

MEMO# 16258

July 2, 2003

INSTITUTE MEMORANDUM REGARDING SHORTCOMINGS IN HEDGE FUND PERFORMANCE MEASURES

[16258] July 2, 2003 TO: BOARD OF GOVERNORS No. 33-03 PUBLIC INFORMATION COMMITTEE No. 21-03 SEC RULES MEMBERS No. 84-03 RE: INSTITUTE MEMORANDUM REGARDING SHORTCOMINGS IN HEDGE FUND PERFORMANCE MEASURES The Securities and Exchange Commission recently solicited comments with respect to its review of the hedge fund industry. 1 In response, the Institute filed the attached memorandum prepared by two of the Institute's senior economists addressing a topic discussed at the SEC's recent roundtable on hedge funds: the reported performance of hedge funds compared to diversified equity mutual funds and the possibility of making private, unregulated hedge funds publicly available to average investors. The memorandum is summarized below. The memorandum points out that many recent reports about hedge fund performance statistics substantially overstate hedge funds' actual performance. In particular, many discussions about average hedge fund returns are based on hedge fund indexes with significant biases. These indexes exhibit upward performance biases while exhibiting downward biases with respect to risk measurements. The memorandum explains that hedge fund indexes used to compute total return and other performance statistics contain biases because these indexes are not representative of the universe of hedge funds. In fact, no universal database exists that contains the records of all hedge funds, both those currently operating and those that have ceased operating. Instead of a universal database, several commercial databases are available that contain subsets of the universe of hedge funds. It is quite likely that these database indexes overstate the performance of hedge funds generally because they do not contain a random sample from the hedge fund population but instead tend to contain better performing funds, as poorly performing funds have little incentive to report to the data services. The memorandum states that, with respect to risk measurements, several researchers have concluded that hedge fund strategies appear to be one situation in which the use of standard deviation, the most commonly used measure of investment risk, is not appropriate. Because hedge funds do not have bell-shaped normal distributions, hedge funds are more likely 1 SEC Press Rel. No. 64 (May 22, 2003). 2 to have larger losses than would be indicated by the standard deviation of those returns. If relied on to measure hedge fund risk, standard deviation will typically significantly understate the actual degree of risk. The memorandum concludes that hedge funds are significantly more risky than is commonly portrayed. Investing in hedge funds is a complicated task that requires financial acumen and advanced analytical tools that are typically beyond the reach of individual investors. Therefore, given the current state of knowledge, hedge funds or hedge fund investment strategies would not seem to be warranted for average individual investors. Dorothy M. Donohue Associate Counsel Attachment Note: Not all recipients

receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 16258, or call the ICI Library at (202) 326-8304 and request the attachment for memo 16258. Attachment (in .pdf format)

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