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PRACTITIONER'S DIGEST

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THE INTENDED AND COLLATERAL EFFECTS OF SHORT-SALE BANS AS A REGULATORY TOOL

PAGE 5

Terrence Hendershott, Ethan Namvar and Blake Phillips

In times of crisis, regulators of financial markets are increasingly turning to bans of short-sale transactions as a market stabilizing tool. This paper reviews the observed intended and unintended effects of short-sale bans. Proponents of these actions argue that short selling encourages speculation and price manipulation, erroneously reducing asset values with the potential to contribute to self-perpetuating price spirals in times of panic. In contrast, advocates of short sales argue they provide an important mechanism to impound bearish investor opinions in prices and contribute to liquidity in the market.

The goal of this paper is to provide regulators and market participants with a survey of the existing evidence if and/or when short-sale bans are contemplated in the future. We divide the effects of the short-sale ban into two categories based on statements of intentions. The intended effects were to thwart the dissemination of false rumors (short-selling speculation) and to improve or stabilize investor confidence. The unintended effects included: (1) reducing overall market liquidity, impeding price discovery, and increasing volatility, (2) increasing the price of options, (3) price inflation and wealth transfers, (4) reducing the level of short covering, (5) causing a near collapse of the convertible bond market, (6) increasing transactions costs of some exchange traded funds (ETF), (7) price inflation in the CDS market, and finally, (8) an opportunity cost relatively to other policy options.

The evidence surveyed here shows that short-sale bans have limited effectiveness and significant costs. The counterfactual of what would have occurred without the 2008 and 2011 bans are not observable. It is possible that costs of the shorting ban were worth incurring because the ban prevented a short-selling induced meltdown of the financial system. However, policy makers need to acknowledge the costs of market interventions such as short-sale bans and clearly state under what circumstances these costs are outweighed by the likely unobservable benefits. Making decisions in unprecedented circumstances is

difficult for regulators. Now that time has passed and the evidence is in, regulatory agencies around the world should develop guidelines for future shorting bans in times of crisis. Principle and rule-based decision making would enable market participants to better prepare for, and cope with, future regulatory actions.

LIBOR VERSUS OIS: THE DERIVATIVES DISCOUNTING DILEMMA PAGE 14

John Hull and Alan White

Prior to the credit crisis that started in mid-2007, banks used interest rates calculated from LIBOR and LIBOR-swap rates when valuing derivatives. Since the crisis this practice has changed. Most derivatives dealers now use rates calculated from overnight indexed swap (OIS) rates when collateralized transactions are valued. For non-collateralized transactions they continue to use rates based on LIBOR and LIBOR-swaps rates. This paper examines this practice. It argues that OIS rates are the best proxies available for the risk-free rate. As such they should be used for valuing both collateralized and non-collateralized derivative transactions.

The first step for a dealer in valuing a derivatives portfolio with a counterparty is to calculate its no-default value, that is, the value it has if there is no chance of either side defaulting and no collateral is posted. A credit value adjustment (CVA) is then calculated to determine the amount by which the value should be reduced to allow for the possibility of a counterparty default and a debit (or debt) value adjustment is calculated to determine the amount by which it should be increased to allow for the possibility of a dealer default. (A further adjustment to allow for the interest paid on cash collateral may be necessary.) The key point here is that the interest rate used to calculate the no-default value of the derivative should not reflect the credit risk of either the dealer or the counterparty as this is taken account of elsewhere. Furthermore the dealer's funding costs should not influence the calculation of no-default values.

The paper produces a result to show that LIBOR discounting can give the correct answer if adjustments are made to the definition of CVA and DVA. However, the use of this result is liable to cause confusion and unnecessary complications in the design of bank systems. It leads to a situation where both discount rates and the calculation of CVA and DVA vary from counterparty to counterparty. A simple numerical example shows that this confusion can lead to large pricing errors. The key conclusion in the paper is that the same (risk-free) interest rate should be used when calculating the no-default value of all derivatives transactions.

GENERATING SUPERIOR PERFORMANCE IN PRIVATE EQUITY: A NEW INVESTMENT METHODOLOGY PAGE 28

S. P. Kothari, Gitanjali Swamy and Konstantin Danilov

A popular focus of research in the area of private equity (PE) portfolio management has been the quest for successful ex-ante identification of individual private equity funds (or "manager selection" within a

portfolio). Outside of that, much of the existing research has mainly focused on answering the question of how much of one's overall portfolio should be allocated to "alternative asset classes" like private equity, and not necessarily on how to manage the actual allocation itself. This lack of examination—likely caused by a deficiency of publicly available data—is in stark contrast to the abundance of research surrounding the application of Modern Portfolio Theory (MPT) and asset-allocation "best-practices" to traditional asset classes such as equities and fixed income.

The aim of this paper is to explore the application of some of the key principles of Modern Portfolio Theory (MPT) to private equity portfolio management. We focus namely on the concept of the Efficient Frontier and the idea that optimal diversification—in this case, between risk-type factors—can help enhance overall returns for a given level of overall portfolio risk. To test our hypothesis, we have developed an investment algorithm to evaluate the PE portfolio selection decisions of several large, sophisticated institutional investors over a recent period of 7–10 years. The algorithm reviews the investment decisions faced by the investors, and selects investments that move the existing portfolio closer to the Efficient Frontier using a subtractive process, thus creating an alternate "modified portfolio". Essentially, any decision that does not improve diversification, thus reducing risk, or improve a priori expected return, is eliminated.

The results show that this even this basic "naïve" (albeit, systematic) asset allocation process can improve portfolio performance, in some cases quite dramatically. As such, the practical application of this experiment is not to provide an exhaustive framework for PE portfolio management. Instead, our aim is to pave the way for further research in developing a more robust framework for PE portfolio construction, one that moves away from the relentless focus on manager selection by instead focusing the tenets of traditional of asset allocation.

DEMYSTIFYING MANAGED FUTURES PAGE 42

Brian Hurst, Yao Hua Ooi and Lasse Heje Pedersen

We show that the returns of Managed Futures funds and CTAs can be explained by simple trend-following strategies, specifically time series momentum strategies. We discuss the economic intuition behind these strategies, including the potential sources of profit due to initial under-reaction and delayed over-reaction to news.

We show empirically that these trend-following strategies explain Managed Futures returns. Indeed, time series momentum strategies produce large correlations and high R-squares with Managed Futures indices and individual manager returns, including the largest and most successful managers. While the largest Managed Futures managers have realized significant alphas to traditional long-only benchmarks, controlling for time series momentum strategies drives their alphas to zero.

Finally, we consider a number of implementation issues relevant to time series momentum strategies, including risk management, risk allocation across asset classes and trend horizons, portfolio rebalancing frequency, transaction costs, and fees.

WHERE THE BOYS ARE—GENDER, RISK TAKING, AND AUTHORITY IN INSTITUTIONAL EQUITY MANAGEMENT PAGE 59

Margaret Stumpp

Attend any gathering of investment professionals and it's likely that fewer than 15% of the attendees will be women. Odds are even lower that you will encounter a female senior investment professional. Other than outright discrimination, why might such a strong gender gap exist? We find this employment disparity cannot be explained by gender-related differences in investment skill, departure rates, or in asset gathering capability. However female investment professionals do appear to be somewhat more conservative than men, suggesting that at least some of the employment gap may be attributable to self-selection away from a career that emphasizes and rewards risk taking.

This observation has important implications for both diversity outreach and career counseling because a stronger emphasis on skills development may not be the best way to to draw more women into the profession. Instead, a more comprehensive approach may be required—one that also addresses gender-related differences in risk tolerance.