Comments on "**Hedge Funds: A Global Perspective on Strategies and Risks** "

- Some statistical analysis across hedge funds

High Correlation among hedge fund returns by strategies (Table 9)

- Hedge funds do not think about risk diversification across strategies.

Correlation among returns of hedge fund returns by strategies and other market returns (Table 10)

- High correlation with high yield assets;
- …. the proof of contagion ? No, showing high risk exposure of hedge funds
- ….Hedge funds do not “hedge” risk
- ….
- Coefficients of correlation are small
- … Hedge funds seem to take risk diversification to some degree……

Monthly persistence of hedge fund returns (Table 11 and 12)

- Does this evidence reflect market inefficiency ?
- No, measurement error problem because manager has an incentive of earning management.
- Says nothing about market efficiency

What is the impact of hedge funds on systemic risk ?

- Difficult to say something from this analysis

- Alternative approach
- Comparison between performances of large and small hedge funds
- Comparison the market performance with and without hedge funds over time

Comments on “Notes” by Rym Ayadi

Six threats that hedge funds pose to financial stability.

1. Risk taking motivated by increasing competition and high performance fees

- The industry dynamics of hedge funds is ***stochastic,*** characterized by a large number of entries and exits …quite different from banking system.

- Is the “unstable” financial system sustainable in the long run?

3. Short Selling

Can hedge funds influence prices independent of fundamentals and cause financial instability ?

It is typical in small and illiquid markets.

But, it may be the case in large and liquid markets, when *herding* behavior of other hedge funds is involved with

…. **Stock price declines of Toyota and Cannon!**

4. Increasing correlations among hedge funds behavior

- ….Leading to increasing risk

- *Game-theoretic approach* is necessary to explain hedge fund behavior.

- Strategic substitutes or strategic complementarities (herding)

- If so, markets are inefficient.

5. Concentration in less liquid markets

- Increasing competition
- Gamble for less liquidity markets for liquidity premium
- Systemic risk from liquidity shortage

- Competition leads to fragility of markets
- …. Is <u>*governance*</u> necessary for hedge funds?

6. High leverage and production of complex derivatives

- Markets for credit derivatives are not transparent;
- …..severe asymmetric information

- *Asset securitization* can pool and reduce credit risk, but may increase the possibility and magnitude of systemic risk.
- … incomplete credit derivatives….it is difficult to hedge “all the credit risk”