

Hedge fund pricing and model uncertainty

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Abstract

This article uses Bayesian model averaging to study model uncertainty in hedge fund pricing. We show how to incorporate heteroscedasticity, thus, we develop a framework that jointly accounts for model uncertainty and heteroscedasticity. Relevant risk factors are identified and compared with those selected through standard model selection techniques. The analysis reveals that a model selection strategy that accounts for model uncertainty in hedge fund pricing regressions can be superior in estimation/inference. We explore potential impacts of our approach by analysing individual funds and show that they can be economically important.

JJEL classification: G11; G12; C11

Keywords: Model uncertainty; Hedge funds; GARCH; Bayesian model averaging; MCMC.

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