

Executive Briefing for the Report:

State of the Hedge Fund Industry in Japan, end 2002

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Introduction

This iteration of *The State of the Hedge Fund Industry in Japan, end 2002* takes account of data and trends observed in a proprietary database of roughly 5,500 single manager hedge funds and their allocations to Japan's financial markets as at end 2002. It is intended as a follow-up to research reports published as at end 2001¹ and mid 2002².

The operational reality for many global hedge funds in Japan at the end of 2002 was one of shrinking scalable opportunities. This theme was prevalent across a wide cross section of hedge fund strategies and was manifest in a general pullback in capital allocations. This mirrors a perceived deterioration in the overall investment environment compared to end 2001, one in which the Nikkei 225 and TOPIX indices slumped over 18% respectively to test multi-year lows.

Number of Hedge Funds Allocating to Japan rises

The total number of single manager hedge funds making allocations to Japan rose 7% to 645. This compares to 478 as at end 2001 and 603 as at mid 2002. The growth of the revised universe breaks down into 478 global hedge funds (such as long/short strategy managers who have some part of their global portfolios dedicated to Japan); 98 in Japan-specific hedge funds; and, 69 in the Asia-including-Japan fund category.

Exhibit 1: Number of Hedge Funds Allocating to Japan

Not surprisingly, the number management firms controlling funds directed in part or whole at Japan rose 11% to 405. This was due to a rash of new managers leading fund launches over the second half of 2002.

Aggregate Capital Allocations to Japan Decline

At the end of 2002, year-on-year allocations of capital before leverage to Tokyo financial markets fell by an aggregate of 14% to US\$ 24.9 billion. This was over 20% lower than the mid-2002 figure. Based on model estimates, aggregate leveraged capital allocations fell sharply to an estimated US\$34.1 billion. This is a decline of 38% year-on-year¹ and over 30% lower than the revised mid 2002² estimate.

Exhibit 2: Hedge Fund Capital After Leverage Allocating to Japan

The category of hedge funds that underwent the biggest reduction in capital allocations to Japan were so called global funds. Global funds comprise investment strategies such as long-short equity with a global focus, convertible arbitrage, global macro, multi-strategy and other funds that include a minority geographical allocation to Japan. The tendency is for these players to be opportunistic in their approach to portfolio allocation and strategies. Interestingly, data showed that the capital allocations to Japan and Asia-focused funds fell only marginally over 2002.

A combination of factors led to hedge funds pulling back capital from Japan. First, a number of high profile larger globally focused funds simply cut back market exposure in Japan due to ongoing stock loan shortages in the wake of Tokyo Stock Exchange equity shorting rule changes introduced in the first quarter.

Second, anecdotal evidence pointed to a number of long-short equity operators became increasingly capacity conscious. For one highly publicized hedge fund, rather than taking increasing investor allocations it announced that it would hand back a sizeable portion of its capital back to investors in order to retain a nimble investment approach.

¹ *The State of the Hedge Fund Industry in Japan 2002*, May 6 2002

² *The State of the Hedge Fund Industry in Japan Mid-Year 2002*, November 28 2002 revised January 20 2003

Third, perceptions that equity market turnover became more a function of cross-shareholding related selling appears to have undermined the majority of long-short strategies, which in reality tend to be long-biased with a longer investment time horizon. A number of institutional investors have apparently grown weary of Japan long/short equity hedge fund under-performance particularly by these so-called value-oriented managers.

Fourth, and a consequence of the above has been a growing trend of global funds allocating to Japan either rebalancing exposure to other geographies or strategies (e.g. energy) or for some Japan focused funds to enlarge their geographical exposure to cover other bourses in Asia on a perception of greater perceived short-term upside potential.

Japan-domiciled Firms Increase Capital Allocations

The distribution of management firm domiciles points to a number of subtle trends.

Firms in the North America region including offshore centers such as Bermuda, have experienced a capital claw-back in allocations from US\$47.1 billion to US\$22.8 billion during 2002. This represents a fall from 87% to below 70% of total allocations end 2002. The changes over the course of the year for European based management firms saw a marginal pullback since mid-2002, largely on the back of estimated reductions in leverage employed.

