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HEDGE FUND PREDICTABILITY AND OPTIMAL ASSET ALLOCATION

Abstract:

The degree of both return and volatility hedge fund predictability is revealed using a regime switching framework. Optimal combinations of regime switching model forecasts allow us to capture the stylized facts of hedge fund returns and construct superior hedge fund return forecasts in the presence of parameter instability and model uncertainty. Our dataset consists of individual hedge fund data from the Barclays hedge fund database for the period January 1994 to December 2013. Our extensive set of predictors contains the Fung and Hsieh factors, factors related to style investing and to investment policies, macro related / business indicators variables and market-oriented factors. The economic value of the proposed predictability models is investigated by studying its effects on asset allocation and active portfolio management.

Keywords:

Hedge fund predictability; regime switching model; asset allocation

JEL Classification: C53, G11