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Other Voices: Misuse and use of hedge fund indices

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Status Review

In contrast to the regulated world of traditional investments, the hedge-fund universe cannot be fully encompassed. Hedge funds are private structures, devoid of any regulatory obligations to disclose the returns they generate. The only access to relevant information is provided by the various commercial databases available. However, these databases' representation of the hedge-fund universe is significantly distorted: hedge-fund managers only contribute to these databases voluntarily. Moreover, each database has a significant way to go in order to cover a sufficiently large part of the universe.

Small samples obtained by means of a non-random drawing process and extracted from a heterogeneous population lead to a significantly biased representation. Hedge-fund indices are built using these databases and therefore inherit their shortcomings. If one is to believe that hedge-fund indices estimate the average return of the total, the hedge-fund universe is thus illusory. In fact, in indices it is impossible to separate out returns from fluctuations on the hedge-fund market and the variation due to discrepancies in index construction. The latter is particularly important, as the heterogeneity of hedge funds indices reveals.

Indeed, two indices which aim to represent the same strategy can betray monthly-return differentials of more than 1,400 basis points (bp). One may be justifiably puzzled by the gap measured for May 2000 between the Altvest Index (-2.6%) and the Tuna Hedge Fund Macro Index (+12%) or by the 2,204 bp spread between the EACM Long/Short Index and the Zurich Long/Short Index (later renamed Dow Jones Long/Short Index). In addition to this, average correlations between the different indices are low, and some long/short indices are not even correlated at all.

At hedge-fund-index level, 34% of maximum monthly return differences over a period ranging from January 1994 to October 2003 are greater than 3%, and 81% of the monthly readings reveal maximum differences exceeding 1%. These differences are significant in comparison to index stability (1x to 2x monthly volatility). Whilst compounding the returns, these monthly differences may cumulate in colossal spreads. For instance, the performance differential between the Tuna Hedge Fund Aggregate Average and the CS/Tremont Hedge Fund Index from 1997 to mid-2000 topped 40%.

Moreover, events subsequent to the discontinuation of a fund are not reflected in hedge-fund indices. This is known as *survivorship bias* and in specific years can total more than 1,000 bp. One simple way to compensate for this weakness is to use investable indices instead of non-investable ones. The former returns keep track of all investments, good and bad alike.

Thus the past returns of dissolved funds are not excluded from an index's performance history.

However, the heterogeneity of investable indices (CS/Tremont All Sector, CS/Tremont Blue Chip, HFRX, FTSE Hedge, MSCI Invest Hedge, Dow Jones Hedge Funds) is much higher in comparison to their non-investable counterparts. From 2008 to mid-2010, convertible-arbitrage investable indices exhibited for 6 months differences in monthly returns that exceeded 10,000 basis points, such as in October 2008 when HFRX Convertible Arbitrage Index recorded a 34.68% loss whilst FTSE Hedge Convertible Arbitrage returned -0.68%. Similarly, the maximum spread between equity-market-neutral indices', fixed-income indices', global macro indices', event-driven indices' and multi-strategy indices' monthly performances were +3,369 bp, +2,309 bp, +1,914 bp, +1,389 bp and +1,214 bp respectively. Clearly, they do not track a common phenomenon. If investable indices are not representative, they can be viewed as funds of funds. The selection of one such index as a benchmark equates to selecting a specific fund of funds as a reference. Obviously, using a fund of funds index is a more adequate and general solution.

Fund-of-funds databases are subject to various statistical biases as regards the fund-of-funds universe for the simple reason that, once again, database contributions are voluntary. Nevertheless, academic researchers have reported a significantly lower level of heterogeneity between fund-of-funds indices than the one between hedge-fund indices: distortions tend to be flattened out by funds of funds' economic nature, their diversification, as well as the convergence of database and fund-of-funds promoters' respective interests.

The advantage of low residual bias lies in the fact that they offer the best possible basis to diversify the residual biases through an index-of-indices approach, which induces smaller differences and an overall smoothing of data. A good recipe using good ingredients always produces better results than a good recipe using ingredients which are past their sell-by date. The EDHEC fund-of-funds index consolidates Altvest, HFR, CISDM-MAR and Van Hedge fund-of-funds indices, with weightings determined by a main-component analysis. This index thus provides the best available estimates of the fund-of-funds and hedge-fund universes.

However, the index-of-indices approach suffers from a lack of transparency (the composition in terms of underlying hedge funds or funds of funds is not known, nor are the weightings) and delays in releasing monthly figures. Thus, it may not be adequate for reporting on funds of funds. Moreover, even a specific fund-of-funds index (such as HFRI Funds of Funds Index) is not wholly satisfactory for monitoring multi-strategy funds of funds. Indeed, the arbitrage/relative-value single-strategy funds of funds or distressed funds of funds may distort the performance of the benchmark for a multi-strategy fund of funds. In 1995, the HFRI Fund of Funds Composite Index reported a rise of +11.17%, whereas the Diversified Funds of Funds Index recorded +7.76%, the spread being explained by the performance of two other components of the Composite Index (the HFRI FoF Conservative, +13.06%, and the HFRI FoF Strategic Index, +16.86%).