Japan-domiciled firms experienced the biggest gain in market share allocations from 2% to 17% or US\$5.9 billion at end 2002.

Allocations from Asia ex-Japan rose marginally to represent 5% of total allocations or US\$1.6 billion by end 2002.

Exhibit 3: Domicile of Hedge Fund Management Firms Allocating to Japan

Convertible arbitrage capital shrinks for now

Based on capital deployed, convertible arbitrage managers are believed to have made the biggest aggregate pullback of capital. Over 2002, this figure is believed to have been as high as US\$2 billion. The analysis points to a potential geographical realignment of capital by some convertible arbitrage and multi-strategy firms despite a 96% year on year increase in Japan's convertible new issuance to US\$8.5 billion³. Many hedge fund operators continue to voice concern at persistently unattractive convertible prices and a lack of market volatility.

Exhibit 4: Style Categories of Hedge Funds Capital Allocations Before Leverage

Emerging Trends

A number of interesting trends appear to have emerged in 2002 and the interplay of these will determine the growth prospects of hedge fund capital allocations to Japan. These include:

Capacity issues. A small and not insignificant number of established long-short managers returned capital to investors or are likely to take steps soon to close their doors to new investors. This is likely to continue as long as managers seek to comply with their stipulated net long and net short exposure guidelines. One can expect institutional investors to gravitate to smaller, newer funds with shorter track records.

³ *Global Convertibles Will Likely Remain An Attractive Choice in 2003*, D.Vazza, Standard & Poors, 02.25.03

Adding Asian strategies. More than one hedge fund manager with predominant exposure to Japan has embraced the concept of geographical diversification or looking beyond Japan for investment opportunities. Investors typically tied to Japan are apparently widening their investment horizons to include China, India, South Korea or even Asian situations. A minor implication of this is likely to be the continued emergence of cross-border arbitrage opportunities, such as in equity or debt-related pair trades pursued by hedge fund players in Japan.

Marketing long-short strategies. Depressed equity markets, persistent bearish sentiment and a lack of inventory for shorting strategies may continue to limit the performance of many Japan long-short equity managers. At the end of 2002, anecdotal evidence on the habits of certain institutional investors suggested some were tiring of some typical large cap long-term buy-and-hold managers (many with a value-style) favoring instead smaller opportunistic managers with a shorter-time horizon for holding stocks and over a range of different strategies. Another growing potential beneficiary is likely to be the more illiquid yet potentially higher octane performing managers focusing on smaller cap equities. All this suggests a more varied diet of investment options may need to be offered by long-short strategy managers to retain capital inflows.

Hedge fund capital slips from 7.2% to 5.4% as Percentage of TSE market cap

One question to ask is whether there been a material change in the impact of aggregate hedge fund capital after leverage on the Japanese equity markets?

In order to assess the impact one must make a distinction between the active and more static segments of the Tokyo Stock Exchange's (TSE) market cap. This is important because a still significant portion of that market cap is linked to equities that are represented by cross-shares and institutional holdings that are traded comparatively less often. This necessitates calculation of some form of TSE free float to arrive at an estimate of TSE adjusted market cap.

Of course, the impact of hedge funds can be magnified as some strategies make them some of the most active institutional traders in terms of portfolio turnover - a factor which is not captured explicitly by our data analysis.

Results show that hedge fund capital fell as a proportion of the adjusted TSE market capitalization over the observed period, from 7.2% at end 2001 to 6.5% mid-2002 and 5.4% at end 2002. This is considerably lower than a 15%-25% range attributed by analysts to hedge fund capital on the bourses of Europe and the U.S. and may be explained by a host of inter-related factors some of which have been already outlined.

Challenges Facing Hedge Funds in Japan

Some of challenges facing hedge fund industry include: a lack of stock inventory to short; the relative attractiveness of ex-Japan investment opportunities; unattractive pricing in the convertibles market; subtle changes in investor demand away from strictly buying "value" long-short managers; capacity considerations of many existing strategies; a general lack of good quality managers; overhanging gloom associated with a still persistent bad bank loan problem; the multi-year recession; and, a relative immaturity of the hedge fund industry in general chasing opportunities outside the North America and European markets.

