Flight-to-Liquidity in the Equity Markets during Periods of Financial Crisis

- **Azi Ben-Rephael**

Discussion by:

- **Francesco Franzoni**
  Swiss Finance Institute and University of Lugano

Paul Woolley Centre, LSE – June 2011

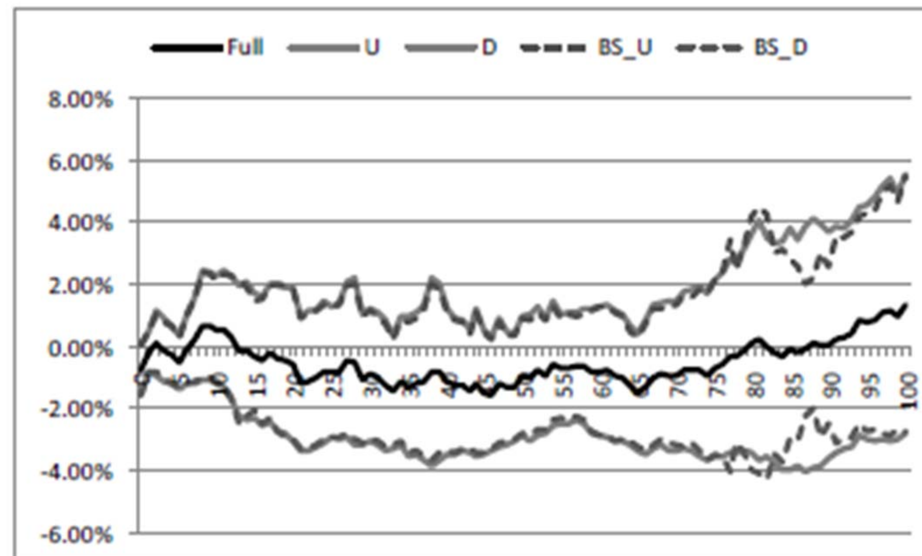
The questions

- Flight-to-liquidity (FTL) is postulated in theoretical models and there is consistent anecdotal evidence
- Focus on “financial crises”
- What is the impact on stock returns of FTL?
- Which investor class is driving the FTL?
- What are these investors’ motives for trade?

Results: return difference liquid vs. illiquid stocks

- 3 months after the crisis start, (illiquid – liquid) portfolio has significant alpha = -2%
- The return difference reverts in the next 3 months

- Cumulative returns for the (illiquid – liquid) portfolio over the 100 following the crisis:



Results: mutual fund sales

- Mutual funds, as a group, sell more illiquid stocks during financial crises

- Other institutions absorb mutual fund sales

- So, price patterns of liquid vs. illiquid stocks seem to result from price pressure due to mutual fund sales

Results: redemptions from illiquid funds

- Do mutual funds strategically reallocate portfolios towards more liquid stocks (flight-to-liquidity)?

- NO!

- Investors redeem shares in funds that invest in more illiquid stocks
- Possibly following poor returns by these funds

- Only these funds dump illiquid stocks in the market

- The reference to theoretical results on FTL (e.g. Vayanos 2004, Brunnermeier and Pedersen 2009) is not appropriate given the evidence

Comment: originality of results?

- This paper combines two known results:

  - Coval and Stafford (2007): fire sales by mutual funds generate price pressure

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  - Amihud (2002): the price of illiquid stocks drops more when liquidity deteriorates in the market (almost by definition of illiquidity)

- So, I read this part of the paper as a cross-sectional extension of Coval and Stafford (2007)

