A new look at who is more susceptible to "hedge fund contagion"

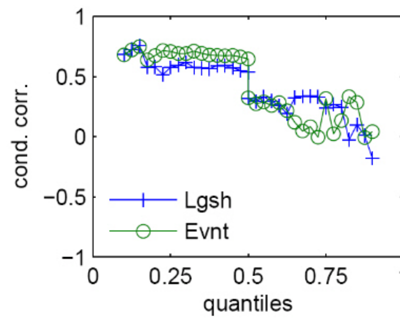
Apr 2nd, 2009 | Filed under: **Today's Post**

In August 2007, as quant hedge funds were swooning in an eerie precursor to the credit crunch, we reported on an academic study of "hedge fund contagion" (**see post**). Researchers found "no systematic evidence of contagion from equity, fixed income, and currency markets to hedge fund indices". However, they did find that there was a contagion between hedge fund strategies themselves.

Now a **new paper** on this topic explores whether the correlation between hedge fund returns changes depending on market conditions and the overall performance of hedge funds. Possible "asymmetric correlation" between hedge funds is of critical importance to funds of funds, and by extension, anyone hoping to benefit from hedge funds' reputed lack of correlation with each other and with equity indices.

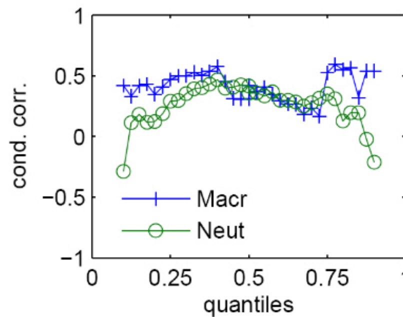
Evan Dudley and Mahendrarajah Nimalendran of the University of Florida focus their attention on the correlation between extreme hedge fund returns only - i.e., those that occur in the left and right tails of the return distribution. Their hypothesis is that the correlation between hedge fund returns is somehow different during these extreme events than they are during "normal" times (a reasonable hypothesis given the often-cited hyperbole about how "all correlations go to one" in times of distress).

It turns out their hunch was correct. *However*, the extent to which correlations increased in hard times was different across various hedge fund strategies. Dudley and Nimalendran first examined the correlation between several hedge fund strategies and the S&P 500. They divided the return distribution of each strategy into quantiles and compared each quantile to the S&P 500. The chart below from the paper shows how two particular hedge fund strategies, Long/Short Equity and Event Driven stacked up:



The correlation between Long/Short Equity returns and S&P 500 returns was much higher in the left side of the L/S/ return distribution than it was in the right side of the L/S return distribution. The same was true for Event-Driven funds. In both cases, the correlation was much lower in the right "tail" of the return distributions and higher in the left tail (the *bad* tail).

However, this wasn't the case for all hedge fund strategies. Global Macro and Market Neutral, two strategies that have recently shown a low market correlation, had relatively consistent correlations with the S&P 500 in both good times and bad.



Interestingly, Market Neutral funds seemed to have a *negative* S&P 500 correlation at the far end of both tails.

The results were somewhat similar, but less extreme, when each hedge fund strategy was compared not to the S&P 500, but to the broad universe of hedge funds. So if you're tasked with monitoring a portfolio of individual hedge funds, and you're being asked tough questions about the reputed diversification properties of hedge funds, you might want to check out this paper.

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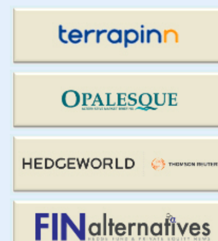

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