Extremal connectedness and systemic risk of hedge funds

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We propose a dynamic measure of extremal connectedness across investment styles of hedge funds, an important driver of financial crises. Using multivariate extreme value regression techniques, we estimate this measure conditional on factors reflecting the economic uncertainty and the state of the financial markets, and derive several systemic risk indicators. Empirically, we study the dynamics of tail dependencies between investment strategies in the HFR database. In a preliminary step, we exploit cross-sections of hedge funds monthly returns grouped by investment styles to estimate marginal fund-specific tail distributions. We show that during crisis periods, some pairs of strategies display an increase in their extremal connectedness. Our results highlight that a proactive regulatory framework should account for the dynamic nature of the tail dependence and its link with financial stress.

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