DAVID CHUI
The Hang Seng University of Hong Kong, Hong Kong

IS SIMPLICITY THE BEST HEDGE FUND INVESTMENT STRATEGY?

Abstract:

This paper introduces a new hedge fund investment strategy based on the selection of: (1) the asset (Asset A) with the highest mean, (2) the asset (Asset B) that stochastically dominates many other assets, and (3) the asset (Asset C) with the smallest standard deviation to form the investment portfolio in the efficient frontier. This proposed strategy simply came from a simple intuitive wisdom that choosing the best of all three Assets (A, B, C) would intuitively yield a superior return than a portfolio with any one or two of the Assets.

To test if the conjectures hold, the test will use both mean-variance and stochastic dominance (SD) approaches to examine the performance of the proposed investment portfolio formed by using all-inclusive hedge funds from emerging and developed markets against (a) portfolios formed with any one or two of the three Assets and (b) the naïve 1/N portfolio in this paper.

The paper shows that the proposed new investment strategy has a superior performance through the testing of the conjectures that investors should include any one or two or three of Assets A, B, and C. Specifically, the testing outcome shows that most of the portfolios with the combination of Assets A, B, and C stochastically dominate the corresponding portfolios without any one, two, or all three of Assets A, B,C, and furthermore dominate most, if not all, of the individual assets and the naïve 1/N portfolio.

This outcome implies the existence of arbitrage opportunities and the market is inefficient. The finding has also confirmed the proposed new hedge fund investment strategy formed by combining Assets A, B, and C in the portfolio is the best strategy with the highest expected wealth and the highest expected utility among all the other strategies used in this paper. These findings contribute to the literature of hedge funds and the reliability of alternative risk frameworks in the evaluation. Furthermore, the findings also provide practical experience to academics, fund managers, and investors on how to choose assets in their portfolio to get significantly higher expected utility.

Keywords:

Hedge fund strategies; Relative value; Equity hedge; T-Bill; Portfolio optimization; Stochastic dominance

JEL Classification: D81, G11, C01