

The Performance of Hedge Funds: Risk, Return, and Incentives

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ABSTRACT

Hedge funds display several interesting characteristics that may influence performance, including: flexible investment strategies, strong managerial incentives, substantial managerial investment, sophisticated investors, and limited government oversight. Using a large sample of hedge fund data from 1988–1995, we find that hedge funds consistently outperform mutual funds, but not standard market indices. Hedge funds, however, are more volatile than both mutual funds and market indices. Incentive fees explain some of the higher performance, but not the increased total risk. The impact of six data-conditioning biases is explored. We find evidence that positive and negative survival-related biases offset each other.

HEDGE FUNDS HAVE BEEN IN EXISTENCE for almost 50 years. However, their recent growth has increased their prominence in the financial markets and the business press. Since the late 1980s, the number of hedge funds has risen by more than 25 percent per year. The rate of growth in hedge fund assets has been even more rapid. In 1997, there were more than 1200 hedge funds managing a total of more than \$200 billion. Though the number and size of hedge funds are small relative to mutual funds, their growth reflects the importance of this alternative investment vehicle for institutional investors and wealthy individual investors.¹

As the name implies, hedge funds began as investment partnerships that could take long and short positions. They have evolved into a multifaceted organizational structure that defies simple definition. There are, however, a

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¹ Statistics on hedge fund growth appear in Hennessee Hedge Fund Review, June 1998; "A hitchhiker's guide to hedge funds," *Economist*, June 13, 1998; "Gaining an edge with hedge funds," *Business Week*, July 29, 1996; and in Lederman and Klein (1995).