Discussion of:
Do Hedge Funds Profit From Mutual-Fund Distress?
by Chen, Hanson, Hong and Stein

Ron Bird
Paul Woolley Centre for Capital Market Dysfunctionality, UTS

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General Comments

- This paper is a typical of what we have come to expect from Harrison Hong (et al):
  - Interesting
  - Thoughtful
  - Simple
- The downside (for me) is that that there is little of a critical nature that one can be said about the paper so I will concentrate my few minutes on what might have been

The Paper(s)

- Coval & Stafford (2005) establish that forced selling (buying) by mutual funds has a temporary negative (positive) impact on the price of the stocks that they are “forced” to sell (buy) and that this provides significant opportunities to those who can successfully front run these trading activities
- Chen et al (2007) take up this story and provide *prima facie* evidence to support the proposition that market-neutral hedge funds are at least one group who benefit by front running these forced sales

It is Not a New Story

- Reading these papers has caused me to reflect on a conversation that I had with Jeremy Grantham approximately 12 years ago where he spoke of a cycle which had and would continue to repeat itself:

  Well performing funds attract large cash flow and their size causes them to invest a sizable portion these funds (Wermers, 2003 suggested about half) *into stocks they already hold thus driving up the price of these stocks and so the fund's performance and they attract more funds and the cycle goes on*

  This cannot last forever as the price of these stocks is driven to unsustainable levels and eventually they begin to fall, the performance of these managers deteriorates, they begin to lose funds and so have to sell their large holdings of these relatively liquid stocks which further drives down their price and so the cycle goes on . . .

Jeremy Grantham (cont.)

- Given Jeremy's observations we should not be surprised by the two major findings:
  - Cash flows have a “knock on” effect on a mutual fund’s subsequent performance
  - The anticipation of these cash flows can lead to profitable investment opportunities to which Harrison has been able to add that that hedge funds appear to be one type of investor that is exploiting this opportunity
  - In a more general sense, this is all an example of the “extreme” profits that one can make from being able to forecast liquidity

- Other evidence that is also consistent with Jeremy’s conjecture:
  - How these flows are heavily related to momentum
  - How these flows (and so their impact on prices) are cyclical in nature
  - The size story: big on the way up and small on the way down
  - And one could go on

Some Questions/Comments

1. Why abandon the POSTFLOW so early in the story?
    - Having established that hedge funds may well also benefit from large positive inflows to mutual funds, this is effectively not pursued as the coefficient is found to be only 20% of that of DISTRESS
    - Although this is not surprising, I wonder if the difference is indicative of their economic significance as this will also be influenced by the volume of opportunities?
    - More analysis of POSTFLOW represents a possible opportunity for the authors to strengthen their case (more soon)

Some Questions/Comments

2. Not all opportunities are equal
   - It would come as no surprise that that the opportunities from mutual fund cash flows are cyclical.
   - Indeed, the authors identify that the period from 1998 to 2000 is likely to drive most of their results.
   - Given this findings I would have thought that there is a good case for a more in-depth concentration on this sub-period
3. Extend the timeframe
   - Given that Coval and Stafford found that cash flows and returns going back around a year played a role in predicting cash flows, this raises the question for me as to when front running might commence and so suggests it might be interesting to examine earlier periods relative to the occurrence of the large cash flows

Some Questions/Comments

4. Be Kind to Hedge Funds
   - The paper leaves as open questions:
     - Whether it is better use of information or inside information that enables hedge funds to appear to be exploiting these opportunities:
       - One way that they could get a feeling for this is by further examining the POSTFLOW as they have access to the long holdings of the hedge funds
     - Whether behaviour like this disadvantages anyone in particular:
       - Let me put aside my academic cap and say that I believe that we are too kind to hedge funds which is an imbalance that the Paul Woolley Centres' might correct in due course

Concluding Comments

- As I said at the beginning, a fine paper

- My comments largely relate to why not write an expanded paper on “Do Hedge Funds Profit from Mutual-Fund Trading?”