

Manager Track Record and Performance In Hedge Funds

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Abstract

Within the past decade, the number of hedge funds has grown dramatically. Today there are an estimated six thousand hedge funds with many new funds appearing each year. The continued growth of the hedge fund area requires a constant influx of new funds and fund managers. The question remains, however, as to the degree that these new managers/funds perform differently from established managers/funds. In this article, we review the performance characteristics of new funds with those of more established funds. Results show that the return performance of new funds may be greater than older funds but that this relative return difference declines as both new and older funds age over time.

Manager Track Record and Performance In Hedge Funds

I. Introduction

Within the past decade, the number of hedge funds has grown dramatically. Today there are an estimated six thousand hedge funds with many new funds beginning operations each year. The continued growth of the hedge fund industry and increased demand for related products require a constant influx of new funds and fund managers. Many of these newly reporting hedge funds are part of already existing fund families while others are primarily startups. The question remains, however, about the degree to which new managers/funds perform differently from established managers/funds.

Academic and practitioner literature has indicated a negative relationship between hedge fund age and performance (Liang, 1999; Fung and Hsieh, 2000; Hersberg and Mozes, 2003); that is, younger funds report higher rates of return.¹ In this article, the relative return performance of new funds is compared with that of more established funds. Results show that the return performance of new funds may be greater than older funds but that this relative return difference declines as both new and older funds age over time.

II. Data and Methodology

¹ Fung and Hsieh (2000) point out that one reason for the reported superior performance of new funds relative to existing funds is due to what they refer to as 'instant history bias.' When a fund chooses to report its performance to a data vendor, the fund's historical performance is added to the database by backfilling the records. This phenomenon takes place because new funds often undergo a period of incubation in which a fund starts with a small amount of seed money from people or institutions familiar with the manager and often have an equity position in the fund. If the fund's initial performance is satisfactory, then the manager decides to open the fund to new investments and thus starts reporting its performance to a commercial data vendor. Because the fund manager can decide when to make the fund's performance public, it is reasonable to assume that the incubation period's performance is generally high. Since Fung and Hsieh do not proscribe the differential return to manager skill, Fung and Hsieh report that the first 12-month's performance has an upward instant history bias of about 1.4% per year across various strategies.

This paper analyzes the impact of the length of track record on historical performance of hedge funds. Five hedge fund strategies (equity market neutral, convertible arbitrage, distressed securities, merger arbitrage, and event-driven) are examined. The universe of managers is created from five principal public hedge fund data sets.² For each hedge fund strategy, managers are grouped based on the classification within that database. Manager data is collected for the period 1990 through March 2003.

Various analyses of the impact of track record on relative performance are conducted. First, the actual performances of new hedge funds are compared to those funds with longer periods of survival. In each year since 1997, differences in means tests are conducted between new funds (those funds which have less than two years of performance) and older funds (those funds which have more than two years of performance). Only funds with complete data in each year are compared. Since funds begin operations in the year before their first full year of reported data, the first full year of data can be viewed as the first year, after the year of inception of the new fund. Secondly, using annual data, we compare the relative returns of new managers (managers with their first full year of performance but with less than two years since inception) to older managers as they both age. For each year from 1997 through 2002, the average annualized return of new managers (with a full year of data) is subtracted from the average annualized returns of funds with more than two years since inception. Each year, for each strategy, the differential returns are averaged based on the number of years since inception to the final year of complete data (2002).

Lastly, to test the relative performance of all managers as they age from inception over the entire time period (January 1990 through March 2003), managers' returns are subtracted from the relevant composite strategy index return (weighted average of EACM, Hedge Fund Research, and CSFB/Tremont strategy indices). The average excess return (over the 60-month period since the month of fund inception) is provided. Results are also presented on standardized excess returns (for each strategy the average of the excess returns is divided by the standard deviation of the average excess returns over the 60-month period since inception). Lastly, we also provide information on the fund volatility by strategy as funds age. For each strategy, the monthly volatility is calculated as the squared value of the difference between the average excess return and the mean of the average excess return through the first 60 months since inception.

III. Results

In Exhibit 1, the average of the annualized return of funds with less than two years of operation since inception, and funds with more than two years of operations since inception, are presented.³ Only funds with complete data for the reported year are analyzed. While on a simple-return basis new funds may outperform older funds, on average, the differential return is generally not significant.⁴ As shown in Exhibit 1, for only five of 30 cases is there a statistical significant difference in returns between those funds with two or more years since inception and those with less than two years since inception.

