Having skin in the game is considered essential in many economic relationships. In hedge funds and private equity funds, the skin in the game is represented by performance fee or carried interest. It is supposed to align the interests of investors and fund managers, reducing agency costs. Measuring the economic value of performance fees and their impacts on an investment’s performance have been the subjects of numerous academic and industry papers. While performance fees are likely to reduce agency costs, they provide asymmetric costs/benefits to both parties. In almost all cases, performance fees have embedded call options, creating incentives to increase volatility and reducing the skin in the game when the firm has performed poorly. The total economic impact of performance fees is difficult to estimate. One recent study by Ben-David, Birru, and Rossi reports that hedge fund performance fees cost investors about 50% of the total profits generated by hedge funds and the total fees cost investors almost 64% of the total profits generated by hedge funds. These figures are substantially different from the nominal performance fees of 20% quoted by most hedge funds and private equity funds.

The lead article of this issue, “On the Valuation of Performance Fees and Their Impact on Asset Managers’ Incentives,” co-authored by Nobel Prize-winning economist Robert Merton, creates a model for dealing with performance fees. Dai, Merton, and Rizova provide a robust and practical framework for assessing performance fees. The model employs the option pricing framework and, therefore, requires fewer inputs to obtain the results. The authors study the incentive impact of performance fees and caution against the unintended consequences for manager behaviors.

The following article, “Measuring Hedge Fund Liquidity Mismatch” written by Aragon, Ergun, Girardi, and Getmansky Sherman, tackles the liquidity mismatch that can arise in managing a hedge fund’s portfolio. Liquidity mismatch between assets and liabilities is a common feature and a source of risk for all financial intermediaries, including hedge funds. In this article, the authors construct a measure of mismatch between the market liquidity of assets and the funding liquidity of liabilities of hedge funds. Using quarterly Form PF filings, the authors construct the liquidity mismatch measure and study its dynamics over 2013–2015. They find that the market liquidity of a hedge fund’s assets is typically higher than the funding liquidity of its borrowings and investors’ capital. However, liquidity mismatch changes as market conditions change.

In “Portfolio Strategies for Volatility Investing,” Campasano examines a portfolio allocation strategy consisting of equal allocations to market risk and volatility risk. The strategy developed in the article uses the information contained in VIX premium, defined as the difference between VIX futures and VIX Index levels, to create expected returns on volatility returns and equity markets risk. While the strategy is predominantly short volatility, the strategy dynamically adjusts the position such that it will be long volatility during much of the global financial crisis. Both long and short volatility allocations prove profitable over the sample period.

“Allocating to Liquid Alternatives for Mean-Variance Diversification” by Hubrich introduces a framework to help asset allocators create diversified portfolios of alternative and traditional asset classes. Allocators need to decide how much to allocate and
how to fund these positions. Further, the permissible allocations are often capped, and formulating explicit return assumptions is particularly challenging. Focusing on liquid alternative mutual funds, the author introduces a framework to assess such an investment purely in terms of its risk, using mean-variance considerations to extract the return threshold that would justify a moderate, realistic allocation. The framework reveals nuanced relationships between the risk properties and attractiveness to the broader portfolio: both greater volatility and a lack of equity market correlation can be advantageous in the sense of lowering this return threshold. The paper’s empirical finds, including the 2020 sell-off, provide additional insights about whether such funds have generated that minimum risk-adjusted return in the past.

The subsequent two articles examine crypto assets. The first one, authored by Hu, Lindquist, and Fabozzi, tackles the issue of modeling price dynamics of this new asset class. The model is then applied to optimal portfolio construction and option valuation. The authors present how an optimal dynamic portfolio of crypto assets that minimizes either return variance or conditional value at risk can be constructed. They carefully back-test the dynamic portfolio model and develop a valuation model for options based on a dynamic pricing model for the underlying crypto index. The article argues that there is a need for a crypto index-based exchange-traded fund, leading to the development of derivatives such as crypto portfolio insurance products.

“A Cryptocurrency Risk-Return Analysis for Bull and Bear Regimes,” by Barkai, Shushi, and Yosef, develops a new framework for analyzing the risk-return profiles of major cryptocurrencies. The article focuses on understanding the price behavior of individual cryptocurrencies and their interactions. By examining their behaviors during bear and bull markets, the paper provides insights into changing crypto assets’ relationships. Also, the article examines sources of potential systemic risks to the system. As more institutions enter the markets for crypto assets, these findings will have significant implications as they develop a toolkit to manage various risks of crypto assets portfolios.

As expectations of a higher future inflation rate spill over into financial markets, more investors are looking to increase their allocations to commodities. In two highly relevant articles, the authors examine the benefits of allocations to commodities and their roles as hedges against inflation. In “Inflation Hedging in the Long Run: Practical Perspectives from Seven Centuries of Commodity Prices,” Zaremba, Szczygielski, Umar, and Mikutowski reexamine the fundamental reason for investing in commodities: a long-run hedge against inflation. The authors comprehensively investigate commodities’ inflation-hedging ability across 50 commodities for 80 countries and seven centuries of data. They confirm that commodities have offered protection against inflation throughout history, especially over long, multi-year periods. Nonetheless, hedging capacity has varied remarkably—both over time and across geographical regions. They recommend that investors should continue to include commodities in their portfolios to protect against inflation. However, not all commodity types offer the same protection level, changing over time and across countries and geographies.

In “Rethinking Commodities,” Boal and Wiederhold find that commodities have long been viewed as a tactical investment, unlike equities and bonds. In contrast to traditional risky assets, commodities prices do not provide a consistent beta return, tied to higher profits and dividends through time. In contrast, they present a collection of unique price returns that reflect the underlying supply and demand dynamics of
physical assets that serve as the global economy's building blocks. The authors take a new look at commodities as an asset class and their uses in a portfolio, discussing alternative investment uses of commodities. Such uses include building blocks to express particular investment themes, tactical trading tools, and multi-asset risk premia allocation components.

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