Editorial

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During the past decade, the correlation among international stock markets has increased with investors flocking to seek shelter in alternative investments for downside equity risk management. Furthermore, with assets nearing the \$1.5 trillion mark and with approximately 8,000 hedge funds, they are solidifying their presence on world markets. Recent predictions state that in the not too distant future 80 to 90 per cent of hedge fund assets will originate from institutions. Such increased competition among hedge funds will further add pressure on them to produce even higher returns and turnover their portfolio positions at a faster rate. Investors are already witnessing this on the big board with the daily average number of shares being traded to the tune of almost \$2 billion.

Hedge funds are here to stay and play an important role in the proper functioning and balancing of world markets. Although plagued by the lack of transparency this is the price investors pay for managerial skill. In the recent speech by the Fed chairman in May 2006, Ben S. Bernanke saw that the effectiveness of the President's Working Group had been successful, with many hedge funds using less leverage than prior to LTCM days. Bernanke's suggestion of maintaining a database of hedge fund positions may very well make hedge funds a part of mainstream investments. The relevance of the papers for this special hedge fund issue to *Derivatives Use, Trading and Regulation* is in the

presentation of new research to gauge the performance of hedge funds, as well as examine the latest and cutting edge research in this area.

The lead paper by Lhabitant examines the topic of 'traditional' hedge fund indices, their construction approach, and the several biases affecting their performance. The author further discusses 'investable' hedge fund indices, frequently presented as an alternative to actively managed funds of hedge funds. The second paper by Kooli investigates hedge funds and funds of hedge funds using spanning tests. The third paper by Botteron explains why hedge funds have been misunderstood during the last years. It shows that the negative press against this industry was probably valid in the mid-1990s, though it is no longer the case nowadays.

The next paper, by Pochon and Teiletche, examines comparative VaR models applied to hedge funds, an area that has been neglected. The paper by Black uses current examples of hedge fund liquidations to demonstrate the market and operational risks of hedge fund investing. The sixth paper by Jones addresses the question of which hedge fund characteristics provide the best performance profile — large or small funds, new or older funds. The research lends substantial credence to conventional wisdom about the performance of smaller versus larger and younger versus older hedge funds. The last paper by Ali

focuses on a very interesting development in the hedge fund sector. Hedge funds have long been innovators in investment strategies and techniques. Yet in this case hedge funds have adopted the ethical investment

strategies that have been popularised by mutual funds.

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