Why Multi-Strategy Funds Outperform Fund of Hedge Funds

05/09/07

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In what is believed to be the first study ever to compare performance of multistrategy hedge funds with funds of hedge funds, two **Georgia State University** professors conclude that multistrategies' consistently better performance can be boiled down to this: self-selection. Their study, to be published in the *Journal of Investment Management*, found that between 1994 and 2004, MS funds outperformed FoHFs on a risk-adjusted basis by 2.6% to 4.8% per year net-of-fees, and 3% to 4.1% per year on a gross-of-fee basis. MS funds' "superior performance," write Professors **Vikas Agarwal** and **Jayant Kale**, "continues to hold even when we control for fund characteristic such as size, management and incentives fees, and other conventional control variables." The key difference may be in the quality of the HF managers, as they note that "self-selection" –meaning hedgies decide on their own to become MS managers – is "the driving force behind superior performance." This suggests, write Agarwal and Kale, that "MS fund managers may possess superior abilities compared" to funds of hedge funds...One can think of MS fund managers [as] having greater timing and ability in allocating capital across different hedge fund strategies." The authors note that the relatively few number of multistrategy funds is evidence of "a limited supply of better ability managers." The study points to strong evidence that MS managers evolved from "poor performing single-strategy funds, in particular, convertible arbitrage funds." And while not all those from failing conv arb funds become successful MS fund managers, those who did "believed/knew that their abilities were superior or more transferable across strategies."