² The databases used to construct the database include CISDM, HFR, TASS, Tuna, and Alvest.

³ It is again important to point out that inception is measured as the first month in the year in which the fund started.

⁴ Student's t-test for independent samples / two-tailed test was conducted. The test did not assume the equality of the two theoretical variances (Satterthwaite's method). A significance level of .05 was used.

Exhibit 1

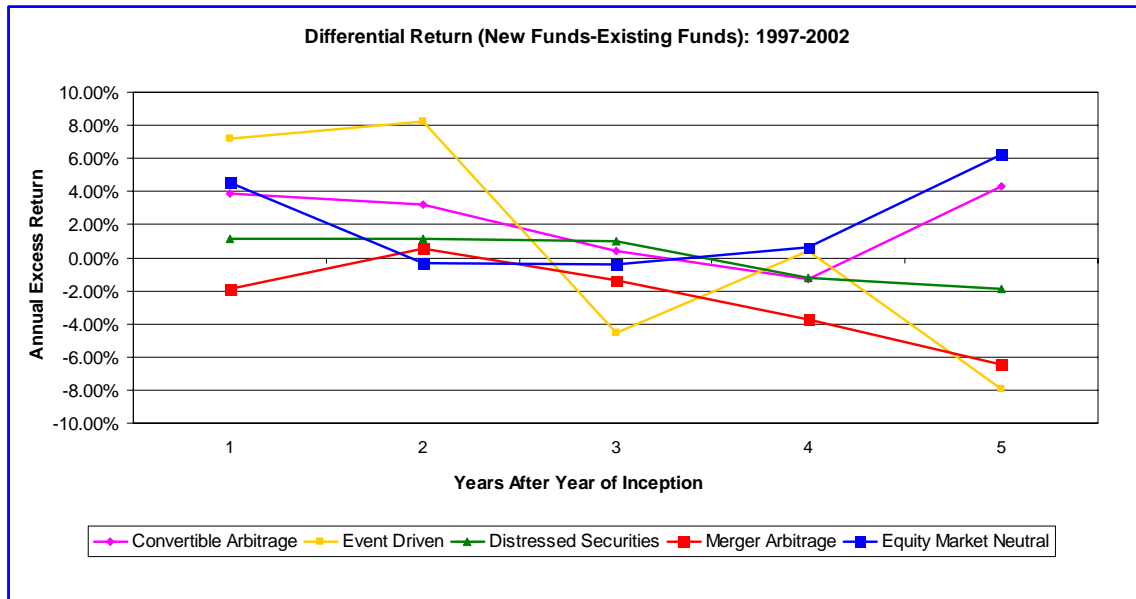
| Performance Comparison of Funds with Track Record ≥ 2 years and < 2 years. | | | | | | |
|---|--------|--------|-----------------|-----------------|--------|----------------|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| Equity Market Neutral: ≥ 2 years | 16.34% | 10.35% | 5.72% * | 15.42% | 5.04% | 2.93% * |
| Equity Market Neutral: < 2 years | 18.66% | 14.60% | 15.93% * | 18.58% | 8.99% | 6.19% * |
| Convertible Arbitrage: ≥ 2 years | 14.56% | 4.62% | 15.07% | 15.92% * | 13.68% | 8.94% |
| Convertible Arbitrage: < 2 years | 18.15% | 9.54% | 15.28% | 23.29% * | 18.85% | 10.80% |
| Distressed Securities: ≥ 2 years | 16.37% | 1.58% | 16.65% | 1.63% * | 15.44% | 4.95% |
| Distressed Securities: < 2 years | 7.22% | 2.32% | 14.18% | 16.63% * | 15.86% | 7.32% |
| Merger Arbitrage: ≥ 2 years | 16.43% | 7.33% | 14.81% * | 19.12% | 2.66% | 0.79% |
| Merger Arbitrage: < 2 years | -3.51% | 12.75% | 24.42% * | 17.85% | 1.45% | -3.09% |
| Event Driven: ≥ 2 years | 21.83% | 0.42% | 26.55% | 9.15% | 11.86% | -1.74% |
| Event Driven: < 2 years | 22.33% | 20.29% | 33.44% | 18.68% | 12.77% | 5.14% |

Bold: Statistically significant difference in means at the .05 level.

