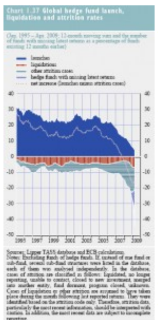
New ECB Model Aims to Predict HF Liquidations

Jun 16th, 2009 | Filed under: **Today's Post**

A lot of the hedge fund research we review each day on AllAboutAlpha.com is produced by academics. But occasionally, we come across some very interesting tidbits from regulators and central banks. The ECB's semi-annual Financial Stability Review (FSR) is one such example (**see previous posts**).

In keeping with previous reports, the **new 1H 09 ECB FSR** is A-OK. As usual, it provides an update on industry leverage, cross-correlation and industry attrition. The chart below right from the report the industry's annual launch and closure rates (click to enlarge).



Obviously, the past year has been rough on the hedge fund business. But what exact are the factors that lead to such an increase in hedge fund liquidations (red) and attrition (green)? This edition also contains an interesting "Special Feature" on estimating the probability of hedge fund liquidations (**downloadable separately here**).

As you might guess, the specter of hedge fund liquidations is never far from the thoughts of a financial regulator. As the report points out:

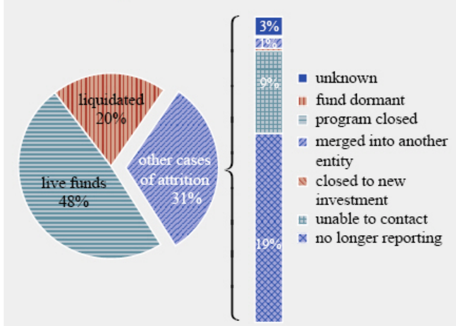
> *"A failure of an individual hedge fund or a group of hedge funds can have adverse implications for financial stability, mainly through an impact on asset prices and market liquidity and through potential losses for the hedge funds' creditors. Therefore, it is important to understand the underlying reasons behind hedge fund failures and to create indicators that would allow strains in the hedge fund sector to be monitored."*

"Half Dead"

The first step in the process of predicting attrition in the hedge fund industry is to identify all funds that are "dead". These funds are routinely listed in the "graveyard database" maintained by most database vendors. Amazingly, over half of all hedge funds that have ever existed are now "dead". The chart below shows that a fifth of all hedge funds that have ever existed are now liquidated and nearly a third have simply gone AWOL.

Chart D.1 Distribution of single-manager hedge fund attrition cases

(percentage of total investment records in the database as at 30 March 2009)



Sources: Lipper TASS database and ECB calculations.
Note: Excluding funds of hedge funds. Numbers do not add up due to rounding.

After filtering out superfluous data such as *parri passu* offshore versions of existing onshore funds, the ECB regressed the liquidated funds against over 50 variables ranging from fees to redemption terms to strategy performance. This list was then whittled down to 15 variables that are statistically significant predictors of the impending liquidation of a hedge fund. We have assembled those variables into the table below (click to enlarge):

Factor Name	Description	Direction
Relative 6-month Return	Fund return (in USD) less applicable CS/Tremont strategy index	Higher return = less chance of fund liquidation
Derivatives	Dummy variable: 1 if fund uses derivatives and 0 if not	Use of derivatives = greater chance of liquidation
High Water Mark	Dummy variable: 1 if fund has a HWM, 0 if not	Use of HWM = less chance of liquidation
Management Fee	Annual management fee (as portion of AUM)	Higher Management Fee = less chance of liquidation
Incentive Fee	Annual performance fee (above HWM and/or hurdle)	Higher Incentive Fee (Possible) = greater chance of liquidation
Non-negative YTD HWM Incentive Fee	Either zero or positive year-to-date return above a high watermark, if any, that was valid at the end of December the previous year multiplied by the Incentive fee.	Higher Incentive Fee (Actual) = less chance of liquidation
Notice Period	Notice period to redeem investment (in months)	Longer notice period = less chance of liquidation
Payout Period	Time before redeemed investment is received by investor (in months)	Longer payout period = less chance of liquidation
Liquidations within Strategy	Ratios of liquidated funds within the fund's strategy to all funds within the fund's strategy at the end of the previous month.	More liquidations within strategy – greater chance of liquidation
Age	Current age of fund (in months)	Older funds = less chance of liquidation
Capital	Fund AUM divided by the median AUM in the respective strategy	Bigger funds = less chance of liquidation
3-Month Percentage Change in Capital		Growth in AUM over past 3 months = less chance of

User ID
Password
Remember Me
Login
Forgot ID or password? What is this?

