

AN EXECUTIVE BRIEFING FOR THE REPORT

“STATE OF THE HEDGE FUND INDUSTRY IN JAPAN, 2002”

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May 6 2002

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State of the Hedge Fund Industry in Japan, 2002

Analysis of the Japanese alternative-investment market suggests that the amount of hedge fund capital targeted at Tokyo markets stands at US\$29 billion before leverage, a sum greater than most would expect.

Anticipating conservative growth of the hedge fund industry and of worldwide securities markets in general, alternative-investment exposure to Japanese markets is on a trajectory to hit US\$89 billion before leverage in five years.

Exhibit 1: Hedge Fund Capital Allocations

Under such a scenario, the hedge funds' share of the volume of the Tokyo Stock Exchange would hit 12% on an absolute basis of the actively traded portion of the market.

The distinction between active and more static segments of the exchange's market cap is important because a 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.

Of course, the impact of this market would likely be much greater given that hedge funds typically employ some degree of leverage and are known as being some of the most active institutional traders in terms of portfolio turnover. Analysis suggests that going into 2002 hedge funds made up 4% of the actively traded portion of the Tokyo Stock Exchange.

Global Funds Dominate

Past studies of hedge fund exposure to Japan have vastly underestimated the importance of alternatives in Tokyo markets. One of the primary reasons for this has been that much of the analysis out there has looked only at Japan-specific and Asia-specific investment vehicles when trying to quantify the size of the universe.

Such a premise is highly flawed. Analysis shows that the vast majority of capital targeted at Japan through hedge funds resides with non-Japanese asset management firms that put only a portion of their money to work in Tokyo securities.

In fact, our analysis showed Japan-only funds make up a mere 20% segment in terms of the aggregate hedge fund allocations engaged in Japan.

Most of the money aimed at Japan from hedge funds comes from large global funds. The characteristics of funds playing Japanese markets vary widely though in terms of asset size and investment style.

Looking at a universe of some 5,000 hedge funds from a proprietary database constructed for this study, analysis suggested that there are 478 individual hedge funds that have some degree of exposure to Japan.

Research suggests that the number of individual hedge fund firms engaged in Japan stood at about 257 in early 2002.

Exhibit 2: Number of Hedge Fund Allocating to Japan 2002

From a bird's eye view, global-focused hedge funds dominate the market. Of the 478 funds with exposure, some 394 are global in their investment scheme. Japan-only funds make up 63, while Asia-focused funds total 21.

Considering the greater maturity of the alternative-investment industry in the United States relative to other geographical regions, it might not be surprising that the bulk of the hedge funds with assets targeted at Japan actually have their primary trading operations based in the U.S.

In fact, more hedge fund assets flow into Japan from portfolios in London than they do from Tokyo.

On an unleveraged basis, North American hedge fund firms oversee \$25.3 billion or 87% of alternative assets at work in Japan's markets.

A Variety of Trading Styles

Another reason that many have vastly underestimated the influence of hedge funds in Japan is a bias towards looking only at long/short equity funds.

Exhibit 3: Style Categories of Hedge Fund Allocations to Japan

Long/short are a very significant component of the hedge fund activity in Tokyo markets based on the number of such funds and their aggregate assets. But long/short is just one piece of the equation. Analysis suggests a significant amount of investment activity in Japan from global-macro funds, convertible arbitrage, statistical arbitrage as well as multi-strategy vehicles.

Long/short comprises about US\$13 billion of hedge fund assets targeted at Japan with the median fund size weighing in at \$62 million.

Convertible-arb was the next biggest group with about \$4 billion, while market-neutral, event-driven, global macro and multi-strategy plays each added up to about \$3 billion, analysis showed.

Multi-strategy vehicles, a small segment in our data sample in terms of number of funds, should not be overlooked.

The large size of these funds, with a median capital allocation in Japan of over US\$600 million (before leverage), is notable because multi-strategy vehicles are known for having a high-threshold of capital capacity, a major issue for the alternative-investment industry.

They are also among the fastest growing funds in assets and are among the most avid users of leverage.

Separately managed accounts, which are often used by institutional investors, are also often left out, which can skew results because such pools of capital often represent the largest blocks of cash that move through the alternative-investment conduit into Japan.

The issue of leverage also dramatically changes the calculus of quantifying the footprint of hedge funds in Tokyo markets.

Most hedge funds use some degree of leverage and even a modest degree can inflate the impact of alternatives in Japan.

Growth Prospects

Based on conservative assumptions of leverage, correlated to particular investment styles, the baseline level of alternative allocations in 2002 for Japan US\$29.1 billion might actually be closer to US\$54.1 billion.

Looking ahead, hedge fund activity in Japan is poised for substantial growth even without taking leverage into consideration.

Exhibit 4: Estimate Growth of Hedge Fund Capital Allocations

Analysis shows that even a modest modicum of leverage combined with a 25% growth estimate (CAGR) would easily put hedge fund capital on a trajectory to hit a multiple of the baseline asset assumptions by 2007.

That would mean in five years hedge fund allocations to Japan could be substantially higher than the assumed (unleveraged) US\$89 billion.

Another scenario worth considering is higher than assumed growth. Should growth (CAGR) hit 40% the outcome on an unleveraged basis would be aggregate hedge fund assets of US\$156 billion in Japan by 2007.

This analysis does not assume any resurgence in the Nikkei over the same time horizon, which would likely accelerate growth further. Other factors that push hedge fund allocations higher is heightened interest from Japanese institutional investors in alternatives as well as the continued growth of the hedge fund industry as a whole.

