Unobserved Performance of Hedge Funds

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12.25.2024

1 Research questions

How does the unobserved performance (UP) of hedge funds predict future hedge fund performance?

2 Why are the research questions interesting?

• Identifying truly skilled fund managers and reliably predicting their future performance has been a challenge.
• The existing methods based on return data or position data have their limitations:
  - The return based approach may not fully capture the skills of fund managers.
  - Position based method is limited by disclosure requirements (only analyze long-term equity positions).
• UP is a novel method that combines return based and position based methods, providing a new perspective.

3 What is the paper's contribution?

***(1)* Literature on hedge fund performance and investment strategies**

Previous: Explored hedge fund performance using two distinct approaches: returns-based and holdings-based.
  - Returns-based investigate relation between funds' reported returns and different risk factors.
  - Holdings-based approaches analyze funds' long equity positions disclosed to the SEC.

This: UP as a new method combines info from both returns-based and position-based method (and beats both).
• Provided new evidence on interaction between managerial skills, performance predictability, and investor traffic.

4 What hypotheses are tested in the paper?

H1: Hedge funds with high UP outperform those with low UP on a risk-adjusted basis.
H2: UP is negatively associated with a firm's trading costs and positively associated with trading activities.

a) Do these hypotheses follow from and answer the research questions?
• Yes, these hypo proposed testable predictions about the relationship between UP and hedge fund performance.

Do these hypotheses follow from theory or are they otherwise adequately developed?
• Hypos are based on frameworks(Berk 2004) regarding equilibrium process in manager ability signals.
• If UP captures managerial skill that is not reflected, funds with higher UP exhibit superior performance.

5 Sample: comment on the appropriateness of sample selection procedures.

Sample is filtered for funds with sufficient return obs and excludes funds denominated in non-U.S. dollars.

6 Dependent and independent variables: comment on the appropriateness.

Independent variables are well-defined and measured, allowing for a rigorous test of the hypotheses.

7 Regression model specification: comment on the appropriateness.

Nine-factor model ensures that the UP measure isolates managerial skill from other risk factors.

8 What difficulties arise in drawing inferences from the empirical work?

Investor reaction to UP is slow, which could affect the persistence of performance predictability.

9 Describe at least one publishable and feasible extension of this research.

Exploring the role of UP in different market conditions or across different types of hedge fund strategies.