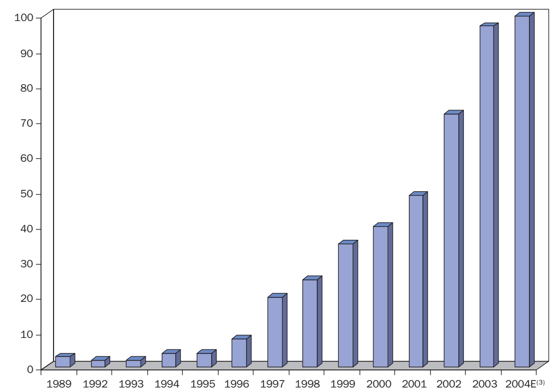
# Key Trends in Asian Hedge Funds

**Alexander Mearns from Eurekahedge, the hedge fund research and advisory group, reviews the Asian hedge funds universe. Based on comprehensive data, he looks back on a phenomenal volume increase, analyses success factors and illustrates key trends of the present.**

As at the end of April 2004 the Asian hedge fund industry was at USD 48.5 billion, a phenomenal increase in assets of 40%(1) since December 2003. February attracted the largest amount of capital for a given month this year when the universe grew by USD 2.5 billion. The ABN AMRO Eurekahedge Asian Hedge Fund Index was up 1.6% in February, so a large proportion of these assets can be attributed to inflows as opposed to performance. April and May were relatively flat as asset flows into the industry were nullified by negative performance. That said, we anticipate that the Asian hedge fund industry will grow to USD 55 billion by the end of this year.

2003 was a stellar year for the industry, and the ABN AMRO Eurekahedge Asian Hedge Fund Index was up 28%, and assets under management rose by about 75%. From inception in the late 1980s, growth was relatively pedestrian for most of the first decade. However, the late 1990s saw a marked change with a rapid acceleration of growth in both the number of funds and assets, albeit from a low base.

**Number of New Funds Launched(2)(4)**



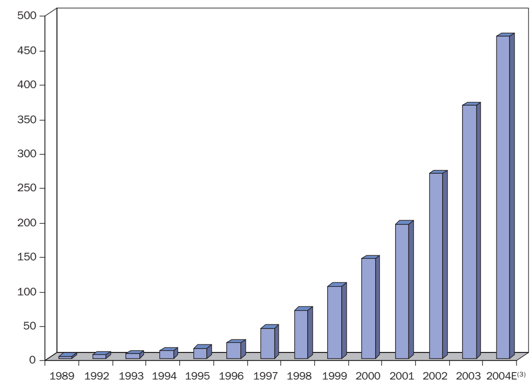

Source: Eurekahedge database

From the start of 2002 to date, the number of funds and assets has tripled from 162 funds managing USD 14 billion to 413 funds managing USD 48.5 billion. In 2003, there were 97 funds launched; we estimate a similar number to be launched in 2004 as the trend in prop-desk traders and investment bankers leaving their institutions to set up new funds increases.

(1) Through a combination of assets flows and performance
(2) Including funds that are now obsolete
(3) 2004 estimate
(4) Not including funds with more than one share class and/or denominated currencies

On our current watch list are 100 funds/managers who will likely launch their products in 2004. If we assume that 20 existing funds become obsolete during the year (just under 5% of the total funds as at end of April 2004), we expect the number of funds to grow to at least 500 by December 2004. Also we expect assets to grow to USD 55 billion through a combination of asset flows and performance. Notwithstanding, we believe these estimates may be conservative.

**Growth in Single Manager Asian Hedge Funds(2)(4)**




Source: Eurekahedge database

Suggestions of a bubble are in our view premature, with the industry in Asia in essence just playing catch-up with the rest of the world. The number of funds and assets deployed remain relatively small in the global context.

