Hedge Fund Dispersion and Crowded Strategies

One way of measuring correlations between managers is to look at cross sectional standard deviations of returns, i.e. the dispersion of returns, between different hedge fund strategies.

Here is what raw dispersion looks like across the HFRI strategy indices:

Disperson is fairly stable in a range except for the 1999/200 equity bubble bursting and the 2008 cerdit crisis. The chart is distorted by overall high volatility across the industry. To get a better picture of dispersion it is necessary to adjust for the industry wide volatility.

Here is what adjusted dispersion looks like across the HFRI strategy indices:

Dispersion looks more stable now. There is still a spike in the credit crisis of 2008. This can be explained by a marked divergence between liquid and illiquid strategies.

A smoothing of the above series reveals a pattern similar to that often found in volatility series whether in credit, equities, commodities or FX. Just as volatility tends to spike and fade, there is a cyclicatility of dispersion that tends to spike and fade. This can be explained by how new strategies, which initially outperform and are also uncorrelated, are learnt and emulated by competition and quickly eventually become crowded.

I’ve extended this analysis to the subset of Asian managers represented by the Eurekahedge Indices.

Here is what adjusted dispersion looks like for Asia ex Japan strategies:

There doesn’t appear to be anything remarkable here. The market recovery in Asia seems to have been captured by most managers and strategies as dispersion fell throughout 2009. We see also how dispersion fell from 2003 once managers adjusted to the reality of a real recovery in Asia post SARS. What it seems to indicate is that for all the opportunities in Asia, Asia remains a very macro dominated market where managers struggle to differentiate themselves and decouple from market beta.

A remarkable chart is one of adjusted dispersion of Asia hedge funds including Japan.

Dispersion has been low since 2004. The dominance of Japan in this data set is indicative of Japanese hedge fund behavior. The herd mentality is high. Dispersions were low going into the bumper 2005 period, and remained low even as managers lost money the following year in a market cap mismatched bear market.

The low dispersion in hedge fund returns in the Japan inclusive sample mirrors the low dispersion of opinions and forecasts among Japan equity analysts.

The silver lining is that for the independent thinker, Japan is a great environment for differentiating oneself.