On the positive side, there is still a new inflow of hedge funds managers willing to exploit new strategies in Japan. For many others, the pullback in leverage and activity could easily reverse if any of the above factors are alleviated.

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EXHIBITS

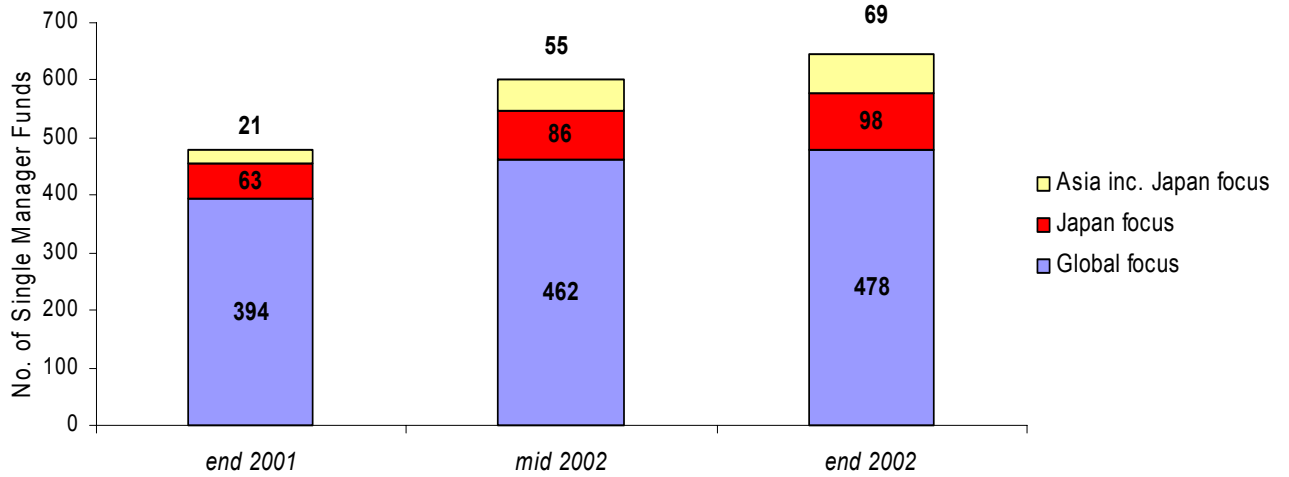
Exhibit 1: Number of Hedge Funds Allocating to Japan

Exhibit 2: Hedge Fund Capital After Leverage Allocating to Japan

Exhibit 3: Domicile of Hedge Fund Management Firms Allocating to Japan

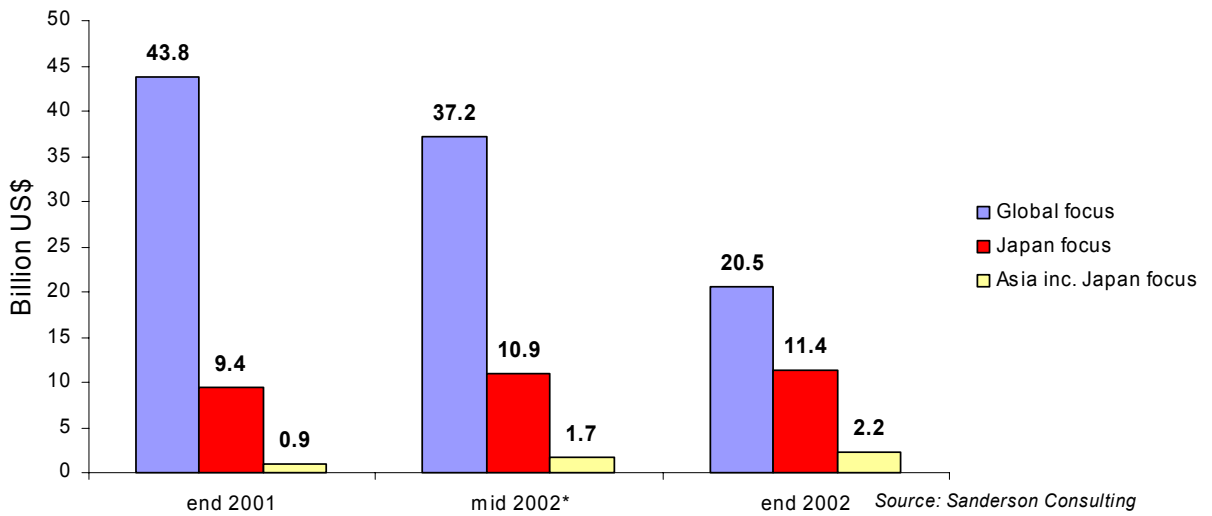
Exhibit 4: Distribution by Style – Hedge Fund Style Categories Before Leverage Allocating to Japan