We believe that there is room for the industry to expand in Asia. Asia Pacific (including Japan) markets represent 15% of the world's market capitalisation. The number of hedge funds that do not have Asian-exclusive strategies is around 5,800, with approximately USD 800 billion under management. Thus, Asia-strategy hedge funds comprise under 7% of the global hedge funds' universe by number and value.

| Investment Geography | Number | Assets USD bn |
|---|---|---|
| Hedge funds Asia | 413 | 49 |
| Hedge funds worldwide including Asia | 6,200 | 849 |
| Asian hedge funds as percentage of total | 6.7% | 5.8% |

*"Suggestions of a bubble are in our view premature."*

The disconnect is even more apparent when comparing the weighting of Japan exclusive hedge funds to U.S. hedge funds. Japan comprises roughly 10% of the world's market capitalization while the U.S. constitutes around 40%. From the table below, we see that the 89 Japan only hedge funds represent only 1% of the total universe by number and value. In contrast, U.S. hedge funds represent 70%.

We are of the opinion that, for a number of reasons, the disconnect between Asia's relative market capitalisation and representation in hedge funds will close in the next five years. First, it appears that short-selling rules are liberalising in Asia outside of Japan while tightening in Europe and North America. Regulators in markets like South Korea and Taiwan, where it was illegal for foreigners to short sell individual stocks three years ago, appear to be loosening these regulations.

| Investment Geography | Number | Assets USD bn |
|---|---|---|
| Hedge funds Japan | 89 | 12 |
| Hedge funds U.S. | 4,000 | 600 |
| Hedge funds worldwide including Asia | 6,200 | 849 |
| Japan hedge funds as percentage of total | 1.4% | 1.4% |
| U.S. hedge funds as percentage of total | 65% | 71% |

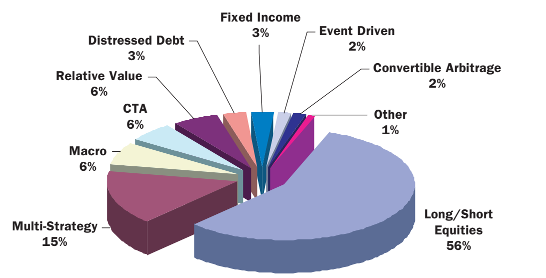
As well, the number of local capital allocators has increased over the past year and will likely rise dramatically over the coming five years. In particular some Japanese pension funds have started to move away from alternative assets in U.S. based funds of funds and are adding an Asian single strategy focus to their portfolios, though these allocations remain small at present.

With the decision recently to allow funds of funds to register in Hong Kong and Singapore, we believe that there could potentially be a strong retail demand for Asian fund of funds products based in the region. As most allocators to Asian hedge funds are currently in Europe or the U.S., local institutional funds of funds could provide a further boost in capital.

**Strategy Breakdown for Asian Hedge Funds**

The assets allocated to Asian hedge funds are still principally going to long/short equity funds; this has been the case since the start of the industry in Asia. However, the number of equity long/short funds is expected to decline as a percentage of the universe if a greater number of proprietary traders begin to launch macrofunds, CTAs and multi-strategy arbitrage funds. As the risk/return balance between a proprietary trading career and launching a boutique hedge fund begins to shift to the latter, the number of these types of funds is likely to increase substantially over the coming years.

**Number of Asian Hedge Funds by Strategy**




Source: Eurekahedge database

| Strategy | Annualised Return(5) | 2003 Return | YTD Return | Annualised Standard Deviation(5) |
|---|---|---|---|---|
| Convertible Arbitrage | 6.1 | 15.3 | 2.6 | 6.7 |
| CTA | 11.0 | 10.0 | 2.4 | 8.1 |
| Distressed Debt | 19.8 | 22.6 | 6.4 | 4.6 |
| Event Driven | 23.1 | 18.2 | 9.9 | 4.4 |
| Fixed Income | 10.8 | 15.3 | 1.9 | 6.1 |
| Long/Short Equities | 17.7 | 39.4 | 4.0 | 8.3 |
| Macro | 14.1 | 30.5 | –10.0 | 10.6 |
| Multi-Strategy | 14.6 | 17.1 | 4.8 | 4.9 |
| Relative Value | 6.6 | 15.1 | –2.6 | 5.2 |

(5) Dec 2000–Apr 2004

The best performing strategy in 2003 was Long/Short Equities, up 40%. This is partly due to the bullish markets and high beta exposure of some managers. It is also the result of the lack of widely available sell-side research and the subsequent pricing inefficiencies in Asian mid- and small-cap stocks.

