On the Performance of Hedge Funds

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Empirical evidence indicates that hedge funds differ substantially from traditional investment vehicles, such as mutual funds. Unlike mutual funds, hedge funds follow dynamic trading strategies and have low systematic risk. Hedge funds' special fee structures apparently align managers' incentives with fund performance. Funds with "high watermarks" (under which managers are required to make up previous losses before receiving any incentive fees) significantly outperform those without. Hedge funds provide higher Sharpe ratios than mutual funds, and their performance in the period of January 1992 through December 1996 reflects better manager skills, although hedge fund returns are more volatile. Average hedge fund returns are related positively to incentive fees, fund assets, and the lockup period.

Hedge funds are private investment partnerships in which the general partners make substantial personal investments. These funds are allowed to take both long and short positions, to use leverage and derivatives, to invest in concentrated portfolios, and to move quickly between various markets. Hedge funds usually take large risks on speculative strategies, including leverage bets, program trading, swaps, and arbitrage.

Unlike mutual funds, hedge funds in the United Sates are not required to register with the U.S. SEC and disclose their asset holdings, primarily because hedge funds are either limited partnerships or offshore corporations.[1] This limited regulatory oversight gives hedge fund managers tremendous flexibility in making investment decisions. Because of the nature of private partnerships, hedge funds are not allowed to advertise to the public. The funds require that 65 percent of all investors be accredited, and the minimum investment requirement is typically $250,000. A lockup period is usually imposed to prevent early redemption.

Hedge funds have special fee structures designed to motivate managers. A management fee is based on asset size, and an incentive fee is established separately to align the manager's interest with the fund's performance. The incentive fee is usually paid only after a hurdle rate has been achieved. A majority of hedge funds also have a "high watermark" provision, under which the manager is required to make up any previous losses before an incentive fee will be paid (i.e., the cumulative returns have to be above the hurdle rate). Furthermore, a manager could "owe" the investors a rebate of fees charged in previous years. All these features give managers better incentives to act in investors' interests than is the case with mutual funds and other traditional investment vehicles.

Hedge fund targets for returns differ from mutual fund targets. Hedge funds are absolute performers; for hurdles, they use some target such as the T-bill rate plus a premium or LIBOR plus a premium. In contrast, mutual funds are relative performers; they use such benchmarks as the S&P 500 Index for equity funds and the Lehman Brothers Aggregate Index for bond funds.

As a result of flexible investment strategies, an effective manager-incentive alignment, sophisticated investors, and limited SEC regulations, hedge funds have gained tremendous popularity. The first hedge fund was established in 1949. By the late 1980s, the number of funds had increased to about 100. Explosive growth in the hedge fund market during the early 1990s, shown in **Figure 1**, has made more than 1,000 funds available to investors today. Moreover, in 1996, to encourage investment in hedge funds, the SEC allowed hedge funds to exceed their previous limit of 100 investors without requiring the kind of registration and disclosure required of mutual funds.[2] The new SEC rules could attract pension funds and other institutional investors to hedge funds.

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