The peer performance of hedge funds☆

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Abstract

The industry standard to measure the peer performance of investment funds is to rank the funds based on their risk–adjusted performance and conclude that the fund outperforms the peers with a worse ranking. When all funds perform equally well, this rate of out–performance is a random number between zero and one, depending on how lucky the fund is. We avoid this pitfall and introduce peer performance ratios that account for the uncertainty in estimating the performance differential of two funds. In the application to hedge funds, we find that the percentile–rank analyses of peer performance tend to be too optimistic about the out–performance of the funds with a relatively higher ranking. Fund size tends to decrease the out–performance ratio and increase the under–performance ratio, but the effect on the under–performance ratio is smaller for funds with a longer track record. Consistent with the adaptive market hypothesis, we find that hedge funds with an improved peer performance tend to have higher short–term returns.

Keywords: Adaptive market hypothesis, career hypothesis, hedge fund, life–cycle theory, peer performance ratio, performance measurement

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