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EXHIBITS

Exhibit 1 :Hedge Fund Capital Allocations to Japan in 2002

Exhibit 2 :Number of Hedge Funds Allocating to Japan in 2002

Exhibit 3:Style Categories of Hedge Funds Allocating to Japan

Exhibit 4: Estimated Growth of Hedge Fund Capital Allocations to Japan in 2007

EXHIBIT 1: Hedge Fund Capital Allocations to Japan in 2002 (Billion \$)

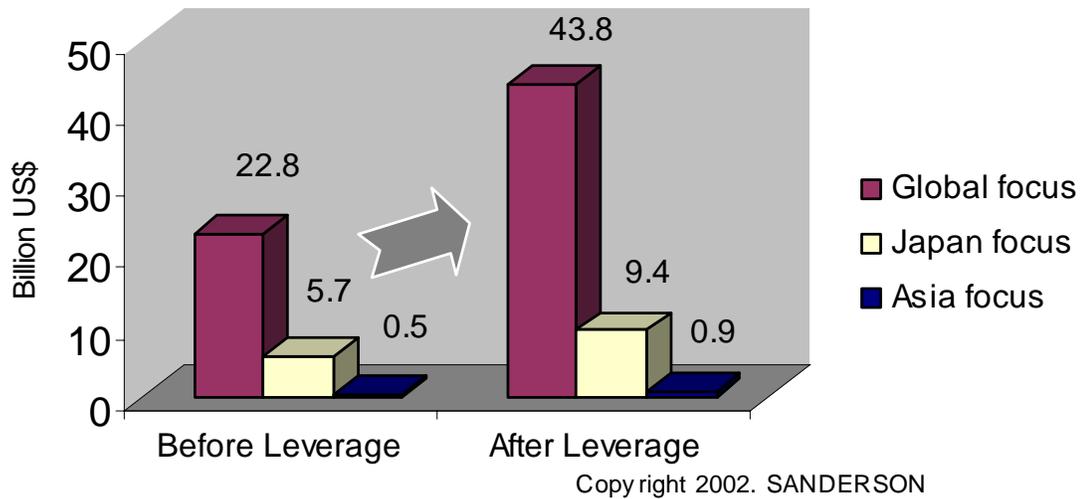
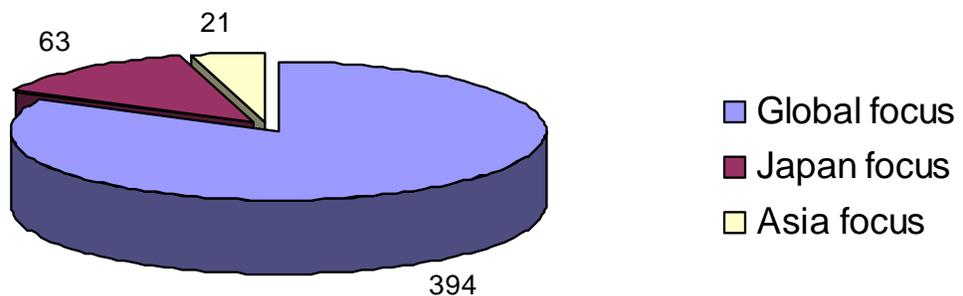


EXHIBIT 2: Number of Hedge Funds Allocating to Japan in 2002



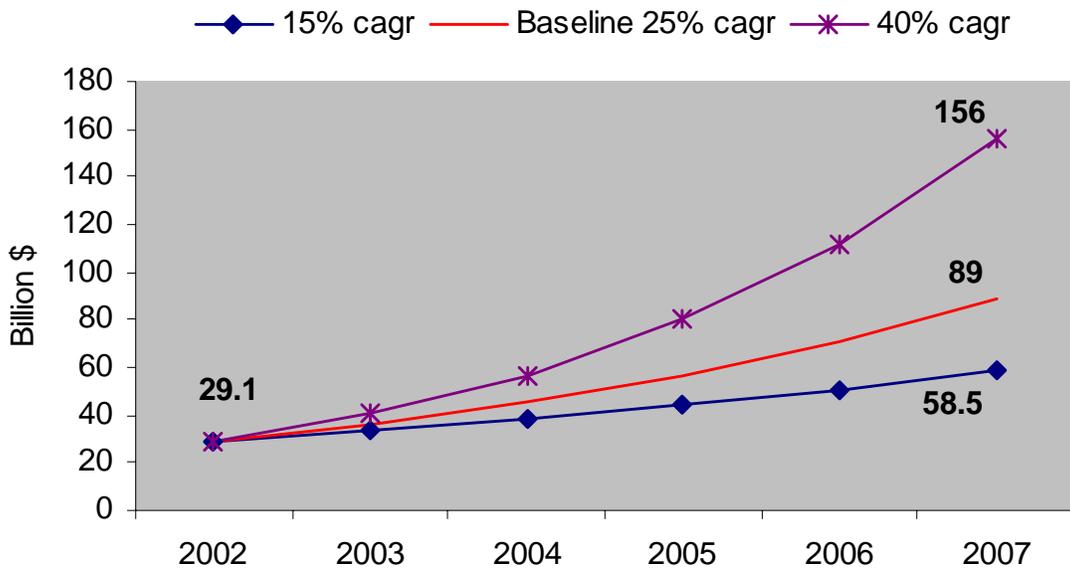
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EXHIBIT 3: Style Categories of Hedge Funds Allocating to Japan

	<u>Capital before Leverage</u>	<u>Median Fund Allocation</u>
Long Short Equity	\$13 bln	\$63 mln
Convertible Arbitrage	\$4 bln	\$75 mln
Event Driven	\$3 bln	\$64 mln
Global Macro	\$3 bln	\$75 mln
Equity Market Neutral	\$3 bln	\$45 mln
Multi-Strategy	\$2.5 bln	\$625 mln

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EXHIBIT 4: Estimated Growth of Hedge Fund Capital Allocations to Japan in 2007 (before leverage)



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