Hedge Fund Alpha: Cycle or Sunset?

Stockholm (HedgeNordic) – Fresh research confirms that hedge funds have been struggling to deliver alpha since the global financial crisis of 2008. According to a study by Rodney Sullivan from the University of Virginia's Darden School of Business, in the decade following the financial crisis, the average hedge fund delivered negative alpha of 0.8 percent per year after fees and costs.

The study titled "Hedge Fund Alpha: Cycle or Sunset?" was conducted by Rodney Sullivan, executive director of Darden's Richard A. Mayo Center for Asset Management and a former vice president at AQR Capital Management. The research shows that in the 15 years leading up to 2008, the average hedge fund manager delivered 3.4 percent in net risk-adjusted returns, or alpha, on average after adjusting for passive exposure to both traditional markets and other risk premia. As mentioned above, hedge funds suffered a significant decline in risk-adjusted excess returns in the ten years following the financial crisis. Sullivan finds similar results when focusing on equity hedge funds.

"Criticism of hedge fund performance most often compares them incorrectly against an all- equity benchmark," writes Sullivan. "Even though reports pointing to poor hedge fund performance often incorrectly compare them to an all-equity benchmark, as we've seen, the more accurate market-risk-adjusted performance of hedge fund managers as a group over the past ten years is also clearly not good (comparing hedge funds to 100 percent equity makes their performance, of course, appear much worse)," he concludes. "This has led some to question whether hedge fund alpha, after ten years of low to no alpha, has disappeared altogether."

Hedge Funds Taking Less Active Risk

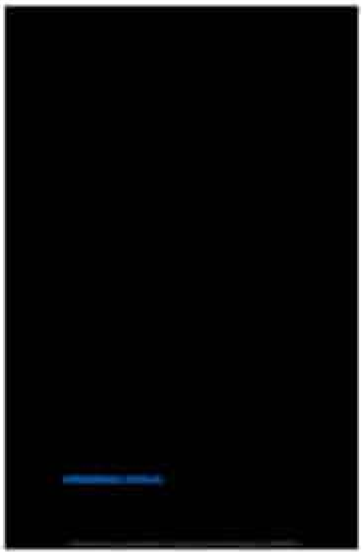
To understand the source of the change in hedge fund performance, Sullivan decomposes returns into various components driven by exposures to traditional market risk, other non-traditional factor premia and alpha – the part that cannot be explained by risk premia. The study finds that in the years following the financial crisis hedge fund managers as a group "have maintained a relatively consistent exposure to market risks, reduced active risk and exposures to many systematic research factors (and in some cases, reversed their exposures), and have added little to no idiosyncratic alpha."

Sullivan's findings reveal that hedge funds have been taking less active risk relative to the pre-crisis period, which implies a closer resemblance between hedge fund portfolios and passive benchmarks. Sullivan points out several possibilities that explain why hedge funds meaningfully reduced their active risk in the post-financial crisis period. One possibility is the steady growth of the hedge fund industry and the expanding manager universe, which has resulted in "greater diversification across a wider array of managers." According to Sullivan, "adding managers with uncorrelated idiosyncratic returns could drive active risk lower."

"Another possibility for the decline in active risk is that hedge funds identified fewer alpha opportunities in the post-GFC period," writes Sullivan. "There would be little reason for a manager to take active risk absent the concomitant benefit of active return, so both active risk and active return decline," he explains.

Sullivan also speculates that the clients of hedge funds might have sought lower active risk from their active managers after the financial crisis and asset managers obliged. "This possibility could be due to asset owners being stung by the market turbulence associated with the GFC and so desired less active risk taking on the part of their managers. Alternatively, a lower desired active risk could be a result of the demands of changing clientele.”

The study “Hedge Fund Alpha: Cycle or Sunset?” can be downloaded below:



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