Comment: real contribution of the paper

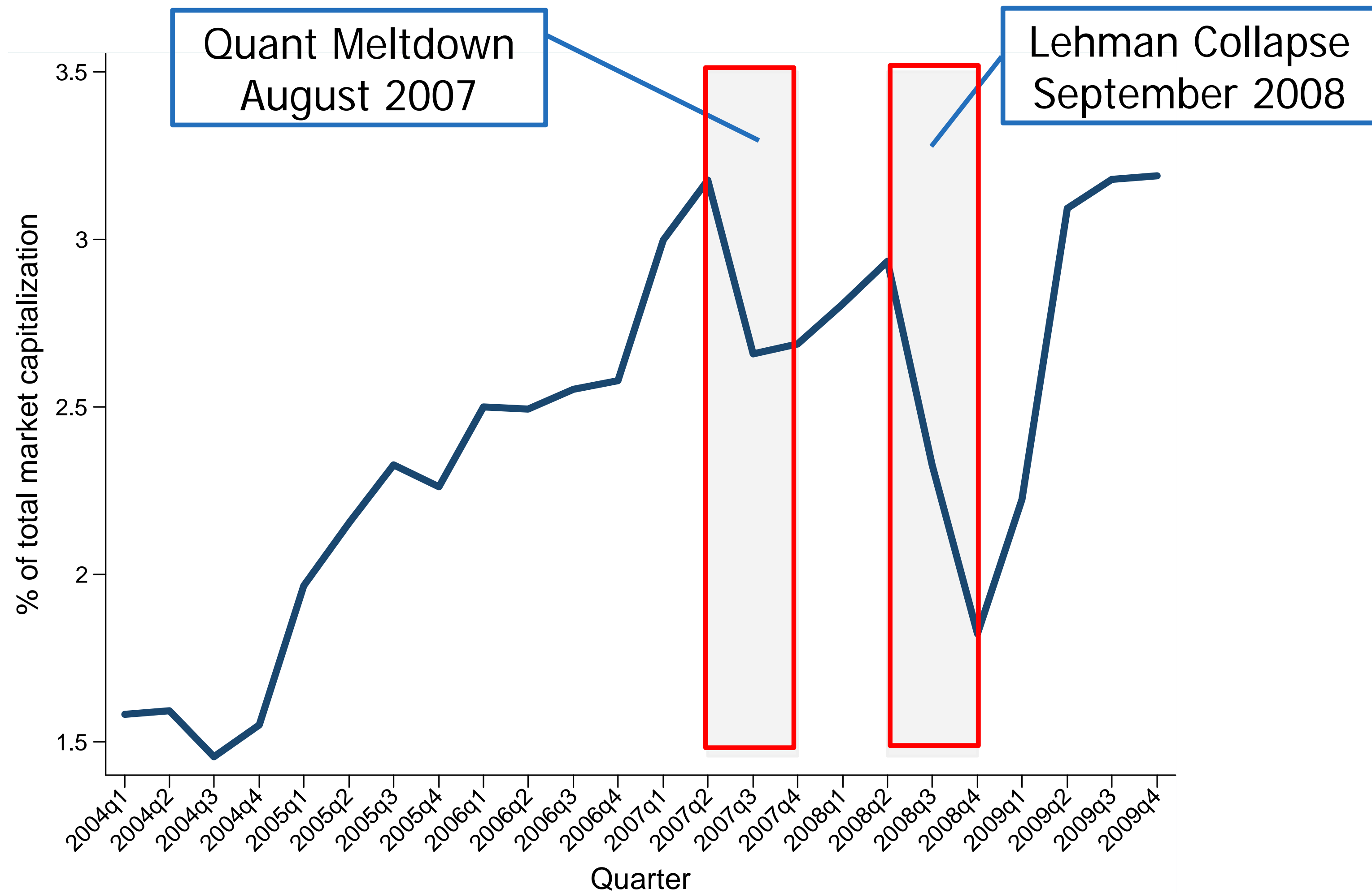
- The truly original finding, in my view, is the run on illiquid mutual funds' assets
- Why do investors do it?
- May want to disentangle two stories:
    1. Illiquid funds are more likely to suffer in bad times → Investors react to poor returns of these funds
    2. Investors try to be the first to get out, anticipating a run-for-the-exit (as in a bank run), exacerbated by asset illiquidity
- Regress fund flows on asset illiquidity, controlling for past returns

Comment: 10 financial crises?

- The paper defines financial crises as the 10 highest monthly changes in the VIX so far
- This definition has hindsight bias → the alphas are not generated by a replicable trading strategy
- 10 “financial crises” in 25 years is a bit too many, even for dysfunctional markets
- There’s a risk of adding Apples and Oranges
- Focus on the last (true) financial crisis
- Or, like in Coval and Stafford (2007), identify mutual funds in distress and focus on their sales patterns

Ben-David, Franzoni, Moussawi (2011)

- Major stock selloffs by Hedge Funds during last crisis
- Mostly due to redemptions and forced deleveraging



Our results

- Unlike this paper, we find that hedge funds sell the liquid stocks first
  - In a fire sale, they want to manage price impact
  - It is also more difficult to sell illiquid assets at the peak of a crisis
- Like this paper, we find that illiquid hedge funds (those with share restrictions) suffer from more redemptions
  - Investors want to avoid being locked in when the fund raises gates
- Question: source of different sale patterns between Hedge and Mutual funds during crisis?

HFs vs. MFs during the last crisis

Hedge funds	Flows/AUM (%)	Trades/Total equity portfolio (%)	Quarterly returns (%)
2007Q3	1.83	-9.87	-0.88
2007Q4	-2.34	-2.74	1.64
2008Q1	-0.56	4.72	-1.91
2008Q2	1.11	3.57	2.85
2008Q3	-0.94	-16.70	-7.69
2008Q4	-11.19	-14.26	-7.36
2009Q1	-14.93	13.88	0.59
Mutual Funds	**Flows/AUM (%)**	**Trades/Total equity portfolio (%)**	**Quarterly returns (%)**
2007Q3	0.79	0.83	1.86
2007Q4	0.46	1.36	-2.39
2008Q1	0.08	-0.04	-8.90
2008Q2	0.79	-4.89	0.15
2008Q3	0.59	-0.12	-11.12
2008Q4	-0.92	-0.24	-22.13
2009Q1	-0.92	1.87	-7.97

- Hedge funds relative to equity mutual funds had:
  - Higher redemptions
  - Higher stocks sales as a fraction of portfolio
- Conjecture: when it comes to selling a big chunk of the portfolio the cheapest way is to sell the liquid assets first

Conclusion

- The paper highlights an interesting new fact:
  - Investors’ run on illiquid mutual funds during a crisis
- I would refocus the paper around this fact
- Investigate the triggers of this behavior
- Contrast with other institutions, e.g. Hedge Funds