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PRACTITIONER'S DIGEST

The "Practitioner's Digest" emphasizes the practical significance of manuscripts featured in the "Insights" and "Articles" sections of the journal. Readers who are interested in extracting the practical value of an article, or who are simply looking for a summary, may look to this section.

WHAT CAUSED THE CURRENT FINANCIAL MESS AND WHAT CAN WE DO ABOUT IT? PAGE 4

John H. Boyd, Ravi Jagannathan and Sungkyu Kwak

This study reviews the causes and evolution of the financial crisis and surveys some of the recent literature on this topic. It documents how bank regulation became essentially ineffective due to the rise of "quasi-banks," that is, large financial intermediaries that perform banking functions but are not chartered or regulated as banks. Further, it shows that the problems in banking were primarily concentrated in very large banks, ones that were believed to be too big to fail (hereafter, TBTF) by the market. While we cannot "prove" that the TBTF policy caused the crisis, the data suggest it may have played a key role. The concluding section deals with policy prescriptions and is unabashedly judgmental, reflecting our views. It lays out our policy recommendations for regulatory reform, recent criticisms of those recommendations, and some counter-arguments.

THE 7 HABITS OF HIGHLY SUSPICIOUS HEDGE FUNDS PAGE 21

Richard Bookstaber

This article presents seven habits of highly suspicious hedge funds—seven warning signs that a hedge fund might be swinging for the fences and blind spots that could keep the investor from knowing when it does.

Underperforming hedge fund managers have incentives to take on outsized risk. If they keep with the status quo, they will see investors look elsewhere, while if they ratchet up the risk, they are the beneficiaries of the asymmetric win-loss distribution. At worst they are out of business—which they might be in any case if they do not increase their risk profile—while if things go well, they take a portion of the returns if they manage to pull their way out of the hole.

Of course, this behavior is not unique to hedge funds. It has played out in banks many times, and indeed any investment fund might face the same temptation. But hedge funds have more tools at their disposal to make good on the try. Hedge funds can lever, delve into wide-ranging and risky markets and readily employ the so-called innovative securities to increase risk in ways that are difficult to discern. And unlike the trader at the bank, the hedge fund can operate without anyone seeing what it is doing. No one is looking over its shoulder at the trading positions each night.

THE RISK THAT RISK WILL CHANGE PAGE 24

Robert F. Engle

Practitioners in investment management will always be comparing possible future returns against a risk assessment. Typically this is a VaR limit which is a short term measure of risk. If the investment is held for weeks or months, then the risk may change during the holding period. If it increases, then the position will be more difficult to liquidate.

The paper introduces measures of long term risk that supplement VaR and take account of the risk that the risk will change. This measure should lead to better investment decisions and would have reduced the investment in the highly levered mortgage products from the period 2003 to 2007 that are responsible for much of the financial distress.

STRIKING REGULATORY IRONS WHILE HOT PAGE 29

Hersh Shefrin and Meir Statman

A study of the history of financial regulations and the process by which they are shaped offers important lessons to investment professionals. First is a lesson to investment professionals who seek to maximize their collective wealth through political action. Capture theory, formulated by George Stigler, describes the process by which interest groups, such as investment professionals, capture politicians and regulators with political contributions which induce regulations that maximize their wealth. For example, bankers can induce regulators to tolerate high credit card fees. However, the power of bankers wanes when the public is outraged and fees are curbed. The paper provides investment professionals with insights about the impact of changing levels of public docility or outrage on their ability to capture regulators.

Second is a lesson about perceptions of risk. Investment professionals often misperceive risk in financial markets. For example, they might increase housing leverage to levels that bring ruin when a crash comes. Investment professionals often misperceive risks in political markets as well. Transgressions such as high leverage might be overlooked or even rewarded in boom times; but they expose investment professionals to political vengeance in times of bust. The fates of Richard Fuld of Lehman and Kenneth Lewis of Bank of America provide two examples. Related to this is a lesson about the need to foresee changes in the financial and political environment and plan ahead to confront opportunities and dangers when the regulatory environment shifts.

Last is a lesson about the civic responsibility of investment professionals. We all tend to tailor our notions of fairness to our self interest. The poor tend to believe that it is fair to spread the wealth while the rich

tend to believe that it is not. The civic organizations of investment professionals regularly prescribe fair and ethical behavior; however, their prescriptions tend to be narrow, catering to the self interest of their members. Earning large profits from trading is considered fair as long as no fraud is involved. Perhaps such civic organizations might benefit by encouraging dialogue among their members about broader notions of fairness that incorporate the common good.

THE DYNAMICS OF LEVERAGED AND INVERSE EXCHANGE-TRADED FUNDS

PAGE 43

Minder Cheng and Ananth Madhavan

As leveraged and inverse exchange-traded funds (ETFs) have grown in assets under management, both investors and industry professionals have sought to gain greater understanding of these products. Unlike traditional ETFs, these funds seek to provide leveraged long or short exposure to the (typically) daily return of various indexes, sectors, and asset classes. To achieve these results, leveraged and inverse ETFs have "leverage" explicitly embedded as part of their product design. The structure of these funds, however, creates both intended and unintended characteristics not seen in traditional ETFs. This paper provides a unified framework to better understand the underlying dynamics of leveraged and inverse ETFs, their impact on market volatility and liquidity, unusual features of their product design, and questions of investor suitability. *The Dynamics of Leveraged and Inverse Exchange-Traded Funds* shows how the long-term returns of leveraged and inverse leveraged ETFs may be substantially different from a simple multiple of longer term returns because of compounding effects and time dependency. The paper also provides guidance on the types of market environments where return deviations are most likely to occur. The paper also highlights for regulators, investors and industry professionals the potential systemic risk from end-of-day re-leveraging activity, showing analytically the similarity to portfolio insurance strategies that were popular prior to the market break of October 1987. The paper emphasizes that financial advisors and investors need to understand how leveraged and inverse products really work.