While reported returns between new funds and older funds may indicate superior performance of new funds, as discussed previously, these results may be due, in part, to instant history bias; that is, young funds report their performance to public databases if they have high, ex post performance in the first year of inception and would be reluctant to report their return history until their performance is deemed to be satisfactory. An important question therefore pertains to the effect of the passage of time on this relative performance. In Exhibit 2, we report the differential return between those new funds which have at least a full year of data but less than two years of data, and funds with performance in the same year but with more than two years of data. As shown in Exhibit 2, the relative returns between new funds and older funds as both groups age, converge to zero. The basis for this relative convergence may be due to several factors that require further analysis. For instance, new funds may have invested in a unique set of assets that differs from investment sets of existing funds. As funds age, they raise additional capital and these funds are invested in ways similar to other existing funds. Also, initial investors in a fund often include people who are intimately familiar with the fund and the

manager, and may include people who have an equity position in the management firm. This means that initially a fund may invest in instruments and trading strategies that would not be acceptable to external independent investors. As a result, as a fund ages and grows, it may change its investment strategy to be more acceptable to external investors.

Exhibit 2

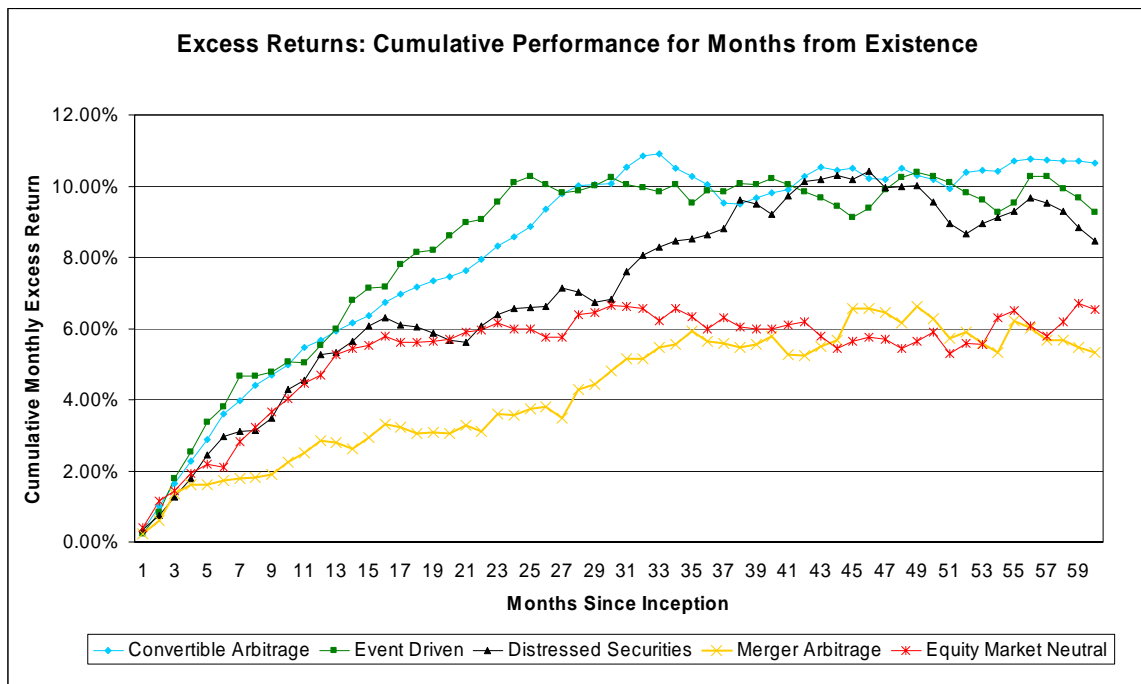


Dividing funds into groups based on yearly data may hide a more disaggregated track record. In Exhibit 3a, the averages of the cumulative excess returns (monthly return of fund less monthly return of the composite strategy index) of funds from month of inception through the first 60 months in existence are presented.⁵ Consistent with earlier research (Fung and Hsieh, 2000), results show that new funds initially outperform older funds, but that this relative out-performance declines over time. In Exhibit 3b, the averaged monthly excess returns are standardized by the standard deviation of the averaged excess returns over the first sixty months.

⁵ The composite strategy index is an equal weighted index of three public hedge fund strategy indices (EACM, CSFB/Tremont, and HFR).

Results show that on a standardized basis there is little indication of significant excess returns (e.g. standardized variable greater than two) after the first two years of since inception.⁶ Exhibit 3c displays the monthly volatility of averaged excess fund returns starting from the first month of their operation through month 60.⁷ There is no consistent pattern of volatility among the various strategies as they age.

Exhibit 3a



⁶ One problem in the use of data set to determine new managers is that many databases do not report manager performance until they have a reasonable return history. Thus often individuals using these databases do not have access to the return process until most of the managers have had over a one-year history.

