

# The Asian hedge fund industry: 2005 and beyond

HSBC's Alternative Fund Services and *AsianInvestor* hosted a roundtable discussion about the future of the hedge fund industry at Cipriani's, the China Club, Hong Kong

## PARTICIPANTS:

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**Christophe Lee**  
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## What are the main trends in the expanding Asian hedge fund industry?

**Paul Smith:** The growth of the industry has indeed been spectacular, and this will be a continuing theme. From an administrator's perspective, we see no slowdown in new product formation in Asia or globally. We have at least 50 new funds in our pipeline at the moment in Asia. Despite the disquiet surrounding hedge fund performance over the last couple of months, assets and net applications into funds, including the June end quarter, is still very positive, globally and locally.

The other trend we see is the advent of the global multi-strategy managers coming into Asia. That is fascinating and what that is going to do for resources in Asia is an interesting subject of conversation.

One of the most positive trends is the increased appetite from Asian institutions for Asian-based asset managers. This has been the case in Singapore, to a certain extent in Hong Kong and very definitely in Japan. I can remember talking five years ago about how the Asian hedge fund industry was never really going to take off until there was an indigenous client base here in Asia to support that industry. Obviously it's still very early days, but that is one of the most encouraging themes we've detected over the last six months.

**Michael Nock:** Europeans are still the biggest source of money, but there is significant and growing interest out of Japan. Increasingly we've been seeing a lot of sophisticated Asian-based family offices take their alternative investment expertise and turning it into funds of funds. Groups like Search are part of this, and have made a big difference in terms of their professionalism regarding due diligence on Asian hedge fund managers.

## Where in Asia Pacific is the most demand for regional exposure?

**Eliza Lau:** The Asian interest is certainly at this point mostly in Japan, which is the area we are most focused on. To some extent there is a lot of institutional interest in China, but they are at the stage where they are interested to find out more, but have not really begun investing.

**Peter Ryan Kane:** A lot of our Asian institutional clients are not very far along. Their interest is more theoretical than practical. In part it relates to the innate conservatism in our client base. We've seen this not only in the hedge fund space but in the context of almost any kind of alternative asset. A lot of the institutional clients don't necessarily have the complete governance criteria to deal with the downside or the headline risk that comes with alternative assets. They seem more easily able to deal with a 15% fall in equity market than a 3% fall in a hedge fund or some other alternative asset.

**Tim Rocks:** There is a growing hope that Asia will start to be the source of its own savings and customers for general investment products as well. If you look at what's gone on for the last few years following the Asian crisis there has just been an enormous amount of savings built up in this region. You've also seen the introduction of pension systems in countries that did not have them before. Australia is the most developed; Singapore, Hong Kong and Korea are other examples. There are enormous institutional funds in Korea that are becoming significant players in the market. That's direct retail participation rather than



Christophe Lee

money coming from offshore institutions. The pool of money available for general investment becomes huge.

**Henry Lee:** What about the Australian superannuation funds, have they started making allocations?

**Colin Lunn:** According to our recent research they are about 2% allocated, mostly to funds of funds and Australian-focused products. Australia is about a \$650 billion market and superannuation funds represent 70% of that, so the opportunity is enormous. Korea is another big market. On average there are about \$2 billion in contributions a month. A lot of these Korean funds have already started looking into alternative investments in the form of private equity.

#### What about high-net worth money?

**Christophe Lee:** A lot of hedge fund product has sold through private banks, but to date it's mostly been global product of better-known brand names or structured products because investors feel safer with a guarantee wrapped around it. Now we're starting to see Asian fund of funds with a two year-plus track record being wrapped in a product and offered to private banking clients.

Also, I think that with global hedge funds looking for alpha in Asia, you might see investors buying into that school of thought and considering Asian managers for the sake of higher returns. Realistically the first step would be a fund of funds. As Asian funds of funds build a track record and as some more established single managers build scale and a brand name, you could see private banks buying into that.

**Eliza Lau:** There is interest in reallocating money to this part of the world. Over the past year, many investors are holding relatively higher levels of cash to avoid the turbulence of the market. They are increasingly finding that the hedge fund industry might not be as risky a business as long-only products, and to some extent they find that

even Asian hedge fund managers provide lower risks compared to the long-only products in their portfolio. Investors are looking to allocate to Asian hedge funds, but are having difficulty diversifying their portfolio outside of the long/short space. 60% of Asian hedge fund managers are still equity long/short.

