

Hedge Funds: A Walk Through the Graveyard

Ross Barry

Overview

A study of the more than 2,200 hedge funds in the TASS database from 1994 (when the major databases began to retain data about defunct funds) to 2001 provides some insight into the biases in hedge fund returns. Understanding these biases is critical to setting expectations for future hedge fund returns and benchmarking their performance. It also provides insight into hedge fund selection strategies that go beyond performance measurement.

Studies by Fung and Hsieh (2000), (2001) identified a number of potential biases in hedge fund returns, most notably due to survivorship and selective backfilling of returns. Understanding these biases is critical to setting expectations for future hedge fund returns and benchmarking their performance. A study of the more than 2,200 hedge funds in the TASS database from 1994 (when the major databases began to retain data about defunct funds) to 2001 provides some insight.

An examination of the probable causes of death for the 936 defunct hedge funds, referred to affectionately as 'the graveyard' reveals that, as in every good thriller, not everything in the graveyard is actually dead. Analysis of hedge fund returns is complicated by three factors. First, not all databases retain historical data about defunct funds. To the extent that these funds die due to poor performance, the conditional average return for live funds (that is, those that survive to the end of the reporting period) will have a positive bias. Even when returns to defunct funds are factored in, survivorship bias may still occur where such funds do not report losses incurred in the final months prior to liquidation.

Second, hedge funds are prohibited from marketing directly to U.S. investors. Maintaining a profile with the leading databases, therefore, provides the most effective way to pitch their services. On one hand, this ensures broad coverage by the major databases. Once a fund raises enough capital and becomes closed to new investors, however, there is little motivation to continue to report. Indeed, it is not uncommon for really promising new funds to have their entire future capacity reserved, in advance, by large investors. Hedge funds that stop reporting, for whatever reason, are transferred by TASS from the live fund database to the graveyard.

Third, hedge funds may exercise a fair degree of discretion in reporting. For instance, it is only natural to expect that, upon entering a database, a fund would only provide earlier returns if these were strong, or select the most flattering start date. In his 1995 study, Park referred to this as 'instant history bias.' A related bias known as 'self-selection bias' arises where funds that are unsuccessful in their early days never report at all. It may be argued, however, that any such bias is negligible. For every sub-par fund that goes unreported there is a successful fund that raises capital without joining a database.

Survivorship and Instant History Bias

The study conducted on the TASS database by Fung and Hsieh reveal a higher level of survivorship bias than that found in previous studies. This occurred because the prior studies estimated survivorship bias by comparing the live fund return index with the all fund return index, which included returns prior to 1994 (which excluded defunct funds) and returns from fund-of-funds. The higher estimate from Fung and Hsieh is likely to be the most accurate because it includes the greatest number of defunct funds.

Interestingly, a review of the defunct funds, which make up around 42 percent of the TASS database, identifies only 56 percent of defunct funds as actually having been liquidated. As stated earlier, not everything in the graveyard is truly dead. Not surprisingly, these funds have, on average, fairly chronic negative returns and much higher levels of volatility than average. Other defunct funds in the TASS database have stopped reporting returns because they are closed to new investors, have been merged with other funds, or have stopped reporting for other reasons.

Fewer studies have attempted to estimate instant history bias. Due to distortions in the data, it seems unlikely that these studies tell us much about instant history bias.

Probable Cause of Death

With respect to liquidated funds, it is tempting to conclude that the primary cause of death is poor returns, excessive volatility or skewed returns. On closer inspection, however, it appears that, in many cases, causality works in the other direction. It is not so much that poor returns or high volatility led to the termination of a fund, but rather that the death of a fund caused the mean, standard deviation and skew to deteriorate sharply in the final six to twelve months of a fund's life. In many cases, returns were stronger and volatility was lower than average prior to this sudden change.

We believe this phenomenon reflects two things. First, it suggests that investors focus more heavily on short-term performance when evaluating hedge funds. More specifically, they respond unfavorably to any sudden deterioration in performance, but they tend to be more tolerant of a slow and less conspicuous erosion over time. Second, it highlights the market impact of

liquidating funds—the magnification of losses when unwinding positions in unfavorable market conditions.

Incentive Fees and Self-Closure

Some 44 percent of defunct funds are not reported to have been liquidated, but have reportedly closed or stop reporting for other reasons. Our cynical side tells us that a large share of these other defunct funds also have been liquidated and are just seeking to protect their reputations. But on closer inspection, we found this is not necessarily so.

A review of the data suggests that, when a fund's NAV drifts well below its previous high-water mark for incentive fees, which are the main revenue source for most funds, the manager may be faced with the prospect of working a couple years or more without earning a bonus. There is little motivation in such situations to continue trading as opposed to setting up a new fund somewhere else.

Conclusion

The information available to investors is not always conclusive and does not necessarily tell the whole story. Therefore, there is a good reason for investors to stick with hedge fund managers who invest in their own funds and have much at stake in the event of liquidation.

About the Author

Ross Barry is a principal of Sovereign Investment Research in Sydney, and advises Australian superannuation funds about alternative investment strategies and risk management. Mr. Barry received a bachelor of economics degree with honors from Australia's University of Newcastle and completed research for a doctorate in applied finance at Macquarie University's Applied Finance Center where he took extensive research into asset pricing, hedge funds and other alternative investment strategies. Previously Mr. Barry was an asset consultant with TRM/Towers Perrin and a proprietary trader for Bankers Trust and Deutsche Morgan Grenfell.

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