



THEORY OF FINANCE – PART 1

Mock Question 5 (1 point) Time Advised: 7 minutes (for this questions) Difficulty Level: EASY

Question 5 (1 point)

Discuss the key differences in terms of strategies and performances between classical mutual funds and hedge funds.

Debriefing.

Are HFs Just Glorified Mutual Funds?

- Although HFs and MFs are both investment vehicles, the trading strategies they employ are very different
- Vs. MFs, HFs employ more dynamic strategies, typically take both long and short positions, and often purchase illiquid assets**
- Until 1997, the tax code made short sales extremely expensive for mutual funds, but it no longer does
- The binding short-sale restriction for MFs is a restriction that funds select—in 2000, 2/3 of reporting MFs prohibited short sales (see Almazan, Brown, Carlson, and Chapman, 2004, JFE).
- The literature has generally found that hedge funds have higher risk-adjusted performance and bear higher risk** (Ackermann, McEnally, and Ravenscraft, 1999, JF; Liang, 1999, FAJ)
- Agarwal and Naik (2000, JAI) find that a ptf comprising of passive asset classes and investment in mainly nondirectional HFs, provides better risk-return tradeoff than just investing passively in equities, bonds, currencies, and commodities

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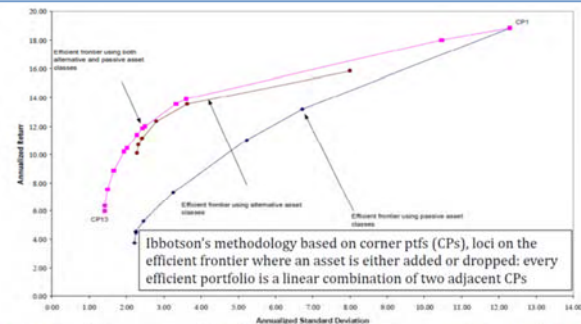
Are HFs Just Glorified Mutual Funds?

- Although HMFs use strategies similar to those of HFs, they underperform by about 3.3% per year after accounting for fees and risk
 - HMFs outperform traditional MFs
- Stulz (2007, JEP) points out that several industry trends will likely cause HFs to more closely resemble and converge to MFs:
 - Increased belief they take too much risk or that their actions destabilize financial markets may result in increased regulation
 - Because HFs' clientele shifted from primarily high net worth individuals to institutional investors, their risk taking may decrease in the face of monitoring by these institutions fulfilling fiduciary duties
- Ackermann, McEnally, and Ravenscraft (1999, JF) use Sharpe ratios and find **mixed evidence of hedge funds outperforming primary asset classes such as stock and bond indices**
- Recently, Bali, Brown, and Demirtas (2013, MS) revisit this issue by addressing the documented limitations of Sharpe ratio

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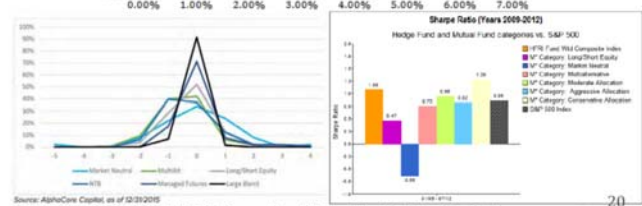
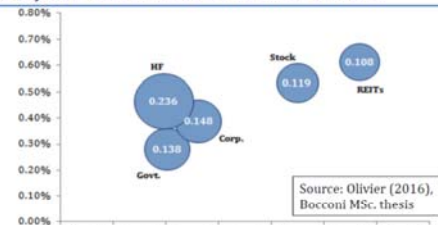


- Agarwal, Boyson, and Naik (2011, JFQA) compare HFs, traditional MFs, and what they refer to as "hedged mutual funds" (HMFs)
 - MFs that employ HF-like strategies but lack the incentive structure and regulatory freedom available to their HF counterparts

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Are HFs Just Glorified Mutual Funds?

- HF payoffs are nonlinear due to dynamic option-like strategies
- This can potentially lead to non-normality of fund returns, making Sharpe ratio a less appropriate measure of HF performance
- Standard deviation and historical beta measures can be misleading because the strategies listed frequently display decidedly non-normal return distributions

Index	Mean	St. Dev.	Skewness	Excess Kurtosis	Correl. w/ Russell 1000
Hedge Fund	0.48	2.06	-0.30	2.88	0.59
Convertible Arbitrage	0.37	1.89	-2.64	17.39	0.38
Dedicated Short Bias	-0.60	4.71	0.72	1.59	-0.79
Emerging Markets	0.44	4.07	-0.85	5.94	0.55
Equity Market Neutral	0.22	2.80	-12.50	181.20	0.30
Event Driven	0.53	1.76	-2.24	11.65	0.65
Fixed Income Arbitrage	0.23	1.57	-4.47	32.93	0.34
Global Macro	0.68	2.64	-0.06	4.53	0.24
Long/Short Equity	0.56	2.73	-0.11	3.63	0.70
Managed Futures	0.26	3.31	0.00	-0.01	-0.08

O'Doherty, M. S., Savin, N. E., & Tiwari, A. (2016). Hedge Fund Replication: A Model Combination Approach. *Review of Finance*, 21(4), 1767-1804.

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