

Alternative Asia

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Against a backdrop of increasing regulatory acknowledgment of alternative investments in the Asian region, the signs are positive for continued asset growth fueled by specialist funds of funds and heightened institutional interest.



Asia's Track Record

The hedge fund industry as a whole has experienced enormous growth over the last decade, growing by some estimates from just 300 funds in 1990 to more than 4,000 today. Figures suggest that hedge fund assets in Asia represent just 3% of the US\$400 billion in hedge fund capital worldwide, or US\$12 billion. Of that US\$12 billion, little more than US\$3 billion is actually managed in Asia.

But in 2001, Asian hedge funds staged a dramatic comeback from the poor performance of 2000. A record 32 funds were started during the course of 2000 and a further 29 got off the ground in the first half of 2001 according to *AsiaHedge* sources. Many commentators are now suggesting that Asian hedge funds are -among the best-performing elements of the average hedge fund investor portfolio. The shame is that most investors sold out at the end of 2000.

Fund management companies in Asia have begun introducing alternative investment products. There is a growing appreciation that hedge fund portfolios exhibit a low correlation with traditional asset classes and that hedge funds should therefore play an important role in strategic asset allocation. Large asset owners have begun to make strategic allocations to hedge funds due to an increase in demand for these products from investors who have lost their faith, nerve or desire to invest in the stock market, following the heavy losses of the past 18-24 months.

Yet it was not so long ago that the sector was dogged by a number of problems. In the aftermath of the 1997 Asian crisis for instance, hedge funds were singled out for their role in contributing to the collapse of some Asian currencies. The sector's dubious notoriety was further enhanced following the spectacular losses and failures experienced by several high-profile market players in the US in 1998.

However, it appears that these setbacks have not stunted the industry's growth. The well-documented characteristics of the Asian markets, such as extreme volatility and rapid sector rotations make an ideal environment for many hedge fund managers. The market seems to be deepening, and there is clear evidence that a new breed of dedicated Asian fund of funds will help power the market forward in the coming months. Fuelling this growth is the belief that a huge restructuring will take place in Asia, presenting countless new opportunities, and that fewer people are looking at these opportunities

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than those presented elsewhere in the world, particularly in the small and medium-cap areas.

A look at the developing alternative investment hubs in Asia — Japan, Hong Kong, Singapore and Australia — illustrates the growing significance of the industry and serves to highlight the idiosyncrasies of each country.

Japan

Against a backdrop of an extremely weak Japanese equity market, low bond yields, and cash returns of almost zero, many organisations are increasingly looking at alternative investments. Japan is a very large market and there is a disproportionately small number of hedge funds relative to market size. While Japan may not seem to be the best place to invest at present, for managers offering hedge funds with a Japanese focus, business appears to be increasingly brisk. Both new and established managers are starting funds focused on Japan, and investors are readily allocating assets to them.

Hedge funds have doubled their trading activity in the Japanese stock market in 2001, according to statistics compiled by Nomura Securities. About US\$75 billion worth of stock trades, including short sales, were recorded in the first six months of 2001 by 30 major hedge funds that trade the Japanese market. This is more than double the figure from a year earlier. Nomura's statistics also show that hedge funds account for just over 10% of the total trading value generated by non-Japanese investors. Foreign investors account for more than half of all Japanese stock trading. These statistics indicate that hedge funds have been transacting almost 6% of all Japanese securities lending.

Hong Kong

An important development in Hong Kong — and one which indicates a growing acceptance of the hedge fund business by the authorities — is the recent publication of a consultation paper by the Securities and Futures Commission (SFC) on the offering of hedge funds in Hong Kong (see article in *Alternative IQ*, October 2001, pp. 31-35, Hedge Funds in Hong Kong: Approaching a Watershed?).

The final date for the submission of comments on the SFC's paper has passed and, at the time of writing, the industry is awaiting the outcome of the consultative process.

The SFC's paper proposed a framework for the authorisation of hedge funds for sale to the public in Hong Kong. Two different approaches to regulation were suggested in the paper:

- o Market segmentation, where only certain types of investors could invest in hedge funds (achieved through a net worth test for investors or the imposition of a minimum subscription) combined with qualitative disclosure; or by
- o General offer, where an offer to the public may be made with full/comprehensive disclosure and where the minimum subscription is *not* regulated.

