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REVIEWER'S REPORT

Manuscript No.: IJAR- 55545

Title: Investigating the Financial Distress Risk Puzzle within the Hedge Fund Industry.

Recommendation:

Accept after minor revision.

Rating	Excel.	Good	Fair	Poor
Originality	✓			
Techn. Quality	✓			
Clarity	✓			
Significance	✓			

Reviewer Name: Dr. Bishwajit Rout

Reviewer's Comment for Publication.

(*To be published with the manuscript in the journal*)

The reviewer is requested to provide a brief comment (3-4 lines) highlighting the significance, strengths, or key insights of the manuscript. This comment will be Displayed in the journal publication alongside with the reviewers name.

1. **Significance**: This study is significant as it extends the distress risk puzzle beyond equities to hedge funds, an underexplored yet systemically important investment class. By demonstrating that high default risk hedge funds deliver lower returns, it challenges traditional risk–return assumptions and provides valuable insights for investors, regulators, and researchers interested in alternative investments and financial stability.

2. **Strength**: The study's main strengths include its large and comprehensive hedge fund dataset, rigorous default probability estimation using logit models, and robust performance evaluation through the Fung–Hsieh seven-factor framework. The analysis across strategies and economic cycles enhances credibility and relevance, while the clear empirical evidence strongly supports the existence of the distress risk puzzle in hedge funds.

3. **Key Insight**: The central insight of this research is that hedge funds with higher default risk are not rewarded with higher returns, even when they survive. Instead, low default probability funds consistently outperform across strategies and market conditions. This finding confirms that the distress risk puzzle persists within the hedge fund industry, challenging conventional risk–return theory and investor assumptions.

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Reviewer's Comment / Report

The paper titled "*Investigating the Financial Distress Risk Puzzle within the Hedge Fund Industry*" empirical study examines the distress risk puzzle where high-risk distressed assets yield lower returns in the hedge fund industry. Analyzing monthly returns of 7,151 hedge funds from 2000 to 2016, segmented by market conditions and strategies, it finds that funds with high default probability deliver lower returns than low-risk ones, confirming the puzzle's presence. Investors in distressed hedge funds are inadequately compensated for added risk. The paper fills a literature gap and offers insights for risk management and allocation.

Suggestions for Improvement:

1. Condense institutional and regulatory background to maintain focus on the research problem.
2. Clearly articulate the research gap earlier, rather than embedding it deep in the narrative. Present research objectives and questions more concisely and systematically.
3. Improve synthesis by grouping studies thematically rather than chronologically.
4. Explicitly distinguish between equity-market distress risk studies and hedge fund literature.
5. Strengthen the transition from general hedge fund literature to the distress risk puzzle.
6. Clearly distinguish null and alternative hypotheses using standard econometric conventions.
7. Align hypothesis wording more closely with empirical tests conducted later.
8. Provide a clearer justification for excluding funds with less than 24 months of data.
9. Explicitly discuss potential survivorship and backfill biases and their mitigation.
10. Clarify how missing observations and reporting gaps were handled.
11. Provide a clearer economic intuition for each explanatory variable included.
12. Report model diagnostics such as goodness-of-fit measures or pseudo-R^2.
13. Improve readability by reducing mathematical repetition and simplifying notation explanations.
14. Justify the exclusive use of the Fung–Hsieh model over alternative asset pricing models.

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The paper offers a rigorous and well-executed empirical investigation into the distress risk puzzle within the hedge fund industry. Its extensive dataset, robust methodology, and clear findings significantly contribute to hedge fund and asset pricing literature. However, improvements in clarity, synthesis, hypothesis formulation, and economic interpretation are necessary. With moderate revisions addressing these issues, the manuscript is suitable for publication in IJAR. Addressing the identified weaknesses will make it suitable for publication in IJAR.

I recommend this paper for publication after minor revision.