

Discussion: Hedge Fund Performance and Systemic Risk

Juha Joenväärä

Discussant: Dale W.R. Rosenthal
University of Illinois at Chicago

BoF/CEPR/JFI/SUERF conference on
The Future of Risk Management

23 September 2011

Objectives and Measures

- Paper studies hedge funds with fund, systemic risk measures.
- Three clear objectives:
 - ① Relate risk measures to fund traits;
 - ② Explain fund performance with risk measures; and,
 - ③ Explain fund failure with risk measures.
- Risk measures (given q quantile):
 - Expected shortfall (ES_q): fund risk; $E(R^i | R^i \leq VaR_q^i)$
 - Marginal ES (MES_q): fund/systemic risk; $E(R^i | R^{sys} \leq VaR_q^{sys})$
 - $CoES_q$: systemic risk; $E(R^{sys} | R^{sys} \leq VaR_q^{sys}(VaR_q^i))$.
- Paper then looks at $\Delta CoES_q = CoES_q - CoES_{median}$

Findings

- Different fund traits are related to ES , MES , $\Delta CoES$.
 - Fees, mgr Δ , smoothing, flow: fund risk \uparrow , systemic risk \downarrow ;
 - Lockup and redemption periods, age increase all risks;
 - Notice period increases fund risk only; and,
 - High watermarks, leverage, size: no effect.
- Relates risk measures to fund excess returns¹, Fung-Hsieh α 's
 - Excess returns well-explained by MES , not by ES ;
 - MES , $\Delta CoES$ decile 1–10: significantly different returns;
 - As risk increases: excess returns \uparrow normally; \downarrow in crisis;
 - Fung-Hsieh α 's only explained by MES .
- Fund failure rate increases with MES , ES .

¹After Fung-Hsieh and Pastor-Stambaugh factors.

Risk and Policy Implications

Author is too modest; undersells how much this study reveals.
Should note other interesting implications:

- Opposite signs for $\Delta CoES$, ES vs some fund traits
 - Funds care about effect on system but not own investors?
 - Suggest funds know they have a ratcheting-strike put.
 - Also suggest funds avoid being “too risky to fail.”
 - Or, are funds trying to stay out of regulators’ sights²?
- Does age raise risk? Or proxy for interconnectedness?
- Some possibilities for effective policy targets:
 - Shorter lockup, redemption periods reduce risk measures;
 - Shorter notice periods increase fund risk (illiquidity?)³.

²*cf.* Chicago local vs national elections.

³Should balance vs other concerns; see w.p. by Sadka.

Governance Issues and Methodological Result

- Look a little deeper in a few places:
 - Do high watermarks relate to risk if fund is “down”?
 - Do high watermarks make sense if so?
 - Typical story: if DOOM, shut down or take large risks.
- Evidence in support of Weisman (2002):
 - $\beta > 0$ for *ES* vs incentive and management fee, manager Δ ;
 - Incentive fee increases P(fund failure).
- Marginal expected shortfall *MES* (effect of system on fund):
 - Aggregate effect on fund returns, alpha is zero; but,
 - Positive (negative) for both normally (in crisis).
 - A new risk factor beyond Fung-Hsieh, Pastor-Stambaugh!

Small Changes

- Number all equations and refer to those equations in tables;
- More discussion of Fung-Hsieh alpha regressions;
- Clearly and explicitly define θ ;
- Need a table of means/std devs/high/low of firm traits;
- Remind reader: higher risk measures \Rightarrow more negative;
- LTCM period: could look at July–September/October 1998;
- Explain CoES more clearly; and,
- Investigate if there is endogeneity between *MES* and *CoES*.
 - If so, this would be evidence of possible contagion.

Conclusion

- Interesting paper which indicates rich possibilities.
 - Prior knowledge mostly one-way: HFs may trigger crisis.
 - May help explore endogeneity between fund, system returns.
 - Might even find early-warning indicators for crises.
- Also highly policy relevant due to concerns about:
 - Effects hedge funds have on markets; and,
 - Effects of systemic risk on market participants.
- Risk measures help tease more information from data.
 - Indeed: *MES* risk measure appears to be a new factor.
- Look forward to reading final version of this paper.