A Risk-Adjusted Performance Evaluation Of US And EU Hedge Funds And Associated Equity Markets Over The 2007-2009 Financial Crisis

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ABSTRACT

Hedge funds are considered to be market-neutral due to their unrestricted investment flexibility and more efficient market timing abilities (Ennis & Sebastian, 2003). They may also be considered as suitably unconventional assets for improving portfolio diversification (Lamm, 1999). The evidence from this study confirms the dominance of hedge funds over the CAC 40, DAX, S&P 500 and Dow Jones from 2004 to 2011. Overall, the Sharpe, Sortino, Omega, Jensen's alpha, Treynor and Calmar ratios illustrate that US hedge funds outperformed both EU hedge funds and the associated equity markets over this period. Evidence was also found that both US and EU hedge funds were more correlated with the S&P 500 and Dow Jones after the financial crisis of 2007-2009 than before the crisis.

Keywords: Hedge Funds; Omega.

1. INTRODUCTION

Hedge funds are defined as pooled investment vehicles that embody a variation of different investment strategies, which can include short and long positions, leveraged positions, and derivate positions to limit market exposure and to increase risk-adjusted returns (Amin & Kat, 2003; National Treasury, 2012). With no investment constraints, a hedge fund manager is capable of investing in any global market to maximise a fund's financial gains (Kanellakos, 2005). This implies that the different investment strategies available can satisfy a variation of investors with different risk preferences (Shin, 2012). As such, hedge funds are considered unconventional assets that contribute to a higher reward level, which can serve as a substitute for cash and bonds during a declining equity market (Lamm, 1999).

However, the certainty of performance persistence has been diluted by the many conflicting results found by past studies. On the one hand the proponents of hedge funds argue that their low correlation with the returns on traditional alternative assets, like currencies, bonds, mutual funds and other equities, therefore, make them a better risk-return trade-off vehicle (Fung & Hsieh, 1997; Lavino, 2000; Amin & Kat, 2003; Al-Sharkas, 2005). This low correlation with the rest of the asset universe is further enhanced because of their exemption from the Company Act of 1940 and from the Security Exchange Act of 1934, providing them greater flexibility regarding different investment options.

It is also argued that hedge funds generate positive alphas, which implies that hedge fund managers as a group have an investment ability and may possess private information that is unavailable to other investors (Li, 2006), thus emphasising the potential dominance of hedge funds. Also, with the possibility of implementing features, like lock up periods, redemption frequencies and notices, share restrictions and minimum investment