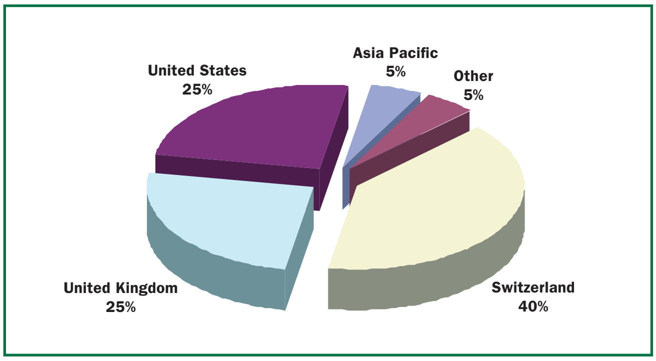
### Latest Trends in Asset Flows to Asian Funds

Asset growth was slow in the first half of 2003 given a combination of SARs, which prevented allocators from visiting the region and subdued equity markets. However, flows picked up towards the end of the third quarter 2003. The trend continued into the second quarter 2004, although the recent market volatility may see current inflows subside somewhat over the summer months.

We estimate that, since October 2003, in excess of USD 1 billion has been allocated monthly to Asian managers; however, February and March this year saw inflows of USD 2 billion each. Fund flows are being derived principally from Europe, with North America being much less significant. We are seeing this situation change in the early part of 2004 with American allocators increasing in importance.

The money is still flowing principally to long/short equity funds, with inflows favouring a limited number of funds; 85% of the money is going to less than 15% of the fund population.

### Source of Funds for Asian Strategy Hedge Funds

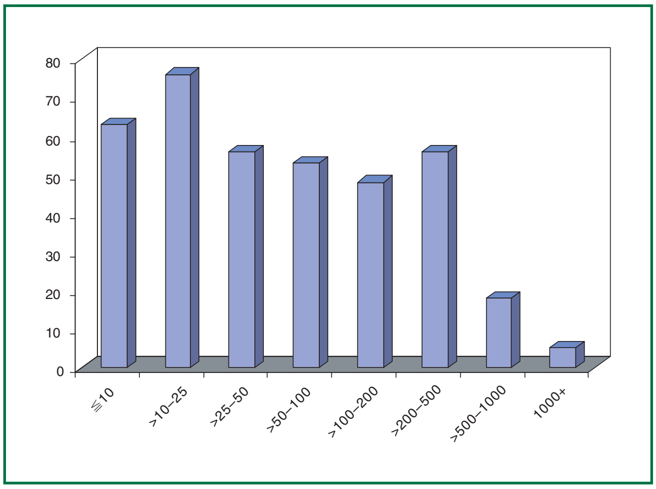



Source: Eurekahedge database

### The Asian Hedge Fund Dilemma

Despite the surge in liquidity we have seen over the last 8 or 9 months, the biggest hurdle amongst new starts is the difficulty in attracting capital, particularly considering the small number of seeders of Asian hedge funds. For example, there are currently less than 50 Asian focused funds of funds (4% of the fund of funds universe) of which probably only 5–10 of these selectively seed new managers. Around 40% of the Asian hedge funds in our universe have under USD 25 million, the break-even point for most management companies. Those that are based in Asia outside of Japan will have a low cost base, but usually cannot survive for more than two years with less than USD 25 million in total assets.

### Number of Funds by Assets under Management




Source: Eurekahedge database

The frustration for most of the small boutique managers is that the inflows to Asian hedge funds are favouring a limited number of funds; 85% of the money is going to less than 40 funds, which are mainly from long established Asian hedge funds (Lloyd George, Sloane Robinson and Boyer Allan), large institutions (JF Funds, Gartmore, GAM and Henderson) or hedge funds where the lead manager was previously employed at a large hedge fund (Soros, Tiger and Kingdon). On the latter, the manager can usually raise assets of a critical mass on day one.

The other problem is that to effectively raise money, the management team needs to be travelling constantly to see prospective investors; if there is only one manager for the firm, time away from trading is severely detrimental to the fund's performance. Ideally, a hedge fund boutique needs a secondary "manager" who will double as marketer or a highly regarded full-time marketer who understands the fund's trading strategy. Investors want to speak with someone who understands the fund's investment philosophy and how trades are placed, not a marketer whose expertise is outside of finance.

