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The True Reason Hedge Funds Performed so Poorly in 2008

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Hedge funds are often sold as a great diversifier to any asset mix due to their low correlation to traditional asset classes. 2008 was one of the worst years for equity markets, yet hedge funds did not provide the diversification benefit that was expected of them. What happened?

First, the numbers. In 2008, the S&P500 returned -37%. The HFRX Global Hedge Fund Index returned -23.25%, and the Credit Suisse/Tremont Hedge Fund Index returned -19.07%.

While all sorts of theories have been offered from a liquidity crisis to a breakdown of strategies, the true answer is poor risk controls and greed.

Alpha with some beta

Most hedge fund strategies have some surprisingly significant exposure to the markets. In a short paper in Canadian Investment Review in 2004, I referred to research by Cliff Asness & al which showed that the aggregate hedge fund had a beta of 0.37. Hedge funds are often sold as having low correlation to the equity markets. There is a simple mathematical relationship between beta and correlation with the market. The only way to have no correlation to the market is to have a zero beta!

Assuming that the aggregate beta is still close to 0.37 today, and since the S&P500 had a return of -37% in 2008, we can estimate the impact of such market exposure for the aggregate hedge fund, independent of the alpha skills of managers, to 0.37 x -37% = -13.7%

Beta underestimated

We also know that standard risk measures like beta, volatility and correlation are underestimated when assets do not trade continuously. This effect is well documented in academic literature under the non-synchronous trading effect, and is present in less liquid assets such as smaller cap stocks and hedge funds trading in them. The impact is dramatic.

Fortunately, there is a statistical way of correcting for such underestimation. In

Asness' study, it was shown that the beta of the aggregate hedge fund, adjusted for this effect, was 0.84. Therefore, the corrected estimate of the impact of the market exposure in the aggregate hedge fund index is not -13.7% as previously estimated but rather 0.84 x -37% = -31%!

Greed

Since the aggregate hedge fund returns were much higher than that, it means that hedge fund managers may have delivered very significant alphas. Unfortunately, they lost it all, and more, due to their (beta) market exposure.

Since investors pay a performance fee of 20%, and since equity markets return 8%-10% in the long run, hedge fund managers are tempted to add some beta in their strategies. However, this means investors pay performance fees on market returns. It also means that when market returns are the worst in history, hedge fund returns follow suit. The greed of hedge fund managers—through significant beta—is responsible for the extreme underperformance in 2008. The hedge fund community missed a great opportunity to show the usefulness of hedge funds in down markets.

In my 2004 paper, I highlighted the fact that two strategies had an adjusted beta close to neutrality: equity market neutral and managed futures. It is not surprising that these two categories were among the best performing hedge fund strategies in 2008.

This is very sad for the hedge fund industry. Hedge fund managers and particularly fund of funds managers could have done it right. While some hedge fund strategies inherently come with market exposure, fund of fund managers can assemble a diversified group of hedge funds which will exhibit very low correlation to the markets.

As long as investors pay performance fees on the beta component of return, greed will continue to incite managers to include market exposures in their products. Many hedge fund strategies can have zero beta if properly managed. 2008 hedge fund returns were generally highly negative because greed led most hedge fund managers to have significant market exposure (beta) in their portfolios.

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