Discussion of:

The Behavior of Intoxicated Investors: The role of institutional investors in propagating the financial crisis of 2007-2008

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Background

- The financial crisis moved in a striking way across asset classes.
- Casual evidence suggests that the movement of the crisis across asset classes was party driven by forced liquidations.
- This paper attempts to explore this contagion hypothesis more rigorously.
  - The argument presented here is that mutual funds' forced and anticipated liquidations pushed the crisis from ABS/Mortgage debt to the corporate debt market.

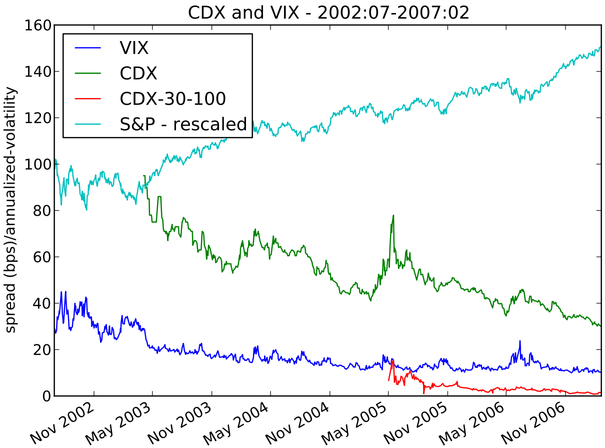
Discussion – Outline

1. *Timeline:* How did the crisis unfold?
    - Volatility and Leverage changes.
    - Movement of infomration across asset classes.
2. *Empirical:* What do the authors empirical findings suggest?
    - Forecasts using *Horizon* and *Holders' Exposure* independent variables.

Definitions:

VIX	*Volatility Index on S&P 500*
SPX	*Level of the S&P 500*
ABX	*Based on a series CDSs based on 20 bonds that consist of subprime mortgages.*
CDX	*The annualized cost of insuring a basket of 125 investment grade corporate bonds over the next 5 years. (=CDX.NA.IG.5y)*
CDX-30-100	*CDX-Super Senior Tranche: The annualized cost of insuring the CDX basket against losses over 30%, and up to 100%*

Decreasing Volatility Preceded Crisis



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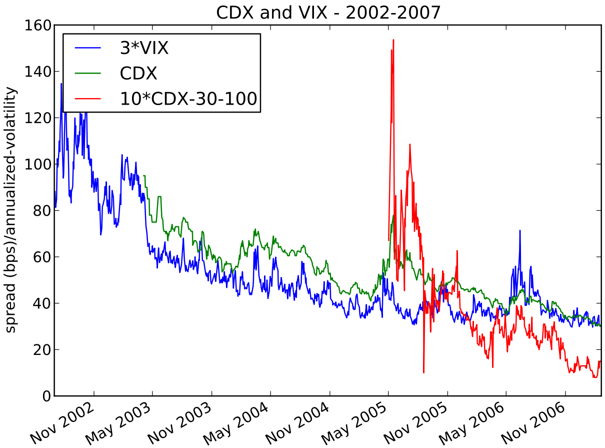


Financial Institutions increased effective leverage

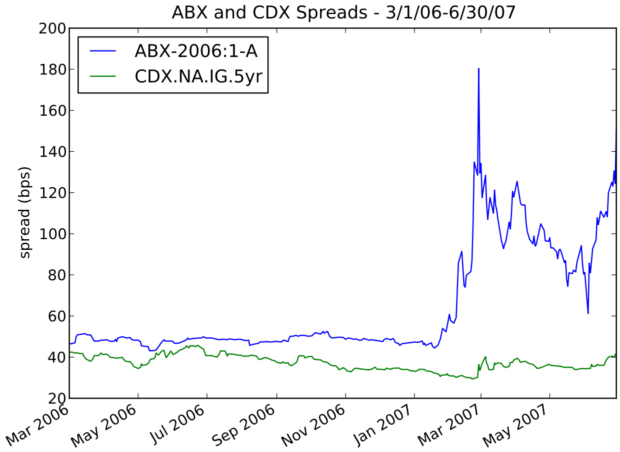
- Perhaps as a response to the perceived lower risk, a number of financial institutions "levered up:"
- By 2007, the leverage of financial institutions was high:

Bear Stearns	40:1	(20:1 in 2002)
Merrill Lynch	32:1	(16:1 in 2002)
Morgan Stanley	33:1	
Citibank	33:1	
Goldman Sachs	25:1	

  - financial institutions were using more short-term financing.
- Hedge-fund leverage had increased (Khandani and Lo (2008))
  - And hedge funds AUM had increased.

