The Journal of Alternative Investments

VOLUME 12 NUMBER 2 FALL 2009

First the good news: Since the last issue the world has not fallen apart. Markets have stabilized, and thoughtful reflection has returned to the investment world. Here is the bad news: Most of the issues and concerns that existed before the recent market crisis still remain. These include many of the factors that led to the crisis. Prominent among many of the concerns that have been raised during the past months has been the role of compensation as a potential driver in financial decisions. The lead section of this issue features an article on hedge fund fee structures. The ideal fee structure aligns the incentives of the investor with those of the fund manager. Mutual funds typically only charge a management fee that is a portion of the funds under management. Hedge funds, on the other hand, generally charge an incentive fee that is a fraction of the fund's return each year in excess of the high-water mark. The justification generally given for these incentive fees is that they provide the manager with the incentive to target absolute returns. As these incentive fees can be considered a call option on the performance of the fund, it is possible that the managers' incentives might vary according to the delta of this option. A number of researchers, with seemingly conflicting results, have used theoretical frameworks to investigate the optimal investment strategies of money managers in the presence of incentive fees. In the first article of this issue, "Locking in the Profits or Putting It All on Black? An Empirical Investigation into the Risk-Taking Behavior of Hedge Fund Managers," Andrew Clare and Nick Motson examine the risk-taking behavior of hedge fund managers in response to both their past returns relative to their high-water mark and their past returns relative to their peer group. They attempt to reconcile their results with the theoretical frameworks proposed.

Concerns have also been raised over what investors know and whether they have been well served by the financial industry in obtaining that knowledge. The next section features articles on hedge fund data and analytics. The accuracy of hedge fund return data is taken for granted in most empirical studies. In the second article, "Measuring the Quality of Hedge Fund Data," Daniel Straumann discusses the quality of hedge fund databases with a particular emphasis on the practical limitations of hedge fund data and devises a tool for the quantification of financial data quality. He shows that hedge fund return time series often exhibit peculiar and most likely "man-made" patterns and develops a statistical testing methodology that can detect these patterns. Based on these tests, Straumann devises and empirically studies a data quality score for rating hedge funds and, more generally, hedge fund databases. In a final step, he attempts to estimate the impact of imperfect data on performance measurement by defining a "data quality bias." In the third article, "Measuring Funds of Hedge Funds Performance using Quantile Regressions: Do Experience and Size Matter?," Roland Füss, Dieter G. Kaiser, and Anthony Strittmatter use quantile regression to analyze the impact of experience and size of funds of hedge funds (FHFs) on performance. Compared to OLS regression, quantile regression provides a more detailed picture of the influence of size and experience on FHF return patterns. Hence, it allows one to study the relevance of these factors for various return and risk levels instead of average return and risk, as is the case with OLS regression. The empirical results suggest that experience and size have a negative effect on performance, with a positive curvature at the higher quantiles. At the lower quantiles, however, size has a positive effect with a negative curvature. Both factors show no significant effect at the median.

At the forefront of concerns driven by the recent market crisis is the issue of risk management and the use of various exchange-driven tools available to help investors better understand market dynamics as well as manage its risk. The third section of this issue features articles on the VIX. In the fourth article, "Is the VIX Futures Market Able to Predict the VIX Index? A Test of the Expectation Hypothesis," Marcus Nossman and Anders Wilhelmsson test the expectation hypothesis by using the VIX volatility index and futures contracts written on that index. Because the VIX is negatively correlated with S&P 500 Index returns the VIX futures price should contain a negative risk premium, which is confirmed in this study. When the futures price is not adjusted with the risk premium, the expectation hypothesis is rejected at the 5% significance level for 20 of 21 forecast horizons. However when the futures price is adjusted with the risk premium, obtained from a stochastic volatility model, the expectation hypothesis cannot be rejected. Furthermore, the results show that the risk premium adjusted futures price forecasts the direction of the VIX index well. The one-day-ahead forecast predicts the direction correctly 73% of the time. In the fifth article, "VIX Futures and Options: A Case Study of Portfolio Diversification during the 2008 Financial Crisis," Edward Szado assesses the impact of a long VIX investment as a diversifier for a typical institutional investment portfolio during the 2008 credit crisis.

The final section features a perspective article. There has been much discussion of the potential clawback liability of investors who withdrew money from Bernard L. Madoff Investment Securities (BMIS) accounts. Counsel for Irving Picard, the court-appointed trustee in the BMIS liquidation proceeding, stated that Picard will pursue clawbacks against investors who withdrew fictitious profits "in substantial dollar amounts over the course of many years." However, in the first formal request letters sent to 223 investors in the week ending April 22, 2009, Picard reportedly requested the return of all redemptions made by these investors within six years of December 2008, rather than just redemptions of "profits." He may also pursue clawbacks against individual investors in feeder funds. In the sixth article, "Clawbacks from Madoff Investors: Questions of Economics, Equity, and Law," Paul Hinton and Jan Larsen with Joshua M. Bennett anticipate and discuss several questions that will be among the issues litigated in the context of clawback actions.

As we recover from the recent market crisis, new theories and practical approaches to better prepare ourselves for the future will be presented. *The Journal of Alternative Investments* remains committed to providing an avenue for the best of those ideas. We look forward to presenting you those ideas and to your comments on how best to serve you in the future.

Thomas Schneeweis
Editor