Asian Economy

Hedge funds beat the odds - for some

By John Berthelsen

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While Asia's markets were suffering through yet another lackluster-to-awful year in 2002, some investors continued to prosper, at least relatively, in the down market. They were investors in hedge funds, the investment vehicles of the super-rich, which are providing comfort and solace at a time when war fever is making world financial markets jittery.

Asia's 250-odd hedge funds delivered average growth of 5 percent for 2002, while the benchmark Morgan Stanley Equity Asia Pacific Free Index of freely traded equities was off nearly 10 percent. The top 10 hedge-fund performers all had annualized profit margins for January above 45 percent, according to EurekaHedge Advisors Pte Ltd, a Singapore-based firm providing advisory services to hedge funds. Overall, Asian hedge funds outside Japan performed best, climbing 9.6 percent, according to EurekaHedge Advisors' annual directory.

And, in Asia as in the rest of the world, hedge funds are beginning to transform the financial community, with implications not just for the wealthy but for common investors as well. EurekaHedge Advisors says that proprietary traders and hedge funds now make close to 60 percent of the trades in most Asian markets. Institutional investors, many involved with massive pension funds, are buying into them, and both in the United States and Asia investment rules are being changed to allow small investors into them as well.

They obviously are not without controversy. Mahathir Mohamad, Malaysia's splenetic prime minister, famously called them the "highwaymen of the global economy" during the 1997-98 Asian financial crisis for their raids on Asian currencies. Warren Buffett, the celebrated American investor, recently said that financial derivatives, widely used by hedge funds, are "financial weapons of mass destruction" and a threat to the world financial system.

In spite of the warnings of Mahathir and Buffett, hedge funds are proliferating at a feverish pace, with assets in Asia growing by 40 percent in 2002 from US$14 billion to US$20 billion. The number of funds increased from 160 in January to 250 by the year-end, with another 80 likely to launch in 2003. Assets dedicated to Asia are expected to grow to $25 billion to $28 billion, an increase of 25-40 percent, by year-end.

In fact, the biggest complaint among Asian hedge fund managers is still the lack of available capital. More than 40 percent of the funds in the EurekaHedge universe have less than $25 million under management, the break-even point. The cost base of those outside Japan is low, but few can survive for more than two years with less than $25 million in total assets. Many smaller hedge funds will hit that mark during this year, raising the possibility of a larger shakeout than the 10 that crashed in Asia in 2002.

Trading in shares, currencies, debt and commodities, hedge funds have tripled globally to more than 6,000 in the past 10 years, with assets under management having exploded from $67 billion to more than $650 billion. They are increasingly supplanting mutual funds, which lost the bulk of the $7 trillion that vaporized in the three-year obliteration of the global equities bubble. In fact, because of their ability to short the markets, some of that $7 trillion ended up in hedge-fund customers' pockets.

The idea of hedge funds is simple, involving making one investment to protect against downside risk in another. The strategies, however, are not simple. They employ a bewildering array of investment tactics, many of them centered on short-selling, which is the practice of borrowing stock and selling it in the hope of buying it back later for a lower price as markets fall - a sound tactic in the world's current three-year bear market, but an extremely dangerous one if markets suddenly turn up. Other strategies include deep leveraging, program trading, swaps, arbitrage and derivatives.

Because of their phenomenal success and their opaque strategies, hedge funds are an elite club, usually restricting themselves to no more than 100 investors per fund. They thus have been exempt from many of the rules and regulations governing mutual funds, which has allowed them much more room to be aggressive. Most have extremely high minimum investment thresholds averaging about $500,000, making them available only to institutional investors and the very wealthy. They typically have lock-in periods ranging up to five years. Most require net worth on the part of investors ranging from $1 million to $5 million.

As with traditional mutual funds, hedge-fund investors pay management fees, although most funds also collect a percentage of the profits. They benefit by heavily linking managers' pay to performance incentives. In the past three to four years, they have attracted some of the best brains in the business away from the region's investment banks and mutual funds.

Mutual funds are regulated by the US Securities Exchange Commission, the Securities and Futures Authority in London and other agencies and entities. Money for the funds is raised from small to large investors in the general public. In contrast to the hedge funds, mutual funds have disclosure requirements and are otherwise heavily regulated. Usually they are restricted from purchasing many types of derivative instruments, leveraging, short-selling, real estate and commodities. In bear markets, they can only hedge by pulling a portion of their funds out of stocks and putting them into cash.