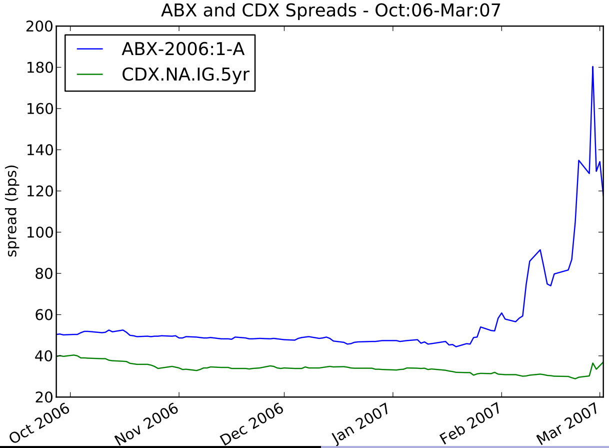
Subprime ABS vol increases in Jan '07

- ABX-A volatility increases dramatically in January 07:



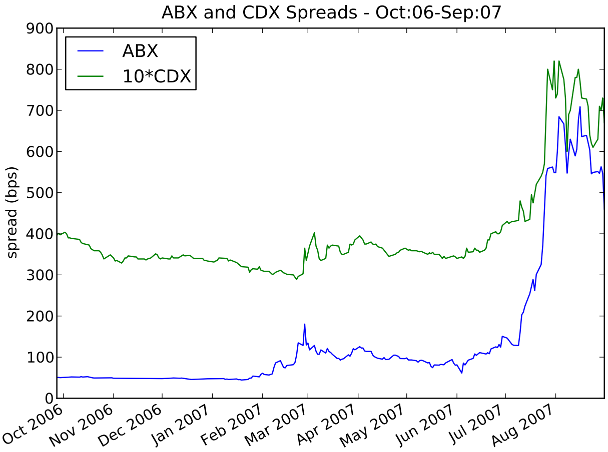
Lags in Shock Transmission

- However, before March, CDX spreads narrowed as ABX widened.



Post July '07, ABX and CDX both increase

- ABX/CDX spreads, volatility and correlation increase.



What is the Transmission Mechanism?

- Financial institutions were employing more leverage because of perceived low risk environment.
- Losses in subprime resulted directly in more leverage in some funds, and also increased underlying asset volatility, causing forced selling.
- Given that we think that levered instituions are mostly responsible for transmitting the crisis, it would be interesting if we were to find substantial evidence of crisis transmission due to mutual fund trading.

Horizon

- A fund's Horizon is a key exogenous variable in the MMY tests. of a fund and it's holdings of securitized debt.
- The proxies for a fund's horizon are:
  1. the volatility of fund flows.
  2. the sensitivity of flows to performance
  3. portfolio turnover.
- All proxies are measured *leading up to June 30, 2007,*
- Given subprime debt performance in early 2007, funds that hold more subprime debt will probably have more volatile (and negative) performance, flows and sensitivity.
- *Can Horizon really be treated as an exogenous variable?*

Holders' Exposure

- An individual bonds' Holders' Exposure measure is a second key exogenous variable in the MMY tests.
- A bond's *Holders' Exposure* is defined to be high if the mutual funds holding that bond also hold large fractions of securitized debt.
- Holders' Exposure is an attempt to capture the effect of contagion from mutual funds holding securitized debt who, faced with losses in their securitized debt portfolios, sell their corporate debt.
- However, it appears to be rather proxying for the quality of the corporate debt.
  - This is something that is difficult to completely instrument for.