Many promoters or managers of hedge funds around the world are not likely to be that interested in promoting or seeking authorisation for their hedge funds in Hong Kong. The vast majority of hedge funds interested in the Hong Kong market are likely to be promoted by traditional retail trust managers with existing Hong Kong operations who are seeking to broaden their product range.

However, the proposed authorisation of hedge funds is generally viewed positively, as it would allow investors access to a broader range of investment opportunities and it may remove some of the negative perceptions global investors currently have of Hong Kong's financial system.

Singapore

In Singapore, boutique firms have been expanding into hedge funds with mixed performance results to date. There are maybe eight firms who have secured boutique fund manager status from the Monetary Authority of Singapore (MAS). Once given this status, foreign investors in a fund pay no Singapore tax. Given that the vast majority of managers in Singapore manage Asian equities and most manage the funds against a set benchmark, there is considerable scope to offer alternative strategies. However, fund raising remains a real challenge in the local market, with no pre-existing culture of institutions providing seed money for fund start-ups.

The recent move by the MAS to allow hedge funds to be distributed in the local market has therefore opened up new opportunities for both market practitioners and investors, bringing a new dimension to the funds industry. Importantly, the MAS will allow retail investors to tap this group of products.

Australia

The Australian hedge fund industry has been a hot bed of activity over the last 12 months. The industry was given a great boost this year when the country's second-largest superannuation fund (the national pension scheme) announced it would put A\$100 million into hedge funds. In June 2001, news broke that CSS/PS, a A\$15 billion pension for Commonwealth public servants, was taking proposals from multi-manager hedge funds. The overall level of activity seems to have escalated of late, with recent reports that some of the biggest names in alternatives are angling for a strategic edge to ensure continued growth in 2002. Such strategic relationships that aim at coupling portfolio management talent with distribution capability will be a critical factor for those targeting individual and retail investors.

Funds of Funds

Most of the Asian institutions that have dipped their toes into the hedge fund market have done so via funds of funds or CTA products, while only a handful have started single manager products. In Japan, for example, where fund of fund flows from insurance companies in particular are on the rise, the interest in funds of funds has been driven by the particularly poor performance of local long-only portfolios. And in many instances the asset allocation decision-making process is being outsourced to experienced advisers.

The present focus on funds of funds in the region can be attributed to the fact that the process of choosing a strategy mix, carrying out due diligence and monitoring a portfolio is time consuming and may still be a talent outside the skill set of many trustees and investment companies. Funds of funds also reduce the upfront cost of setting up a hedge fund portfolio, but the price of this convenience is reflected in the higher fees.

The fact that the Asian hedge fund industry is so new, however, means that investors have trouble building models for back testing their strategy. This could further delay fund launches. Moreover, investors are often having to rely on six- to nine-month track records, and a perceived lack of strategy diversification in the region. There are a number of very good hedge fund managers operating in Asia, but the question is whether there are enough to make up a dedicated fund of funds. Is the variety of strategies wide enough to achieve a sufficient level of diversification and spread?

Asian markets may always be affected by violent swings in sentiment and liquidity. However, lower interest rates and abundant domestic liquidity with attractive absolute and relative valuations have thrown up some of the most attractive investment opportunities in the world today. Consequently, although one might expect the US market to be range-bound, Asian markets have the potential for more interesting performance. However, the overwhelming focus on Asian equities continues as the latest statistics indicate. This itself is not bad news, but managers need to bring new ideas to the market-place to increase their competitive position.

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Institutional Investors

The investor group in Asia is becoming more sophisticated and institutional investors are increasing their involvement. Institutions appreciate that hedge funds should not be viewed purely as a way of geographically diversifying a portfolio, but as an opportunity to allocate money to inefficient markets where the potential for profits is high — and Asia is one of those markets. They realise that hedge funds will continue to grow in significance in strategic asset allocation and will increasingly challenge conventional investment management. The structure of the hedge fund industry, and growth in the supply of market inefficiencies, suggest that the advantages inherent in hedge fund investments are unlikely to diminish soon.

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Conclusion

Hedge fund assets in the region should continue to grow significantly. The signs are very positive, particularly as the number of specialist Asian funds of funds continues to grow. This could develop into a stampede if the Hong Kong and Tokyo authorities make hedge fund investing easier — as is widely expected.

Looking ahead, the development of the hedge fund business in Asia is also dependent on the US and global conditions. The current environment is ideal to emphasise the benefits of long/short investing in Asia. Attractive Asian equity valuations in a global context of slower growth will make returns in Asia stand out for the foreseeable future.

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