The Economist

Hedge funds
Trimmed hedges

Best not rely too much on that glowing track record

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INVESTORS are perennially warned that a fund's past performance is no guarantee of future returns. This is little use to those keen to invest in hedge funds, which seldom disclose more than their track records. A new study finds that even those should be taken with a pinch of salt: hedge funds routinely revise their performance data, often in ways that seem designed to fool outsiders.

Academics at the Oxford-Man Institute of Quantitative Finance tracked (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934543) the monthly submissions of 12,128 funds to industry databases between 2007 and 2011, and found that just under half the managers subsequently modified their data. Some tweaks are tiny but many are material: around 30% of managers revised past figures by 0.5% or more, roughly equivalent to a month's returns.

Some revisions may be down to cock-up but a closer look hints at conspiracy. Counter-intuitively, most fixes aim to make performance look worse than originally stated. That is probably because two-thirds of funds charge performance fees only if they are at or above their highest valuations. Eager to bring forward the time when they can charge fees again, such managers have an incentive to belittle past returns. Indeed they are the most avid revisers, knocking an average 0.62% off the numbers.

In contrast, funds with no need to beat past high-water marks typically inflated their first submissions by 0.4%, making them look more successful to prospective backers. The suspicion is that managers are either making phoney corrections, or pushing through legitimate corrections only when it helps.

Regardless of whether a fund revises figures up or down, it is probably best avoided. Investors who systematically sold out of hedge funds immediately after they first adjusted their results outperformed those that did not by a hefty 3.3% a year.

Might mandatory disclosures by hedge funds be the solution? These are timidly being introduced for large American managers, though only regulators will get a peek. Hedge funds lobbied against the change, worried that disclosing trading secrets would be akin to Coca-Cola giving away its recipe. But a study (http://www.cfapubs.org/doi/pdf/10.2469/faj.v68.n2.1) in the *Financial Analysts Journal* suggests their fears are over-egged. It compares the performance of secretive hedge funds with those that give clients full disclosure, by holding their securities in segregated "managed accounts". Managers who offered transparency achieved slightly higher returns. Better still, the hedgies won't be able to adjust their own performance later on.

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