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STRATEGIES

When All Numbers Are In, Do Hedge Funds Shine?

By MARK HULBERT

HEDGE funds use many strategies to try to produce extraordinary returns in any market. But a new study suggests that, on average, hedge funds may perform worse than mutual funds.

Previous studies have overstated average hedge fund returns because of several deficiencies in hedge fund performance databases. Until now, researchers have not had access to information that would let them determine the extent of the bias.

Pieter Jelle van der Sluis, an assistant professor of finance at the Free University of Amsterdam, and Nolke Posthuma, vice president for research at ABP Investments, based in the Netherlands, recently found the necessary data. They reported their findings in "A Reality Check on Hedge Fund Returns," a working paper that has been circulating since July in academic circles; it is available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=438840

Both hedge funds and mutual funds pool investors' money into single managed portfolios. Unlike mutual funds, however, hedge funds are generally unregulated and require high minimum investments.

According to the authors of the new study, databases for hedge fund performance are misleading because participation in them is voluntary. Each hedge fund decides whether to provide its performance data. Because young hedge funds have too little data to interest those databases' customers, the managers of these new funds often wait several years before starting to report their track records. If their records over those initial years turn out to be poor, they may choose not to report at all.

That wouldn't necessarily create a bias, however, if the databases recorded a hedge fund's returns only after it began reporting performance. But at major databases, that has not been the case. When adding a hedge fund, they also include its historical returns. Because that process, known as backfilling, excludes the poor returns of funds that choose not to report, it paints an overly optimistic portrait of the average hedge fund's performance.

The researchers measured the magnitude of this so-called backfill bias by using the TASS database of Tremont Capital Management; the researchers say that this database includes the greatest number of hedge funds from around the world.

Once backfilled returns were eliminated, they found, the average annual return of hedge funds from 1996 through 2002 dropped to 6.4 percent from 10.7 percent.

But even the 6.4 percent figure is upwardly biased, the researchers said, because hedge funds typically do not report their returns over the last few months before they go out of business, during which their

returns may be dismal. For example, the record of Long Term Capital Management in the TASS database ends in October 1997, nearly a year before its collapse.

The researchers were unable to measure the magnitude of this second type of bias. Professor van der Sluis and Mr. Posthuma came up with an estimate, however, by assuming that the net asset value of a fund that is closing shop declines 50 percent in the month it stops reporting to the databases. On that assumption, average hedge fund returns from 1996 through 2002 dropped to almost nothing - just 0.1 percent a year, annualized.

That is far worse than the performance of the average mutual fund. According to Lipper Inc., the average annual return of a domestic equity fund over that period was 4.9 percent; for domestic bond funds, it was 6.1 percent.

LOWER returns for hedge funds could be justified if their volatility were much lower than that of the average mutual fund. In fact, hedge-fund volatility should be quite low, because few of these funds bet all or nothing on the direction of any market.

Using data from Professor van der Sluis and Mr. Posthuma, I calculated the average monthly volatility of hedge funds to be about one-third that of the Wilshire 5000. Still, no amount of reduced volatility could make an annual return of 0.1 percent attractive.

Mark Hulbert is editor of The Hulbert Financial Digest, a service of CBS MarketWatch. His column on investment strategies appears every other week. E-mail: strategy@nytimes.com.