Buffett and other major government and private figures have called for closer regulation because of the potential damage some funds can wreak on world financial markets. Most famous was the US Federal Reserve's 1998 forced $3.6 billion rescue of Long-Term Capital Management, which specialized in trading of esoteric derivatives. Then-US treasury secretary Robert Rubin and Fed chairman Alan Greenspan grew alarmed that LCTM's potential failure could imperil the entire global financial system. At the beginning of that year, LTCM had capital of $4.8 billion and a portfolio of $200 billion. It also had borrowing capacity in terms of leverage and derivatives with a notional value of $1.25 trillion for which it would have been liable had it gone under when markets suddenly turned against its positions.

Nor was LCTM alone. Hedge-fund tycoon George Soros took a $2 billion pounding in the Russian market by betting the wrong way on the ruble - after having made billions earlier by betting against the British pound. Derivatives trading wrecked the venerable Barings investment bank in the mid-1990s and landed its star trader, Nick Leeson, in Singapore's Changi Prison.

Globally, in 2002, some 73 percent of funds failed to earn their operators performance fees, generating concerns that the failure rate could spiral. As many as 800 hedge funds, or a fifth of the global total, closed down, according to data from industry tracker CSFB Tremont. Capco, the Antwerp-based financial consulting firm, warned this month that as many as 50 percent of the hedge funds that collapse do so because of operational failures, with another 38 percent going under because of bad investment decisions. One major failure last year was the $300 million Eifuku Japan Fund, a highly secretive, opportunistic equity long/short fund domiciled in Tokyo.

US Hedge fund failures: Only the strong survive

Year	**Failed funds**	**Failure rate (%)**
1995	79	7.7
1996	145	12.2
1997	119	9.2
1998	174	12.2
1999	253	17.5
2000 (est)	288	12.0

Data based on funds tracked by TASS Research

Despite these risks, over the past few months the United States has moved to lower the threshold to allow smaller investors into the game. The governments of Singapore and Hong Kong as well have moved to make the funds more democratic, with the Hong Kong Securities and Futures Commission (SFC) last November authorizing the first batch of hedge funds for sale to retail investors. Singapore has also eased retail investors' access to hedge funds, with the Monetary Authority of Singapore (MAS) writing new guidelines that would allow investors to buy into certain hedge funds for much smaller amounts.

Both governments, however, have been troubled with the lack of disclosure by hedge funds. The MAS described them as "less transparent and more difficult to understand". Hong Kong's SFC in November issued guidelines requiring the funds to provide detailed information on such subjects as Sharpe ratios, a risk-adjusted measure of return, and other minutiae.

Outside of Hong Kong and Singapore, only Australia in the Asia-Pacific region is even trying to regulate hedge funds. As they are not without controversy, they are also not for the faint-hearted. While most take on less risk than many proprietary equity trading desks, some can provide moments of heart-stopping excitement. For example, the India Capital Fund, a London-based fund dealing in India pharmaceuticals, fell a dizzying 31 percent in a single month in 2000 after having risen 27.7 percent in a month shortly before, according to EurekaHedge's latest annual directory.

Then again, when they are good, they can be really good. The top performer in the EurekaHedge directory for 2002 was the Bilbo Capital Fund, whose annualized return was 86.1 percent as of this January. Bilbo is managed by a young Singporean commodity trader named Lee Kum Swee, who started investing during undergraduate study in 1998.

Across the board, for February the ABN AMRO EurekaHedge Index posted a positive return of 1 percent, while the MSCI AC Asia Pacific Free Index fell 1 percent. Only the India and Indonesia markets in Asia posted even small, although negligible, positive returns. In fact, ABN AMRO's three EurekaHedge indices beat every other single share index in Asia except for Shanghai B shares.

Those returns, however, are balanced by a so-called "bottom 10" whose annualized returns went as low as a negative 19 percent as of January, according to EurekaHedge.

The ABN AMRO EurekaHedge Index is a comprehensive register of all strategies and regions within Asia. It includes funds based anywhere in the world that have at least 60 percent of assets employed in markets ranging from Japan in the east, Pakistan in the west and Australia and China to the south and north, respectively.

According to the ABN AMRO index, distressed-debt funds, in which managers buy the equity or debt of companies that are in or facing bankruptcy, performed the best of all Asian hedge-fund strategies. They were closely followed by commodity trading advisors (CTAs), which trade commodity futures, options and foreign exchange and which are most highly leveraged. The relatively few macro and relative-value funds also did exceptionally well on the whole, returning more than 10 percent for each strategy.

Trade on US dollar weakness worked exceptionally well for many macro fund managers and arbitrage opportunities in Japan helped relative-value funds. The weaknesses in long/short equity and multi-strategy funds were a drag on the overall performance of the ABN AMRO EurekaHedge indices.