SEARCH ALLABOUTALPHA
Search

INDUSTRY PARTNERS
INTEGRA ALPHA BETA STRATEGIES

TOPICS
- CAPM / Alpha Theory (123)
- Portable Alpha & Alpha/Beta Separation (147)
- Hedge Fund Industry Trends (210)
- Alternative Beta & Hedge Fund Replication (94)
- Investment Management Fees (71)
- Performance, Analytics & Metrics (54)
- 130/30 (81)
- Hedge Fund Regulation (71)
- Liability Driven Investing (8)
- Institutional Investing (70)
- Media Coverage of Hedge Funds (27)
- AAA Newsreels (23)
- Retail Investing (23)

NEW REPORTS IN OUR RESEARCH DOSSIERS
- The future of hedge funds
- Key findings of the Edhec 'European alternative multi-management practices' survey
- Testing the Capital Asset Pricing Model (CAPM): The Case of the Emerging Greek Securities Market

ARCHIVES
Select Month

HEDGE FUND INDEX RESULTS
- Barclay Hedge Fund Indices
- CASAM
- CogentHedge
- Credit Suisse/Tremont
- Dow Jones Hedge Fund Indexes
- Edhec
- Eurekahedge
- FTSE
- Greenwich
- HedgeFund.Net
- HedgeWeb.Net
- Hennessee Group
- HFR
- Lyxor Hedge Fund Indices
- Morningstar/MSCI
- RBC Hedge 250
- 130/30 & Alternative Beta Indices

MEDIA/EVENT PARTNERS
OPALESQUE
HEDGEWORLD

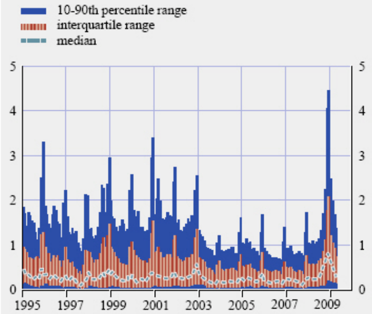
		liquidation
12-Month Percentage Change in Capital		Growth in AUM over past year = less chance of liquidation
November	Dummy Variable: 1 if November, 0 if not	If November, higher chance of liquidation
December	Dummy Variable: 1 if December, 0 if not	If December, higher chance of liquidation

The accuracy of the resulting predictive model is pretty good (see Page 165 of the report for details).

The good news is that it appears the risk of single manager hedge fund liquidations may have peaked in late 2008 and is now down at levels that are quite common over the past decade as the chart below from the report shows:

Chart D.5 Composite indicator of single-manager hedge fund liquidation risk

(Jan. 1995 – Apr. 2009; distribution of percentage probability of liquidation)



Sources: Lipper TASS database and ECB calculations.
Notes: Based on 2,152 single-manager hedge fund investment records. The most recent data are subject to incomplete reporting.

Email This Post Print This Post

LEAVE COMMENT

Name (required)

Mail (will not be published) (required)

Website

Submit Comment

RECENT COMMENTS

- John R. Crittenden on ***The new look for hedge funds this summ…***
- PD CAIA on ***The United People's Front for the Pres…***
- Abhilash R on ***New spin on an old metric***
- Alpha Male on ***Help us put Harry Markowitz on the hot…***
- Cristina Chen-Oster on ***HF Managed Accounts: A tool for change…***

STAY INFORMED

AllAboutAlpha.com RSS Feed Click Here to Subscribe