

# Portfolios of Hedge Funds What Investors Really Invest In

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## Abstract

Using monthly return data over the period June 1994 – May 2001 we investigate the performance of randomly selected baskets of hedge funds ranging in size from 1 to 20 funds. The analysis shows that increasing the number of funds can be expected to lead not only to a lower standard deviation but also, and less attractive, to lower skewness and increased correlation with the stock market. Most of the change occurs for relatively small portfolios. Holding more than 15 funds changes little. The population average appears to be a good approximation for the average basket of 15 or more funds. With 15 funds, however, there is still a substantial degree of variation in performance between baskets, which dissolves only slowly when the number of funds is increased. Survivorship bias is largely independent of portfolio size and thus cannot be diversified away. Finally,

our efficiency test indicates that one only needs to combine a small number of funds to obtain a substantially more efficient risk-return profile than that offered by the average individual hedge fund.

## Suggested Citation

Gaurav Amin & Harry. M Kat, 2002. "**Portfolios of Hedge Funds What Investors Really Invest In**," **ICMA Centre Discussion Papers in Finance** icma-dp2002-07, Henley Business School, Reading University.

Handle: *RePEc:rdg:icmadp:icma-dp2002-07*

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