

# Common Fund Flows: Flow Hedging and Factor Pricing

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# This paper has several important findings

- 1 Macro shocks, e.g. economic uncertainty, drive common fund flows
- 2 The flow beta is priced in the cross-section of stock returns
- 3 Channel: Fund managers hedge against common fund flow shocks by tilting away from high-flow-beta stocks
  - Fund manager fees are based on AUM

# These findings bear important implications!

- Rationalizes how economic uncertainty shocks can be priced in the stock market
  - Even if retail investors cannot form accurate long-term expectations and sophisticated dynamic investment plans
  - Reconciles assumptions for the ICAPM framework
- Sheds light on the effect of delegated asset management on asset prices
  - Mutual funds are a key player in capital markets
  - Key friction: fund manager compensation pegged to fund size and hence fund flows
  - A new channel of intermediary-based asset pricing

# The execution is truly impressive!

- Comprehensive and thoughtful analysis
  - Model rationalizing results
  - Extensive empirical tests
  - Event study \* 2
- The channel/interpretation behind each result is carefully explored
  - Economic uncertainty → common fund flow shocks
  - Fund manager fees based on AUM → incentive to hedge against fund flow shocks → flow beta is prices in the cross-section
- Writing is very clear

# Some big picture comments

- ① What is behind the common flow shocks?
  - Fundamental versus non-fundamental drivers
- ② What is behind the flow beta?
  - Relationship with flow-induced selling pressure and price impact
- ③ What do the results imply going forward?
  - Trend towards more passive over active investment, i.e., away from hedging

# 1. What is behind the common flow shocks?

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- → Consistent with the model
- → helps rationalize how economic uncertainty shocks are priced in equilibrium even if retail investors are not so sophisticated

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But can the results be interpreted more generally?

- Given fund managers that care and hedge against common flow shocks, **anything that drives common flow shocks will be priced into stock returns**

# 1. What is behind the common flow shocks?

This implies that there is a flipside of the coin:

- Delegated asset management can “help” by pricing fundamental macro shocks into stock returns, rationalizing ICAPM
- Delegated asset management can “hurt” by pricing in non-fundamental shocks that affect common flow shocks into stock returns
  - Table OA.3 shows comovement of common flow with sentiment
  - Large literature on behavioral aspects of retail fund flows



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## **Both sides of the coin matter for the implications of the results**

- Suggest to reflect in motivation/interpretation as well
- Future work could potentially dive deeper into the non-fundamental sources driving common fund flows

## 2. What is behind the flow beta?

I am also curious about what drives stock betas!

- One possibility: Stocks with high betas →
  - ① Held more by funds whose flow shocks comove more with common flow shocks
  - ② More likely to be sold given outflow shocks + less likely to be bought given inflow shocks
  - ③ Have higher price impact when sold ( $\uparrow$  market illiquidity)
- Then, **there could be a direct effect between common flow shocks and stock returns** → the flow-induced price impact channel
- Recall the proposed channel → flow shocks are priced because of the hedging demand by mutual funds

## 2. What is behind the flow beta?

- Stocks with high betas →
  - 1 Held more by funds whose flow shocks comove more with common flow shocks
  - 2 More likely to be sold given outflow shocks + less likely to be bought given inflow shocks
  - 3 Have higher price impact when sold ( $\uparrow$  market illiquidity)
- Motivated by the flow-induced price impact literature, e.g., Coval and Stafford 07, Lou 12
- Consistent with the paper's findings
  - high stock betas  $\rightarrow$  positively correlate with Amihud illiquidity but cannot be explained fully by Amihud illiquidity

