Unobserved Performance of Hedge Funds

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Abstract

We investigate hedge funds’ unobserved performance (UP), measured as the risk-adjusted return difference between a fund firm’s reported return and the hypothetical portfolio return derived from its disclosed long equity holdings. We find that high UP is (i) positively associated with measures of managerial incentives, discretion, and skill, and (ii) driven by a fund firm’s frequent trading in equity positions, derivatives usage, short selling, and confidential holdings. Fund firms with high UP outperform fund firms with low UP by more than 6% p.a. after accounting for typical hedge fund risk factors and fund characteristics.

Keywords: Confidential Holdings, Derivative Usage, Discretion, Frequent Trading, Hedge Funds, Managerial Incentives, Short Selling, Unobserved Performance

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