L-Performance with an Application to Hedge Funds By Serge Darolles, Christian Gourieroux and Joann Jasiak

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General comments

- Very interesting approach to evaluate Hedge Funds' performance
- Uses performance measures based on Lmoments rather than on the standard Sharpe ratio
- Great advantage: provides more detailled information about the extremes (robust to outliers)

L-moments

- Summary statistics for probability distributions and data samples
- Analogous to ordinary moments (location, dispersion, skewness, kurtosis) but computed from linear combinations of the ordered data values

Advantages over ordinary moments

- Should provide better characterization of return distribution (especially if asymmetric)
- For L-moments of a probability distribution to be meaningfull, requires only that the distribution have finite mean (i.e. no high order moments need be finite)
- For SE of L-moments to be finite, requires only that the distribution have finite variance

Main results

- Sample of 36 HF from various categories
- Asymmetric returns
- Ranking appears quite stable across performance measures (10 out of 36 consistent with Sharpe performance measure)
- Departure distribution from symmetric distribution used as an indicator of data manipulation

Hedge Funds and investor risks

Liquidity risk	Limited ability to withdraw money at short notice, given that lengthy lock-up periods or other redemption constraints are in place.
Valuation risk	Although generally valuation of hedge fund assets is outsourced to administrators or prime brokers, the manager retains the final right to modify asset values and hedge fund performance may be misrepresented.
Human risk	The success of a hedge fund depends on key people managing it; the departure of certain managers may therefore adversely affect future performance.
Style drift risk	The risk that the manager may change or abandon the stated primary strategy or strategies without informing investors; the future risk-return profile, correlation with other asset classes may no longer suit the investor portfolio.
Size risk	Some strategies may no longer be viable when assets under management exceed a certain threshold.

Questions / Issues for discussion

Hedge Funds' Main features

Return objective	Positive absolute returns under all market conditions, without regard to a particular benchmark. Usually managers also commit their own money; therefore, the preservation of capital is very important.
Investment strategies	Position-taking in a wide range of markets.Free to choose various investment techniques, including short-selling, leverage and derivatives.
Incentivestructure	Typically 1-2% management fee and 15-25% performance fee. Quite often high watermarks apply (i.e. performance fees are paid only if cumulative performance recovers any past shortfalls) and/or a certain hurdle rate must be exceeded before managers may receive any incentive allocation.
Subscription/Withdrawal	Predefined schedule with quarterly or monthly subscription and redemption. Lock-up periods for up to one year until first redemption. Some hedge funds retain the right to suspend redemptions under exceptional circumstances.
Domicile	Offshore financial centres with low tax and regulatory regimes, and some other onshore financial centres.
Legal structure	Private investment partnership that provides pass-through tax treatment or offshore investment corporation. Master-feeder structure may be used for investors with different tax status, where investors choose appropriate onshore or offshore feeder funds pooled into a master fund.
Managers	May or may not be registered or regulated by financial supervisors. Managers serve as general partners in private partnership agreements.
Investor base	High net worth individuals and institutional investors. High minimum investment levels. Not widely available to the public. Securities issued take the form of private placements.
Regulation	Generally minimal or no regulatory oversight due to their offshore residence or "light touch" approach by onshore regulators; exempt from many investor protection and disclosure requirements.
Disclosure	Voluntary or very limited disclosure requirements in comparison with registered investment funds.

Weaknesses of L-moments

- The approach uses trimmed L-moments: therefore leads to withdraw the information stemming from extreme events (elaborate on parameter *r*)
- L-moment diagram (Figure 4) is not helpful to identify the most appropriate distribution (general tendency to accept a generalised extreme value distribution)

Hedge Funds' classification