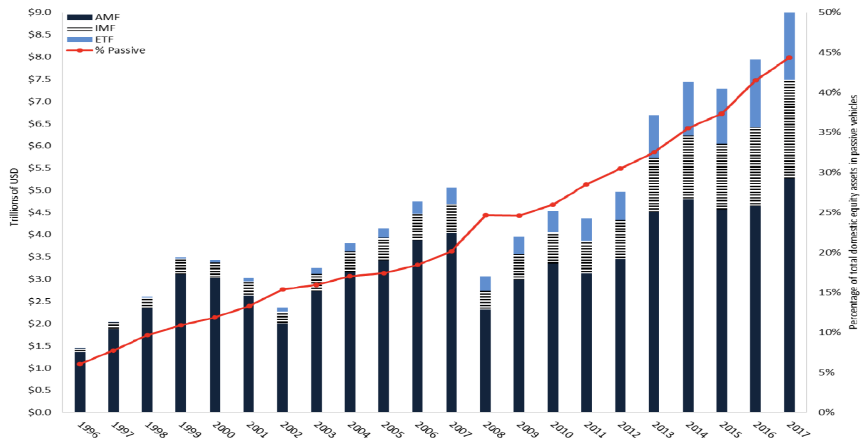
## 2. What is behind the flow beta?

### **There is no conflict - both channels could coexist!**

- Would be interesting to explore further
- (1), (2), (3) are all empirically measurable
- Could help relate to flow-induced price impact literature
- Interpretation of the betas and the mechanisms at play matter for thinking about the common flow shock factor going forward

### 3. What do the results imply going forward?

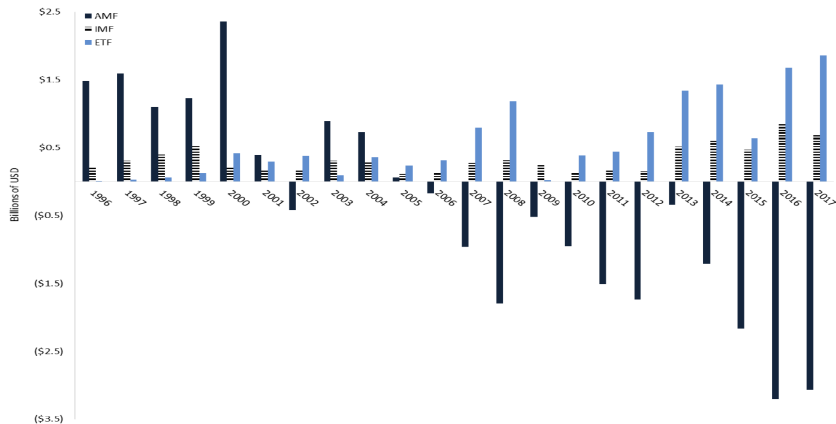
Figure: Asset Size of Active versus Passive Funds



Dannhauser and Pontiff 19

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Figure: Flows at Active versus Passive Funds



Dannhauser and Pontiff 19

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- What happens to the common flow shock factor as we trend towards passive investing that constrains hedging?
- Results suggest that flow shocks are not priced with passive funds
  - Long-short portfolios sorted on the betas of common flows of index funds have insignificant market-risk-adjusted returns
- Consistent with “flow shocks are priced because of the hedging demand by mutual funds ... index funds are less able to hedge against fund flow shocks...”

Really? Would common flow shocks in a passive world not be priced at all?



### 3. What do the results imply going forward?

#### One possibility

- Passive funds are not only constrained from doing flow-hedging
- They are specifically tied to track an index, often a market index
  - Funds tracking the S&P 500 are literally tracking the market
- Their common flow shocks may be very correlated with the market and have little independent variation after controlling for market risk
- → common fund shocks may still affect stock returns but may overlap more and more with the market
  - Statistically the same result, economically different implications!
- Could be tested: time-series and cross-sectional variation in the proportion of a stock held by passive versus active equity funds

# Conclusion

- This is a great paper!
  - ① Common fund flow shocks priced in the cross-section of stock returns
  - ② Economic uncertainty is an important driver of fund flows
  - ③ Fund flow shocks are priced because fund managers do flow-hedging
- Very rigorous execution!

# Conclusion

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  - ① Common fund flow shocks prices in the cross-section of stock returns
  - ② Economic uncertainty is an important driver of fund flows
    - There could be behavioural drivers of fund flows too
  - ③ Fund flow shocks are priced because fund managers do flow-hedging
    - Interpretation of flow beta → there may also be a direct channel of flow induced price pressure
    - With more passive investment, will common flow shocks no longer be priced or just be superimposed on the market?
- Very rigorous execution!
- Mostly big picture comments about interpretation and implication