
PRACTITIONER'S DIGEST

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LIQUIDITY SHOCKS AND HEDGE FUND CONTAGION

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Nicole M. Boyson, Christof W. Stahel and René M. Stulz

Hedge funds are typically managed according to a specific investment style, such as market neutral, global macro, or convertible arbitrage. Managers of these funds often attempt to achieve “absolute returns”—performance that is not dependent on market movements or movements in other hedge fund styles. However, an interesting feature of hedge fund returns of different styles is the tendency for their worst returns to cluster together in time. In other words, despite differences in stated style, when one style of fund performs poorly, other styles also perform poorly. This contagion between funds of different styles is related to shocks to liquidity, as measured by shocks to credit spreads and the TED spread, shocks to bank and prime broker stock prices, and shocks to hedge fund cash flows.

Given this contagion between hedge fund styles, we further investigate whether there is also contagion between hedge funds and stock, bond, and currency markets. We uncover strong evidence of contagion between hedge funds and small-cap, mid-cap and emerging market equity indices, high yield bonds, emerging market bonds, and the Australian Dollar. We show that this contagion between hedge funds and markets is also significantly linked to liquidity shocks, especially for small-cap domestic equities, Asian equities, high yield bonds, and the Australian Dollar.

Our findings have several practical implications. First, diversifying across hedge funds of different styles does not provide significant downside protection since poor returns tend to cluster among funds of different styles. Similarly, investors that use hedge funds as diversification tools against poor returns in main markets should also be careful. Finally, the relationship between liquidity and contagion implies that if a central bank is considering intervening in financial markets during an economic downturn, the

success of the potential intervention could be affected by the perceived impact on market and funding liquidity.

ASSET ALLOCATION DYNAMICS IN THE HEDGE FUND INDUSTRY **PAGE 35**

Li Cai and Bing Liang

In this paper, we examine whether dynamic hedge funds with frequent adjustment in asset allocation can outperform non-dynamic funds that make stale assets allocations. We find evidence of significant difference in fund performance from the two fund groups. Further, time series analysis suggests that the advantage of dynamic asset allocation is significant in the early years of our sample but the advantage gradually fades away over time due to increased competition.

HEDGE-FUND PERFORMANCE AND LIQUIDITY RISK **PAGE 60**

Ronnie Sadka

This paper demonstrates that liquidity risk, as measured by the covariation of fund returns with unexpected changes in aggregate liquidity, is an important predictor of hedge-fund performance. The results show that funds that significantly load on liquidity risk subsequently outperform low-loading funds by about 6.5% annually, on average, over the period 1994–2009, while negative performance is observed during liquidity crises. The returns are independent of share restriction. Liquidity risk seems to account for a substantial part of hedge-fund performance.

There are several practical implications. From a risk-management perspective, the paper provides a useful tool for evaluating a fund's exposure to liquidity risk. Absent transparency regarding a fund's positions, the measurement of a fund's liquidity exposure requires only its historical monthly returns. The results suggest that investors that might be concerned with underperformance during liquidity crises, such as retail investors and funds-of-funds, should avoid funds with significant positive exposures to the liquidity-risk factor. Nonetheless, the significantly positive high-minus-low liquidity-risk return spread implies that investors that are willing to tolerate underperformance during times of crisis are well compensated during non-crisis periods. Therefore, investors, such as endowments and pension funds, may find it reasonable to select managers whose funds exhibit high liquidity-risk exposures. Finally, the liquidity risk of funds seems unrelated to their share restrictions, pointing to a potential imbalance between the liquidity a fund promises to its investors and the sensitivity of its underlying positions to market liquidity conditions. The practical implication is that funds with high liquidity risk and low share restriction are more likely to gate assets during periods of crisis.

THE DOWNSIDE OF HIGH WATER MARKS: AN EMPIRICAL STUDY **PAGE 73**

Sugata Ray

I examine the effects of a fund being below the high water mark (HWM) on the fund's returns, risk and probability of fund closure. Given the well known incentive problems associated with being below the

HWM, I empirically test the magnitude of risk shifting that results from being below the HWM. I find funds 10% below the HWM take significantly more risk, leading to monthly return standard deviations that are 0.9% higher on average. Additionally, funds 10% below the HWM have significantly lower Sharpe ratios and higher closure rates. With more than \$2 trillion under management in the hedge fund industry and much of it managed under contracts with a HWM feature, these results have a strong bearing on investment, renegotiation and fund closure decisions for funds below the HWM.