EXHIBIT 1: Number of Hedge Funds Allocating to Japan



Source: Sanderson Consulting

EXHIBIT 2: Hedge Fund Capital after Leverage Allocating to Japan (Billions US\$)



Source: Sanderson Consulting
*revised leverage estimate

EXHIBIT 3: Domicile of Hedge Fund Management Firms Allocating to Japan

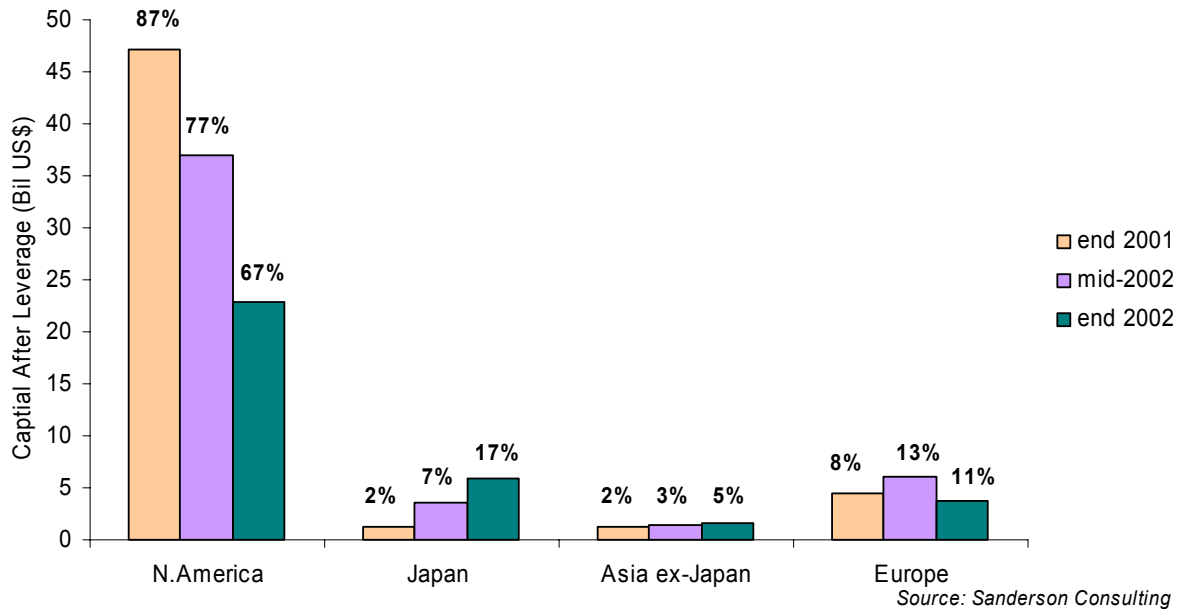


EXHIBIT 4: Style Categories of Hedge Fund Allocations Before Leverage

	<u>end 2001</u>	<u>mid 2002*</u>	<u>end 2002</u>
Long Short Equity	\$13 bln	\$15.8 bln	\$14 bln
Convertible Arbitrage	\$4 bln	\$3.8 bln	\$2 bln
Event Driven	\$3 bln	\$1.5 bln	\$1 bln
Global Macro	\$3 bln	\$1.8 bln	\$2 bln
Equity Market Neutral	\$3 bln	\$2.3 bln	\$2 bln
Multi-Strategy	\$2.5 bln	\$5.7 bln	\$4 bln

Source: Sanderson Consulting

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