hedge Funds Hedge?

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Intentionally or unintentionally, hedge funds appear to price their securities at a lag, we found in a cursory examination of monthly returns from 1994-2000. These results based on monthly data may be misleading, causing a downward bias in simple risk estimates. Accounting for this effect can erase much of the return and diversification benefits claimed by the broad hedge fund universe and many subcategories within it.

Many hedge funds hold illiquid exchange-traded or over-the-counter securities, which often do not trade at, or even near, the end of every month (even small- and medium-capitalization stocks may be subject to thin trading). The lack of fresh prices gives hedge funds "flexibility" in how they mark these positions for month-end reporting, and can artificially reduce estimates of volatility and correlation.

This type of non-synchronous price reaction has been the subject of research for empirically estimating betas of small-capitalization stocks and other illiquid securities. We apply these and other techniques to hedge fund returns, and find that simple monthly beta and correlation estimates greatly understate hedge fund equity-market exposure. Similarly, simple estimates of volatility using monthly returns seem to understate actual hedge fund volatility.

Furthermore, when we account for a more accurate level of market exposure, we find that the broad index of hedge funds and most hedge fund subcategories do not add value over this period beyond what would be expected given their average market exposure. In other words, according to our tests, aggregate hedge fund returns over this period might be due to market exposure rather than to alpha or manager skill.

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