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New EDHEC-Risk Institute research provides a suggestion for remedying the overstated performance of non-investable hedge fund indices

The biases that inflate the performance of hedge funds have been well documented in the financial literature. Survivorship bias, which results from the *ex-post* exclusion of unsuccessful funds from databases, and backfill or instant history bias, which occurs when the historical performance of a successful fund is retroactively added (backfilled) into the database, distort the performance of the hedge fund industry. These biases tend to inflate the returns posted by non-investable hedge fund indices. Investable hedge fund indices can help investors mitigate the effects of these biases, but investable indices cannot include all existing funds. The number of underlying funds is often twenty times less than that of non-investable indices. In these conditions, investable indices are naturally less representative than non-investable indices. Consequently, it is hardly surprising that investable indices tend to underperform their non-investable versions.

In a new study entitled "**A Suggestion for Remedying the Overstated Performance of Non-Investable Hedge Fund Indices**," EDHEC-Risk Institute examines whether the liquidity crisis that followed the Lehman collapse and significantly impacted the performance of hedge fund strategies (especially the strategies exposed to credit risk) has increased this excess return or not. The study compares the excess returns of non-investable indices and those of their investable counterparts before and after 2008.

The results show a striking contrast between liquid and illiquid strategies. For the latter, the significant increase in the excess returns of the non-investable indices during the second period perfectly coincided with the global credit crunch. By contrast, the most liquid strategies saw the excess returns of the non-investable indices decrease over the second period. By comparison with the upward trend characterising illiquid strategies, however, this downward trend is negligible.

The performance of multistrategy indices whose portfolios included illiquid (or less liquid) strategies was extraordinarily overstated after mid-2008. For example, the annualised performance of the HFRI EWS index was flat from January 2008 to January 2010 even though that of the investable index was down 635 basis points!

In the study, EDHEC-Risk Institute suggests a practical and easy-to-implement solution that could substantially reduce the biases that overstate the performance of non-investable indices, especially in periods of market stress. The solution involves a useful strategy by strategy adjustment between the non-investable EDHEC Alternative Indices and their investable equivalents. The model consists of regressing the returns of the non-investable EDHEC-Risk Alternative Index on the returns of the corresponding investable indices. The fraction of variance explained by the non-linear models varies from 43% to 82%.

A copy of the study can be downloaded via the following link:

EDHEC-Risk Publication Suggestion for Remedying the Overstated Performance of Non-Investable Hedge Fund Indices

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About EDHEC-Risk Institute

EDHEC-Risk Institute is part of EDHEC Business School, one of Europe's leading business schools and a member of the select group of academic institutions worldwide to have earned the triple crown of international accreditations (AACSB, EQUIS, Association of MBAs). Established in 2001, EDHEC-Risk Institute has become the premier European centre for financial research and its applications to the industry. In partnership with large financial institutions, its team of 56 permanent professors, engineers and support staff implements six research programmes and eleven research chairs focusing on asset allocation and risk management in the traditional and alternative investment universes. The results of the research programmes and chairs are disseminated through the three EDHEC-Risk Institute locations in London, Nice and Singapore.

EDHEC-Risk Institute validates the academic quality of its output through publications in leading scholarly journals, implements a multifaceted communications policy to inform investors and asset managers on state-of-the-art concepts and techniques, and forms business partnerships to launch innovative products. Its executive education arm helps professionals to upgrade their skills with advanced risk and investment management seminars and degree courses, including the EDHEC-Risk Institute PhD in Finance.

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