



Investors Keener on Structuring Alternatives

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Institutional investors in Asia are increasingly finding that structured products are a useful way to buy exposure to hedge fund returns. Driven by market volatility and a greater focus on capital treatment, insurers and financial institutions are increasingly buying funds of hedge funds with principal-protected wrappers. They are also using derivatives and structured products to switch hedge fund investments into their local-currency allocation or even to make them Shariah-compliant.

It may not have been a great year for hedge funds so far, but investment banks and asset managers in Asia say that there is still strong growth in demand for structured ways to invest in alternative strategies.

Regulatory requirements are a big driver. Under the Basel II framework, financial institutions' investments in hedge funds are subject to a greater risk weighting thanks to their lack of transparency, which had prompted many big investors in Asia to either reduce their exposure or to delay entering the market in the first place.

In Japan, for example, where Basel II has been in effect since April 2007, almost three-quarters of regional banks cut their hedge fund exposure in the run-up to the introduction of the new rules, according to AIMA, the alternative investment management association, and as many as two-thirds continue to do so.

Now, after an initial period of uncertainty, banks in Japan – particularly the smaller regional players using the standard approach – are realising that principal protection is one of the most efficient ways to gain access to hedge funds. Insurers are also demonstrating more risk aversion.

"If you were talking to an institution 18 months ago, they definitely didn't need protection and were looking at leverage," says Giselle Lee, head of sales for Man Investments in Hong Kong. "Today, institutions are still deploying capital, but the stance is definitely a lot more conservative and as a result we are seeing an increasing demand for principal protection rather than buying an open-ended version of the fund."

Figuring Out the Fees

Another significant driver of fund-linked structures is the constraints on offshore investment allocations in countries such as Malaysia and Taiwan. Needless to say, there are few opportunities to buy hedge funds in ringgit or Taiwanese dollars, so investment banks use a quanto structure to convert offshore hedge fund returns into local currency.

These kinds of structures are quite different to the traditional fund-linked products sold to retail investors. "Retail customers ask for a lot of exotic structures because they are always keen to have attractive performance and a high potential return," says Cyrille Troublaiewitch at Citi. "When interest rates were fairly low, if you wanted to have some attractive potential return you had to put some exotic features in the product – a simple CPPI (constant proportion portfolio insurance, a common form of principal protection) or an Asian call on the underlying was not enough."

Troublaiewitch says that the most popular fund product Citi has traded during the past year was a tracker on a BlackRock fund that provided 2x leverage.

Such structures appealed to retail investors, but institutions and even high net worth investors can access leverage from borrowing in the market or, for rich individuals, from their private bankers.

There is also a cost/benefit issue that institutions have to weigh carefully before deciding to put a structure on top of a fund of funds. Using principal-protected structures for regulatory reasons or to quanto into another currency is the most popular approach among institutions because it adds real value, but investors who buy structures just to provide some protection are not always getting a good deal.



"If you buy a diversified fund of hedge funds, you know the volatility is going to be 4% or 5%, so it doesn't always make sense to pay for principal protection," says Troublaiewitch from Citi. "If a provider offers principal protection on such a fund they are going to charge between 1% and 2% per annum, so some people would argue that you are basically paying for something that's not really needed. You have a fee at the level of the underlying funds and a fee at the level of the fund of funds, and if you put a structure on top you have another fee there, so a client really needs to make sure that the structure makes sense."

Protection in Demand

Having said that, recent experience has led many investors to re-calibrate their risk assumptions – in an environment where triple-A CDOs can become worthless junk and a leading investment bank can collapse overnight, many institutions are deciding that it makes sense to pay 2% for principal protection.

One option is to offset the cost of protection by using a CPPI structure to add a little bit of leverage, which can produce the pleasing result of a principal-protected product that outperforms the underlying fund.

The entry of institutions into the fund-linked market has led to a lot of asset managers and investment banks ramping up their structuring capabilities to offer solutions to these clients. GAM, for example, added a fund-linked derivatives team at the end of last year and now offers structured solutions in Asia.

"Long-only and traditional mutual funds are clearly not in fashion at the moment so our distribution currently is focused more towards pension funds and institutional or end investors, where we're able to wrap or package some of our alternative funds," says Rossen Djounov, head of structured products at GAM in London. "Investors' mood is sombre, they believe market volatility will persist, they see no clear direction in traditional beta instruments, so they're looking for the underlying to be primarily alternative but also the focus is primarily much more on capital preservation, capital protection, and asset substitution."

DIY

Except for very simple structures, asset managers offer these products to investors by partnering with investment banks. "We don't take full risk on our balance sheet so we usually try to outsource that," says Pirmin Stutzer, a member of the structured client solutions team at Man Investments in Switzerland, who adds that there is nevertheless a lot of benefit for clients to buy structures from Man rather than direct from a bank.

"We currently have more than US\$60 billion of assets under management, more than half of it fed through structured products, so we are quite experienced and have some power to negotiate good pricing with the banks," he says. "Quite often if the client would directly approach a bank they might not have the same level of experience when it comes to this type of negotiation or just not the same convincing economic power as we sometimes have."

And, clearly, negotiating a call on hedge fund is far more involved than buying an index call on the S&P. There is no standardised pricing model, so asset managers need to compare pricing from a number of banks. The illiquidity and lack of transparency of hedge funds can also make it very difficult for banks to hedge their risks, so any transactions will typically involve the bank trying to win some concessions in this area, such as clearer investment guidelines and enhanced liquidity.

"That's one of the key advantages when we do structured products on our own funds," says Stutzer. "We are close to the investment manager and we can have a much better feeling about what is going on in the underlying portfolio. A bank will usually just see us as a fund of fund provider but they don't have this granularity when it comes to the underlying information on the underlying investment strategy."

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