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ALTERNATIVE INVESTMENTS

Predictability in Hedge Fund Returns (corrected)

Noël Amenc, Sina El Bied & Lionel Martellini

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Abstract

A significant amount of research has been devoted to the predictability of traditional asset classes, but little is known about the predictability of returns emanating from alternative vehicles, such as hedge funds. We attempt to fill this gap by documenting evidence of predictability in hedge fund returns. Using multifactor models for the return on nine hedge fund indexes, for which the factors were chosen to measure the many dimensions of financial risk, we found strong evidence of significant predictability in hedge fund returns. We also found that the benefits of “tactical style allocation” portfolios are potentially large. We obtained even more spectacular results for an equity-oriented portfolio that mixed traditional and alternative investment vehicles and for a debt-oriented portfolio that mixed traditional and alternative investment vehicles.

These results do not seem to have been significantly affected by the presence of reasonably high transaction costs.

The value of the hedge fund industry worldwide is estimated to be more than $500 billion, distributed among more than 5,000 funds, and most institutional investors 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 risk (proxied by default spreads), and liquidity risk (proxied by trading volume). We show that a parsimonious set of models captures a significant amount of predictability for most hedge fund styles.

We also found that the benefits of tactical style allocation are potentially enormous. The article first provides evidence of the economic significance of the performance of hedge fund style-timing models by comparing the performance of a market timer with perfect forecasting ability in the alternative investment universe with the performance of a perfect market timer in the traditional universe. Then, the performance of a realistic style-timing model is presented. An equity-oriented portfolio that mixed traditional and

alternative investment vehicles and a similar debt-oriented mixed portfolio produced spectacular results. Moreover, the results do not seem to be significantly affected by the presence of reasonably high transaction costs.

Some specific features of hedge fund investing do not facilitate the implementation of tactical allocation strategies. In particular, the absence of liquidity and the presence of 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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