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ALTERNATIVE INVESTMENTS

Predictability in Hedge Fund Returns (corrected)

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Abstract

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The valu ... an $500 billion, ... estors seem to be moving toward holding hedge funds in their portfolios. As a result, portfolio

managers face the challenge of making strategic and tactical asset-allocation decisions for multistyle, multiclass portfolios that mix traditional and alternative investment strategies.

The consensus now in empirical finance is that the expected returns (and also the variances and covariances) of traditional assets, such as stocks and bonds, are to some extent predictable. But little is known about the predictability of returns emanating from alternative investment vehicles, such as hedge funds. Also, and not surprisingly given the absence of academic evidence on the predictability of hedge fund returns, little is known about the performance of tactical asset allocation involving hedge funds. In particular, although the out-of-sample performance of optimal strategic asset allocation decisions based on alternative investment vehicles has recently been documented, no such evidence is available on the ability of investors to generate superior risk-adjusted returns based on timing among various hedge fund styles.

This article is, to the best of our knowledge, the first to document the existence of predictability in hedge fund index returns and to focus on its implications for tactical allocation decisions. Specifically, we examined (lagged) multifactor models for the return on nine hedge fund indexes. We chose factors that would measure the many dimensions of financial risk—market risks (proxied by stock prices, interest rates, and commodity prices), volatility risk (proxied by implicit volatilities from option prices), default r … ng volume).
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lockup periods, which are typical of investments in hedge funds, are likely to prevent investors from implementing any kind of dynamic allocation among funds. We believe, however, that the future of hedge fund style timing is even brighter than its past or present. The hedge fund industry is still relatively new, and market conditions are evolving at an astounding pace. Although the world of alternative investing has consisted of a disparate set of managers following disparate specific strategies, significant attempts at structuring the markets have occurred in the past few years. Important, well-established firms are creating relatively liquid investment products designed to track the performance of hedge fund indexes.

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