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The Evolving Beta-Liquidity Relationship of Hedge Funds[☆]

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Abstract

Hedge funds are known to have liquidity-timing capability, but this might be conditional on aggregate market conditions. To test this, we analyze changes in the relation between hedge funds' stock market exposure and aggregate stock market liquidity. Employing an optimal changepoint approach, we find that equity-oriented hedge funds display a significant shift in liquidity-timing behavior after the major market microstructure changes in the year 2000. The shift is from a negative relation between market beta and liquidity towards a positive relation. We rule out a mechanistic explanation of the results by computing the returns to several familiar risk arbitrage strategies, finding in them no evidence of a similar shift in liquidity timing.

Keywords: hedge funds, market timing, liquidity timing, changepoint regression, dynamic strategies

JEL-Classifications: G14, G18, G23

1 Introduction

Hedge funds seem to be able to time general market trends and risk factors. Market timing behavior is observed from their early exit from the technology bubble as well as quickly changing exposures to market risk factors (see Brunnermeier and Nagel (2004) and Patton and Ramadorai (2013). Dynamic trading strategies employed by hedge funds potentially get reflected

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