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ALTERNATIVE INVESTMENTS

Predictability in Hedge Fund Returns (corrected)

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Pages 32-46 | Published online: 02 Jan 2019

🗨️ Cite this article 🔗 <https://doi.org/10.2469/faj.v59.n5.2562>

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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 a hedge fund index (including returns on many alternative asset classes, such as equities, fixed income, commodities, and currencies) using a large number of factors (including market returns, default rates, and commodity prices), and we found that the returns on the hedge fund index are predictable (using lagged returns on the factors). We show that the predictability of hedge fund returns is not spurious, and that it is not due to the presence of reasonably high transaction costs.

We also show that the predictability of hedge fund returns is not due to the presence of hedge funds with perfect forecast ability. The predictability of hedge fund returns is due to the presence of a realistic asset allocation strategy that mixes traditional and alternative investment strategies. The predictability of hedge fund returns is produced 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.

Research for this article received the support of the EDHEC/MISYS Multi-Style/Multi-Class Research Program. We would like to express our gratitude to Sébastien Bonnet and George Martin.

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