Wharton
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Discussion on

“Liquidity Provision in a One-Sided Market: The Role of Dealer-Hedge Fund Relations”

by Kruttli, Macchiavelli, Monin, and Zhou

Yao Zeng, Wharton School, University of Pennsylvania

Why I like this paper

Despite the “predator” reputation, hedge funds actually stabilize bond markets in crisis times

- Impressive data, careful empirical analysis, surprising results

“I'm looking for a hedge against my hedge funds.”

Headline result drew from a triple interaction

Dependent variable:	Cost	
HF Expo×Crisis	-0.556	0.045
	(2.276)	(2.357)
MF Shock×Crisis	1.779**	
	(0.662)	
HF Expo×MF Shock ×Crisis	-0.073**	-0.065***
	(0.032)	(0.022)
Log(TTM)	33.369***	
	(7.526)	
N	229,856	161,633
R^2	0.335	0.582
Dealer FE	Yes	Yes
Day FE	Yes	No
Bond FE	Yes	No
Bond-Day FE	No	Yes

Dealers with more hedge fund connections charge lower transaction costs for bonds suffering more mutual fund liquidations during March 2020

- Interesting, but curious why triple interaction?
- How should we interpret the insignificant result for the simple two-way interaction?

Overall, a very plausible story of dealers channeling mutual fund fire sales to deep-pocketed and potentially better-informed hedge funds

- **Heterogeneity** of non-banks matters!

What would be the ideal data to test the hypotheses?

I can envision two “ideal” data to test the paper’s empirical hypotheses

1. Hedge fund data on trades/positions of corporate bonds
2. TRACE data with buy-side identifiers

Such data is unavailable… but clever use of 2nd-best (unique!) data is what stands the paper out

Rest of my discussion focuses on two points to further tighten the economics

1. Why does relationship matter?
2. Why hedge funds?

Why does relationship matter?

Why does relationship matter for bond dealers at all?

SEC Form PF tells us the **prime brokers** of a hedge fund

What does the relationship between hedge funds and prime brokers mean?

- Access to long-term institutional investors such as pension funds that have massive security holdings and serve as a source of securities to lend for short-selling purposes
- Access to commercial banks that have funds available to make large margin loans

But then where are dealers in this story?

- Prime brokerage and bond market-making are handled by separate trading desks
- Form PF doesn’t suggest a “relationship” between hedge funds and a bond trading desk

Why does relationship matter for hedge funds' bond arbitrage?

Suppose different trading desks are subject to institution-wide balance sheet capacity constraints

- A dealer benefits from a better prime broker-hedge fund relationship

But then why do hedge funds as arbitragers care about such a relationship?

- A priori, they go where the alpha is regardless of any "relationship"

Suggestions:

- Spell out the institutional details that make the relationship between hedge funds and prime brokers matter for bond dealers' price-setting
- Tests on hedge funds gains from liquidity provision, e.g., do HF-absorbed bonds outperform?

Why hedge funds?

Who are the natural buyers?

A priori, hedge funds are not what came to my mind first as “natural buyers”

- Insurers and pensions: Coppola 2022, Bretscher/Schmid/Sen/Sharma 2023, Li/Yu 2023
- Some mutual funds: Anand/Jotikasthira/Venkataraman 2021

What makes (some) hedge funds a better liquidity provider than these traditional natural buyers?

- Or maybe insurers are still better liquidity providers? Very different policy implications

Suggestions:

- Run a horse race between hedge funds and insurers?
- Are hedge funds particularly good at absorbing mutual fund selling pressures?

Conclusion

Interesting and informative paper about the cross-section of non-banks as liquidity providers

- Hedge funds absorbed mutual fund selling pressures during the Covid crisis
- Expand the usual understanding of patient versus impatient investors

Fleshing out the economics could make the contribution even crisper

1. Why does relationship matter at all for bond market-making
2. Why hedge funds are the natural buyers