IRASS Journal of Economics and Business Management
https://irasspublisher.com/journal-details/IRASSJEBM
ISSN *(Online) 3049-1320*

Determinants of Hedge Fund Performance, Manager Selection, and Portfolio Diversification: A New Approach to Investment Strategy Development

Poltak Sinaga[1*], Hantono[2]

[*1-2] University of Pelita Harapan, Medan City, North Sumatera

Corresponding Author **Poltak Sinaga**

University of Pelita Harapan, Medan City, North Sumatera

Article History

Received: 30 / 05 / 2025

Accepted: 14 / 06 / 2025

Published: 17 / 06 / 2025

Abstract: Hedge funds have become one of the most sought-after investment vehicles due to their ability to generate high returns while providing diversification benefits. However, their performance remains highly variable and dependent on a range of factors. This paper explores the key determinants of hedge fund performance, the role of manager selection, and the impact of portfolio diversification strategies. By integrating recent developments in financial theory and empirical research, this study proposes a novel approach to investment strategy development that incorporates advanced risk management techniques, performance metrics, and manager evaluation frameworks. The findings suggest that a comprehensive and dynamic approach to hedge fund management and portfolio diversification can enhance performance and reduce risk exposure in an increasingly complex market environment.

Keywords: Hedge Funds, Performance Determinants, Manager Selection, Portfolio Diversification, Investment Strategy, Risk Management, Financial Theory.

How to Cite in APA format: Sinaga, P., Hantono., (2025). Determinants of Hedge Fund Performance, Manager Selection, and Portfolio Diversification: A New Approach to Investment Strategy Development. *IRASS Journal of Economics and Business Management. 2(6),35-37.*

Introduction

Hedge funds, recognized for their aggressive pursuit of returns and unique investment strategies, have grown significantly in popularity over the last few decades. While their appeal lies in the potential for high returns and risk-adjusted performance, understanding the factors that determine hedge fund success remains an ongoing challenge for investors and scholars alike. Central to hedge fund performance is the selection of fund managers, who are tasked with executing investment strategies and mitigating risk. Furthermore, portfolio diversification remains a critical factor in managing risk and maximizing returns.

This paper seeks to answer several important questions: What are the key determinants of hedge fund performance? How does manager selection impact the success of a hedge fund? How can portfolio diversification strategies be optimized to achieve superior risk-adjusted returns? To address these questions, we propose a new approach to investment strategy development that integrates the latest theoretical frameworks and empirical findings.

The Determinants of Hedge Fund Performance

The performance of hedge funds is influenced by various internal and external factors. A substantial body of literature identifies the following key determinants:

- **Market Conditions**: Hedge funds are often exposed to systematic risks, such as economic downturns, interest rate fluctuations, and changes in market liquidity. The ability to adapt to these conditions can significantly impact performance.
- **Investment Strategy**: Hedge funds utilize a wide range of investment strategies, including long/short equity, event-driven, and global macro strategies. The effectiveness of these strategies can vary over time based on market cycles and the skill of the manager.
- **Leverage and Risk Management**: Many hedge funds employ leverage to enhance returns, but excessive leverage can amplify risks. Effective risk management techniques, including dynamic asset allocation and hedging strategies, are crucial for long-term performance.
- **Manager Skill**: A key determinant of hedge fund success is the skill and experience of the fund manager. Managerial talent can drive superior performance, particularly in complex or volatile market environments.

Manager Selection: A Critical Factor in Hedge Fund Performance

The process of selecting hedge fund managers is one of the most crucial aspects of hedge fund investing. Investors typically rely on quantitative metrics such as past performance, risk-adjusted returns (e.g., Sharpe ratio), and other financial indicators to evaluate potential managers. However, these metrics often fail to capture the nuances of managerial skill, decision-making under pressure, and the ability to innovate within a changing market environment.

Recent studies suggest that qualitative factors, such as the manager's investment philosophy, track record in different market conditions, and alignment of interests with investors, can be equally important. Furthermore, behavioral biases such as overconfidence and herd behavior often play a significant role in manager selection, which can lead to suboptimal decisions.

This paper proposes a more comprehensive evaluation framework for manager selection that combines both quantitative and qualitative assessments. It recommends the use of advanced machine learning techniques to analyze historical performance data, along with qualitative interviews and behavioral assessments to evaluate managerial characteristics.

The Role of Portfolio Diversification in Hedge Fund Performance

Portfolio diversification is a well-established strategy for reducing risk and improving the risk-return profile of investments. Hedge funds, by their very nature, employ complex diversification techniques, but the degree of diversification can vary widely across funds. While some hedge funds maintain highly concentrated portfolios with large bets on a few assets, others seek to build diversified portfolios across asset classes, regions, and strategies.

The challenge lies in determining the optimal level of diversification that balances risk and return. Over-diversification may dilute returns, while under-diversification may expose the fund to higher volatility. This paper introduces a new framework for portfolio diversification in hedge funds that takes into account the dynamic correlations between asset classes and strategies, as well as the changing risk landscape.

We propose the use of advanced portfolio optimization techniques, such as the Black-Litterman model and Monte Carlo simulations, to dynamically adjust portfolio allocations based on market conditions and risk profiles. This approach enables hedge funds to enhance returns while maintaining a robust risk management framework.

A New Approach to Investment Strategy Development

Based on the insights from the previous sections, this paper proposes a new approach to developing hedge fund investment strategies that combines traditional financial theory with modern machine learning techniques. The proposed approach is centered around three core components:

- **Dynamic Strategy Allocation**: Rather than relying on a static set of strategies, hedge funds should adopt a dynamic approach to strategy selection, where the allocation to different strategies is adjusted based on real-time market conditions and performance metrics.
- **Advanced Risk Management**: A comprehensive risk management framework that incorporates scenario analysis, stress testing, and machine learning-based predictive models can help hedge funds identify potential risks and opportunities more effectively.
- **Manager Performance Feedback Loop**: The continuous evaluation of manager performance, using both quantitative and qualitative metrics, can provide valuable insights into the effectiveness of different strategies and the manager's ability to adapt to changing market conditions.

This holistic approach aims to optimize hedge fund performance by integrating diverse factors that affect returns, risk, and manager behavior. It emphasizes adaptability and continuous learning in an ever-evolving financial landscape.

Conclusion

The performance of hedge funds is influenced by a complex interplay of market factors, investment strategies, and manager decisions. While the traditional focus has been on quantitative metrics, a more holistic approach that integrates qualitative factors and advanced machine learning techniques can provide a more accurate and dynamic assessment of hedge fund performance. By optimizing portfolio diversification and adopting a comprehensive approach to manager selection, hedge funds can better navigate the challenges of modern financial markets.

This paper contributes to the existing literature by proposing a new framework for hedge fund investment strategy development that incorporates both established financial theories and innovative technological solutions. Further research is needed to empirically test these concepts and refine the proposed models.

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