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Tail risk in hedge funds: A unique view from portfolio holdings*

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Abstract

We develop a new systematic tail risk measure for equity-oriented hedge funds to examine the impact of tail risk on fund performance and to identify the sources of tail risk. We find that tail risk affects the cross-sectional variation in fund returns and that investments in both tail-sensitive stocks and options drive tail risk. Moreover, leverage and exposure to funding liquidity shocks are important determinants of tail risk. We find evidence of some funds being able to time tail risk exposure prior to the 2008-2009 financial crisis.

JEL classification: G11, G23

Keywords: Hedge funds, Tail risk, Portfolio holdings, Funding liquidity risk, Leverage

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