

# Do institutional investors stabilize equity markets in crisis periods? Evidence from COVID-19

Discussion

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Long Term Investors' trends:  
Theory and practice

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# The paper in a nutshell

- Interesting empirical work on the response of Institutional Investors during the COVID-19 outbreak
  - Forensic approach
  - Policy implications
  
- Question: did institutional investors contributed to amplify equity markets distress during the COVID outbreak?
  
- Main findings:
  - Institutional investors engaged in “fire sales” that destabilised equity markets, leading to large valuation losses in the cross-section of Russell3000 corporates. Driven by:
    - Redemptions
    - Portfolio rebalancing towards firms that were more financially robust (less leverage, more cash)
  
  - Retail investors (at least from RH) provided the liquidity required
  
  - Key takeaway: when a tail risk event materialises, institutional investors amplify price crashes.

# Fire sales: The Who

- Known fact: indiscriminate sales (= fire sales) by certain investors in a context of limited market liquidity drove large valuation losses during March 2020
  - Cross-market deleveraging event: BIS (2020), Vissing-Jorgensen (2021, for US Treasuries), Schimpf et al (2020, fixed income, funding), Avalos and Xia (2021, MMFs), Aramonte and Avalos (2020, corporate bonds).
  - Comparable developments in commodity markets (Avalos, Huang and Tracol – forthcoming).
  
- Are all institutions the same? Figure 7 of the paper illustrates very different responses across institutional types
  
- More can be done to apportion price impact and drivers of institutional deleveraging → but it may require higher frequency data (more below)
  
- Hedge funds sold off much more than any other institutions, and according to the paper findings (Table 5), they sold off different stocks than the other institutional investors
  
- Different institutions face different constraints and incentives: a more detailed analysis of the *who* and the *why* could provide valuable insights for policy.

# Are redemptions a key driver of fire sales?

- Overall, the evidence seems consistent with a sudden deleveraging event triggered by a liquidity squeeze.
- Redemptions are a potential driver of the event, but its actual weight is not really quantified, and there are reasons to underweight them
  - Pension funds are not subject to any sort of large-scale redemptions.
  - Hedge funds, the largest sellers, typically have redemption windows or redemption advise periods that shields them, to some extent, from fleety investors.
  - Mutual funds are exposed, but their sales are not the largest. Still, it would be interesting to find out if their ownership swings were closely associated with market distress.
- Market intelligence and analysis suggest that, in many cases, and certainly in the case of HFs, **margin calls** on derivative positions created the liquidity pressure. That could also have been the case for some off-balance sheet vehicles popular among pension funds (eg UK LDIs).
- That calls for attention towards a different aspect of funds' portfolios: their fragility, as represented by their overall leverage, explicit and synthetic.

# Are portfolio rebalancings a driver of fire sales?

- The paper proposes and tests whether portfolio rebalancings were another driver of fire sales.
- Firms more financially fragile (more leverage, thinner cash buffers) suffered lower returns and saw more pronounced drops in IOs during Q1 2020.
- Sounds unlikely that institutional investors, which are typically very mindful of the price impact of their trading, suddenly stampeded out of certain stocks as a result of a strategic portfolio decision.
- In fact, the extension of this shift to Q2 2020 (as shown in Table 6) suggests that this was part of a longer trend that simply continued in that quarter.
- The Authors could provide additional empirical evidence that the shift was not ongoing in previous quarters.
- Market intelligence could also be brought to the table to give more support to that specific hypothesis.

# The timing of fire sales, and fundamentals

- Timing issue with the correlation between IO before the COVID-19 outbreak and stock returns during the “Fever” period.
- With these quarterly data, it is hard to argue that this is evidence of institutional trades driving stock returns through fire sales
  - What if sales happened in January? Or after 23 March? Ideally, data with much higher frequency are needed to support such a conclusion (Avalos and Xia 2021).
- The paper emphasizes that stock returns during the “Fever period” did not seem to reflect changes in analysts’ earnings expectations, and so they deviated from fundamentals.
- “Excess volatility puzzle”: stock prices fluctuate much more than their fundamentals, as a result of frequent and large swings in the equity risk premium.
- Table 3 does suggest that firms with higher IO saw a larger wedge between stock prices and fundamentals. But IO may be proxying for the overall liquidity scarcity in markets.
  - Yet again, what institutions are those? Are the differences between holdings of different institutions immaterial? If IO actually proxies for liquidity, are there any institutions that provide the best signal?

# Minor observations

- What is the role of the ES scores in the paper?
- When added in the regressions of Table 4, key coefficients become non-significant, as sample size drops by over 20%.
  - Can we have more information about the observations lost? Are there any patterns linking them?
  - Are the overall results driven by a specific subsample?
- S&P500 firms with high leverage or low cash buffers suffered losses during the “Fever” period, but did not experience significant IO drops. Does that weaken the initial argument of the paper linking both for the broader Russell3000?
- Table 6 shows that stocks recovered despite the fact that institutions continued withdrawing from high leverage and low cash firms. Does that cast any doubt over the original narrative linking low returns in the Fever period to the rebalancing?

# Extensions

- More information about portfolio funding and leverage vulnerabilities could be brought to the analysis.
  
- Why was the response to September 11, another exogenous shock, so different?
  - Without understanding that, we are not really understanding the events of March 2020 → impossible to formulate an appropriate policy response
  - The main conclusion of the paper is not really warranted, as we cannot tell that ALWAYS in situations of tail risk realisations institutions will respond with fire sales. Was there something different this time around?
  
- Do these swings in valuation actually affect corporate decisions?



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