⁷ Monthly volatility is calculated as the squared value of the difference between the averaged excess return and the mean of the averaged excess return through the first 60 months.

Exhibit 3b

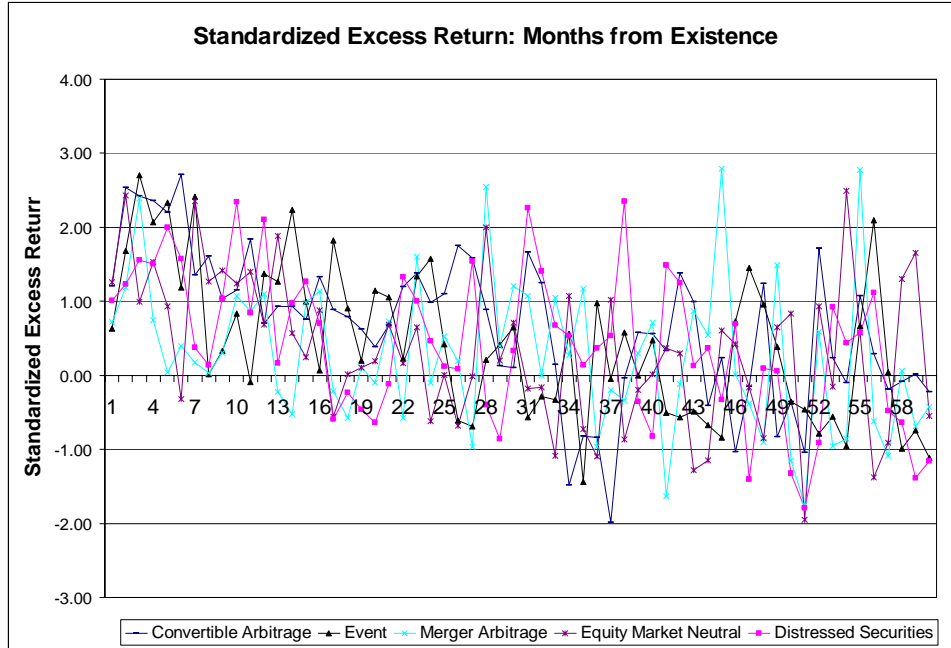
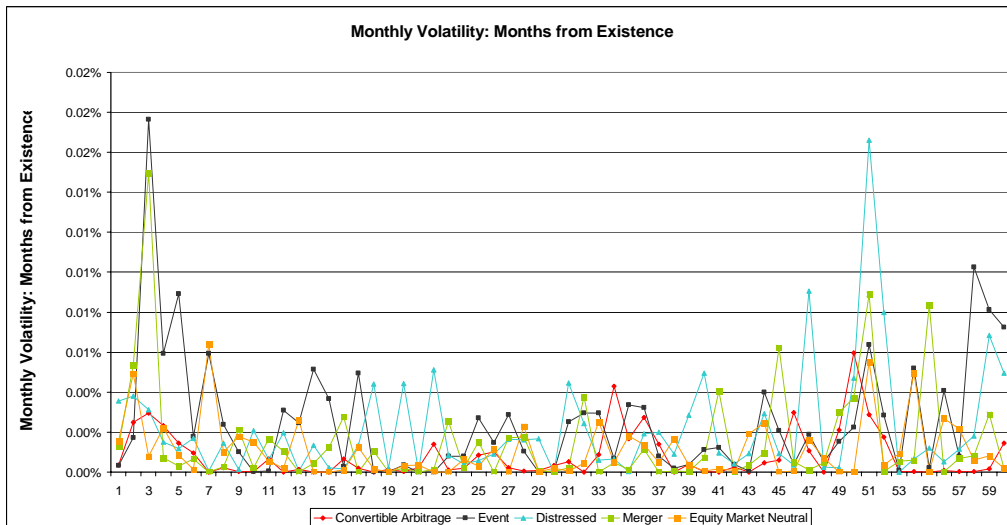


Exhibit 3c



V. Summary

Within the past decade, the number of hedge funds has grown dramatically. Today there are an estimated six thousand hedge funds with many new funds beginning operations each year. The continued growth of the hedge fund area requires a constant influx of new funds and fund managers. The question remains,

however, as to the degree that these new managers/funds perform differently from established managers/funds. In this article, we compare the characteristics of new funds with those of more established funds. Results show that while the return performance of new funds may be greater than older funds, relative return differences decline over time.

Selected References

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