Comments on
Gunter Löffler’s paper
Stability and Impact of Hedge Funds’ Country Allocation in Emerging Markets

Emerging Markets Conference Mumbai
December 15-16 2010

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Three issues

A very fascinating paper that raises several interesting issues:

1. How does the paper succeed in estimating so many country weights with so few data points?

2. Why does alpha persist when weights are applied with a one month lag?

3. What happens to volatility when the hedge funds get in and get out?
Positive weights

Löffler assumes that country weights are non negative.

Why does this make such a big difference in estimation accuracy?

I interpret this from a Bayesian perspective:

- Informative priors can lead to sharp posteriors even in very small samples.
A Bayesian Perspective

The restriction to positive weights essentially replaces
- a diffuse prior over an unbounded parameter space (an $n$ dimensional affine hyperplane) by an
- uniform prior over a compact parameter space (a unit $n$-simplex).

With such an informative prior, the emergence of sharp posteriors is not surprising!
Is this the best prior?

- Short sale prohibition may not be the best way to produce an informative prior:
  - Increasingly liquid derivative markets make short selling easier in emerging markets.
  - Regulatory restrictions on short selling vary over time and space and are not binding always and everywhere.
  - Even emerging market hedge funds use a modest amount of leverage (shorting the risk free asset).

- What are the alternatives?
  - Constraining weights to a range: say [-0.5, 0.5] (replacing the $n$-simplex with a hypercube).
  - Multivariate normal around the neutral (market capitalization) weights with a reasonably large variance.

How reasonable is this?

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Why does one month lag work?

The preservation of alpha even when weights are lagged by one month raises the question whether emerging market hedge fund strategies are momentum based (trend seeking).

This should be tested as it would have implications for the volatility results.

Volatility and momentum

Volatility results would not be surprising if the hedge funds are exploiting and/or creating momentum in emerging markets.

Serial correlation induced by momentum would reduce volatility of returns.

But it could create/exacerbate boom-bust cycles (volatility in levels).

Hedge funds could make this cycle worse if they short emerging markets when they go bust.

- But the estimation methodology does not allow short positions at all.