Lastly, being closer to the investor still counts: 90% of money dedicated to Asian hedge fund strategies is coming from North America and Europe. Our findings show that managers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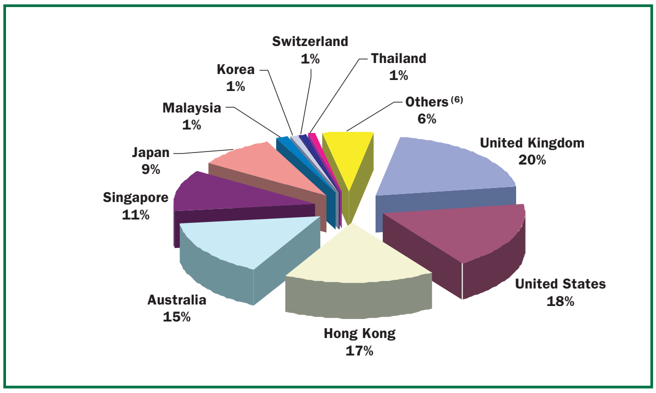
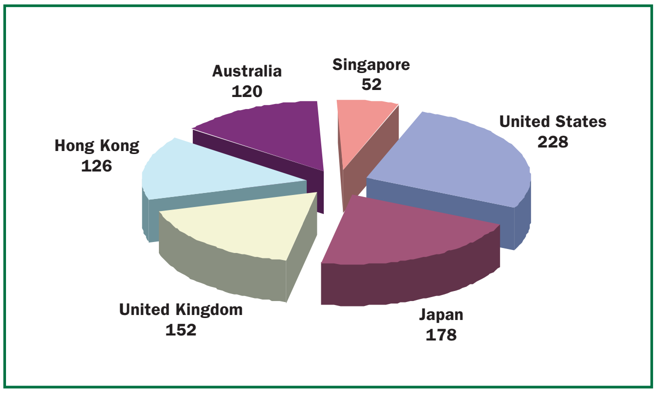
based in New York and London raise money faster and have more assets than their brethren in Hong Kong or Singapore. The exception is the relatively few managers based in Tokyo (24% of all Japan-only funds) who have on average raised USD 190 million mainly because of good performance (the ABN AMRO Eurekahedge Japan index is up 63% since the end of 1999) and their strong connections within the investor universe from previous positions at Soros or Tiger.

### Location of Asian Hedge Fund Managers




Source: Eurekahedge database

### Average Asset Size of Funds (USD m) by Manager Location




Source: Eurekahedge database

### Start-up Trends

Capital raising success stories such as Ward Ferry and Doric in Hong Kong, Speedwell in Tokyo, EN Benton in London and Aman Capital in Singapore are, we believe, spurring increased start-up activity. As stated previously, the change of the risk/reward ratio between an investment banking career and running a boutique hedge fund has shifted towards the latter; this should add to the number of managers coming from proprietary desks and mutual funds to start their own hedge funds.

Institutional firms like Martin Currie and JF Funds, who successfully launched their first general Asian hedge fund product in 2002, are now beginning to launch their third and fourth hedge funds, this time country-specific. We are also seeing an increase in single-country hedge funds for South Korea, India and Greater China from new boutique firms. With the bull market in commodity prices, a number of CTAs based in Asia have emerged in the last two years. It appears more and more that commodities are an excellent way to play the China growth story.

On the surface, it appears that significant capacity is available for the investor; however, our analysis suggests an increasing lack of quality capacity. The managers with previous hedge fund experience, who launch their own fund, will raise around USD 200 million at launch and immediately reject new investors. Managers who do not have the requisite hedge fund experience but show good performance over 12 months will receive capacity recommendations from initial investors that force an early soft closure. This has put greater pressure on allocators to make investment decisions earlier than they would previously had to have made them. We believe that the combination of the best relative returns from Asian hedge funds, a larger universe and the occurrence of pre-eminent funds closing earlier than before will force hedge fund allocators around the world to devote more resources to the Asian hedge fund universe.

There are currently 40 funds, about 10% of the universe, closed to investors. Of these our analysis suggests that 50% are still taking in cash from either existing or new "special case" investors month to month.

(6) Include Argentina, Bermuda, Brazil, British Virgin Islands, Cayman Islands, Channel Islands, China, Luxembourg, Mauritius, New Zealand and Taiwan

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