Comments on Gunter Löffler's paper

Stability and Impact of Hedge Funds' Country Allocation in Emerging Markets

Emerging Markets Conference Mumbai
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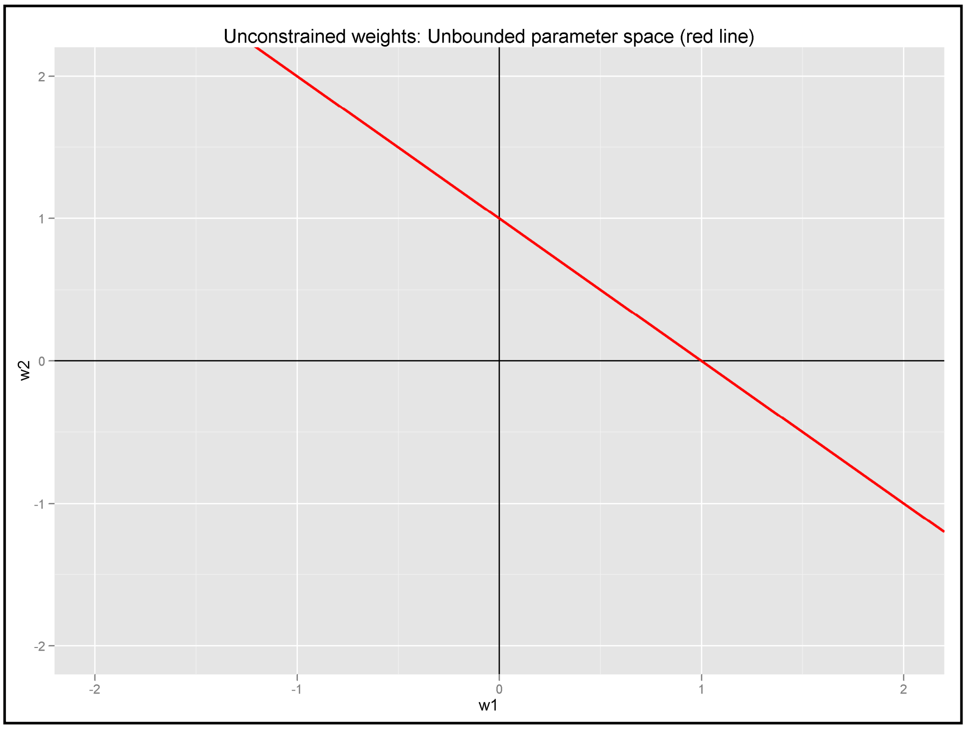
Three issues

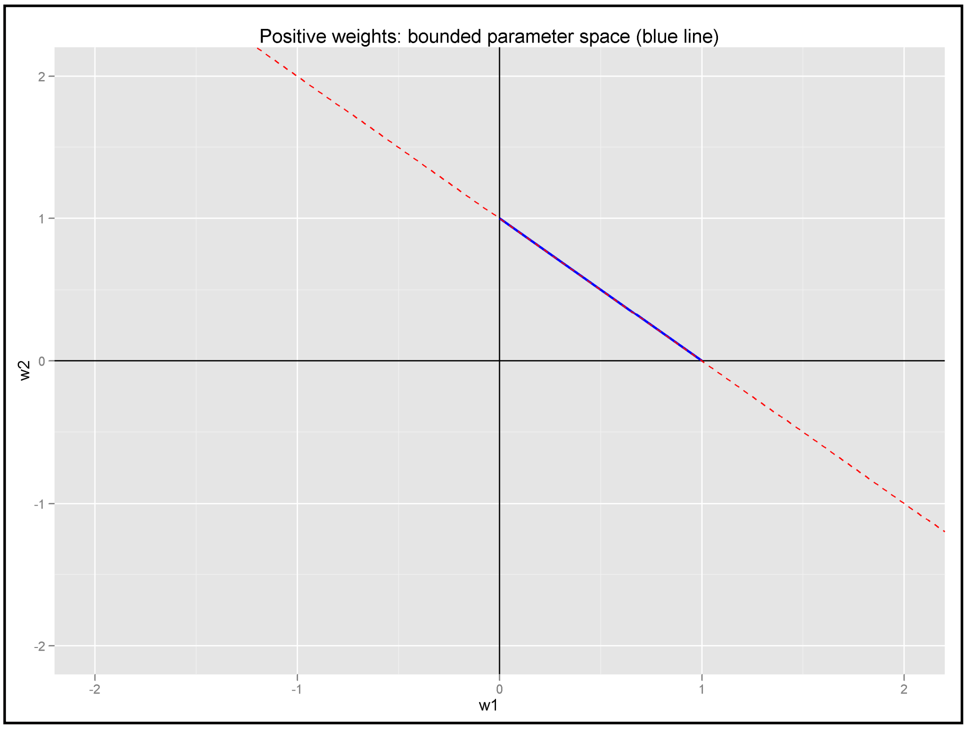
- **A very fascinating paper that raises several interesting issues:**

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.





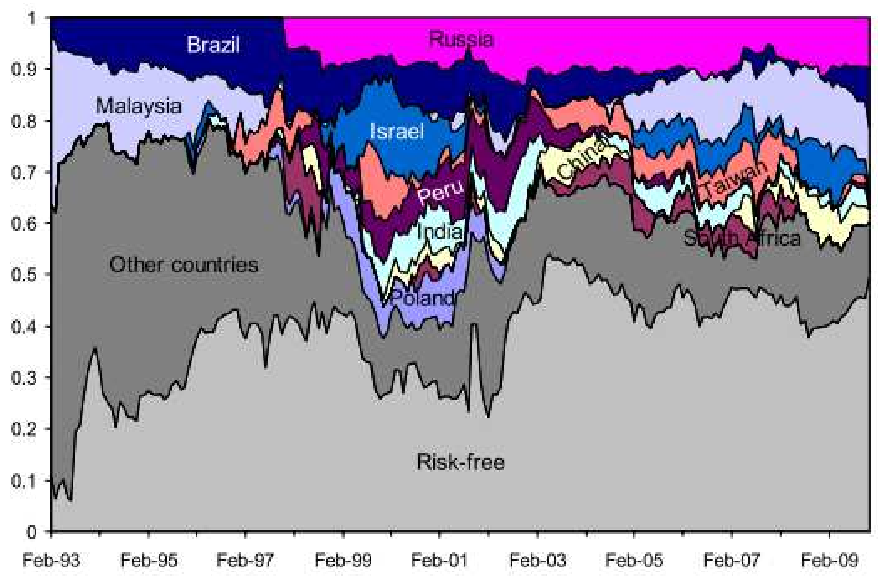
A Bayesian Perspective

- **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?



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.

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