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Hedge fund managers expect to resume upward path

27.02.08

Asia's hedge fund industry may be reeling from a monthly decline of more than 5 per cent in January, its worst performance for at least eight years, but the sector remains confident that the setback - one experienced practically across the board by the global hedge fund industry - will only prove a hiccup in what has seemed an irresistible ascent over the past decade.

The 5.18 per cent decline for January reported by Singapore-based data provider and research firm Eurekahedge (based on reporting from managers making up some 76 per cent of the aggregate net asset value of the 423 funds in its database) comes after five successive years of double-digit performance, including an average return of 18.78 per cent last year. The net asset value of funds tracked by Eurekahedge has grown by a cumulative 151 per cent through performance since the firm launched its Asia Hedge Fund Index at the beginning of 2000.

'January looks like one of the worst months the Asian industry has had for a long time,' says Peter Douglas, principal of Singapore-based consultancy and investment adviser GFIA. 'The average plain vanilla Asian long/short equity manager has probably dropped around 5 per cent, within a range of 3 per cent on either side, and there are a few outliers, with Indian-focused managers having a particularly bad time. But in the context of what Asian equity markets have done, the industry hasn't made a bad stab at protecting people's capital.'

The industry's vigorous performance has been matched by the growth of funds that focus on investment in Asia, which are now estimated to number between 1,200 and 1,300, and in the flow of assets to them. According to Eurekahedge, Asia has been - along with Latin America - one of the prime beneficiaries of the trend toward investment in emerging markets. 'Total allocations to Asia have more than doubled over the last eight quarters, compared with a rise of just 33 per cent in US-invested assets,' the firm says in its 2007 asset flow report.

'The industry has grown across the board over the past year in terms of assets and number of managers,' Douglas says. 'In relative terms, the long/short space has grown slightly more slowly, partly because it was probably the most densely populated strategy. More of the big global players are putting in place Asian desks to trade part of their capital here or to trade specific Asian products as spin-offs from multistrategy funds in various guises.'

The big exception is Japan, which has seen an exodus of assets that began in the first half of 2006 and continued through last year. 'That's a function of performance and of the world's overall lack of interest in Japan,' he argues. Gordon Shaw, a member of the global management team at Fortis Prime Fund Services with responsibility for Asia, concurs: 'Japan is picking up a little bit, but in context it is not doing very well. China saw 47 per cent growth in 2007 and India almost 40 per cent.'

As in North America and Europe, one of the most striking characteristics of the Asian market has been the outsized growth of the biggest managers and funds. 'The average fund size has been going up,' says André Valente, global head of business development and client relationships at UBS Global Asset Management's Fund Services business. 'Five years ago it was USD100m, but now it's USD150m, in line with growth of the global market.'

Douglas estimates that there are now between 30 and 40 managers based in the region with more than USD1bn, and he says times are getting tougher for start-up managers that lack a pedigree or an existing reputation within the hedge fund industry. 'It's very hard to start with a blank sheet of paper now,' he says.

'Even three years ago, someone with a reasonable reputation, but without the experience of having run a hedge fund, could climb the curve if they worked hard and delivered the numbers. Now, because the industry is institutionalising and at last the biggest global allocators have become comfortable with allocating to Asia, the large volumes are going to big managers with the organisation and operational infrastructure to keep the big investors happy.'

Douglas notes that with well over a thousand managers now active across the region, investors seeking exposure to Asia no longer need to take a gamble on up-and-coming managers that lack a substantial track record. 'New managers who have previously worked in an existing hedge fund do start with a reasonable chance,' he says. 'But it has become very difficult for someone who has not really earned a reputation in a hedge fund or who doesn't have a lot of starting capital to make much headway.'

Observers agree that an important contribution to the development of the industry has come from the growth of the services infrastructure surrounding it, notably specialist administrators. A sector that was once dominated in the region by Bank of Bermuda (now part of HSBC), followed at a distance by Citco and Fortis, now comprises around a dozen administrators with operations within Asian time zones and that are actively seeking hedge fund business. Notably the Monetary Authority of Singapore has encouraged the development of an administration hub with substantial resources on the ground.

'You need to offer local servicing within the same time zone,' says Michelle Chua, head of business development and client relationships in the Asia-Pacific region for the Fund Services business at UBS Global Asset Management. 'We have three executives in Hong Kong and two more in mainland China, working with existing clients, developing business in the region and targeting new clients.'

Shaw says the market has changed dramatically in recent years. 'We were one of the original service providers in Asia,' he says. 'There were only really a couple of administrators until the past couple of years, when the market really started to take off. Now increasingly competitive providers are moving in and expanding their product and service offerings, as are we.'

Prime brokers have also rushed into the region, but Douglas questions whether all the new arrivals will be successful in establishing a critical mass. 'A lot of both first- and second-tier providers have made Asia a priority over the past couple of years, but the downturn at the end of last year and into January may have been giving some of the second-tier firms second thoughts,' he says. 'Some of them have been basically buying business. I suspect there's a pause in the aggregate growth of prime brokers, and there will be a split - some will put on more and better-quality business, and some will go home.'

Hedge funds and their service providers are certainly benefiting from the increasing sophistication and liquidity of financial markets across Asia. 'There are still some constraints in the important markets of India and China that make it difficult for foreigners to invest,' Douglas says. 'But generally across the region, the supply of stock borrowing is infinitely better. Over the past two years any given hedge fund strategy in Asia has probably doubled the amount of capacity it can deal with.'

He also points out that hedge funds are playing an increasingly important role in the region as a provider of liquidity to capital markets. 'A lot of the big hedge funds are providing liquidity directly to issuers in the form of trade finance, asset-backed finance, block trades or private convertible bonds,' he says.

'The main competition for these kinds of trade used to come from the commercial banks and the proprietary trading desks of investment banks, but in the second half of last year they disappeared from the market. The commercial and investment banks are simply no longer competing for that kind of funding deal. The share of liquidity provided to capital markets by hedge funds increased very dramatically in the second half of last year.'

One area of the alternatives industry in which Asia lags behind other regions is on the investment side, even for players such as UBS Global Asset Management that have better channels than most through the group's wealth management business. Says Valente: 'Distribution is a case of promoting the brand and targeting clients through referrals and local distribution agents, but for the private Asian client distribution is a challenge.'

Douglas notes: 'It's quite difficult to find distribution into Asia, partly because the market is very fragmented and every jurisdiction is quite different. By contrast, most marketing groups that we see now expect to have some Asian product on the platform. The channels are now there for selling a good-quality Asian hedge fund into the rest of the world.'

Attitudes among institutional investors vary from market to market. 'There are some very big and sophisticated hedge fund allocators in Japan, which has been a big market for alternatives for a number of years,' he says. 'Korea is beginning to wake up, and there have been a number of allocations by big institutions, in particular to funds of funds, which could turn out to be quite substantial. The Taiwanese have been early adopters of hedge funds, along with a few institutions in Hong Kong and in Singapore, while many big Australian superannuation funds have been comfortable allocating to hedge funds for quite some time.'

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