#### Do Asian markets have the depth to support strategies other than equity long/short?

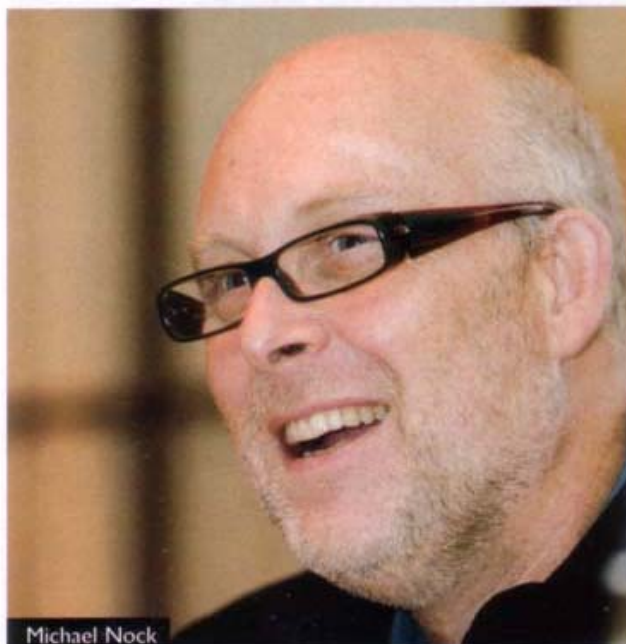
**Christophe Lee:** Sun Hung Kai just launched a pan-Asia quant fund that's market neutral. We aim to be roughly long 100 stocks and short 100 stocks. If you go back to three years ago, the short 100 stocks would not have been practical because of the cost, lack of market depth and the regulations. And it's only going to get better as there are more China IPOs in Hong Kong, and as markets like Korea and Taiwan develop.

**Tim Rocks:** The other interesting trend is that Asian corporates, instead of going to banks to borrow money, are now starting to issue more and more debt on the market. That's a process of disintermediation that's been going on in industrialized countries for the last 20 years and is now starting to happen in Asia. As this happens, more products are available for asset managers, increasing the opportunity for hedge funds to add alpha.

**Michael Nock:** Plus the investment that the prime brokers are making in terms of product is quite huge. When we started six years ago there were only two prime brokers around that we could talk to with any great confidence. But today there's a dozen. They are getting more and more innovative.

**Paul Smith:** Yes, the explosion of Indian hedge funds has been entirely due to the creativity on the prime broking front in creating the short side for that business. That's been a very interesting self-feeding mechanism.

**Peter Ryan Kane:** One of the things we are watching as the investment banking industry loses talent to hedge funds is that the underwriter risk is changing. When a



Michael Nock

prop trader was part of a large investment bank he had a different operating environment. He could cut losses or make large losses and walk back into work the next day. A trader trading for Deutsche in Tokyo is very different from one trading for a \$20 million hedge fund. I'm not sure that everyone is completely on top of the big change in underwriting risk that has taken place. We watch that and worry about it. If there comes a point where stresses become more widespread, I don't think the sort of underwriting that investment banks are able to provide their prop traders exists to the same degree in the hedge fund space.

**What about fixed income?**

*Henry Lee:* More participants should create more liquidity and hopefully further institutionalization of the business, but diversity cannot be created by the investor side alone. There has to be a lot of new issuance. Asia needs good risk-free benchmarks. One of the key reasons for the 1997 financial crisis is that there weren't deep enough bond markets outside of Japan. And this is still the case. Countries and issuers need to proactively create those bond markets. Asia is not going to get diversification among hedge fund strategies unless there is liquidity in those strategies. Because, if people have to buy and hold, that is much less attractive than if they can buy and trade on a secondary market.

**How will the arrival of global multi-billion dollar hedge funds in Asia affect the local boutique industry? Will we see most of the Asian talent joining the US players?**

*Henry Lee:* I think the arrival of the global hedge funds in Asia is positive for the local industry, I don't think there will be any cannibalization. Asia has a deep talent pool of



Henry Lee

qualified analysts and traders on the sell side who know companies well and do good fundamental work. I think the manager who wants to go and set up on his own has an entrepreneurial bent, but there are many people who aren't ready for that. I don't think the two options can really be compared, it's like apples and oranges.

Another interesting trend we've seen is that there are a lot of Asian-Americans residing in New York and London who now have a desire to return to Asia, when it wasn't previously in their career thinking to even be in Asia. But we've been getting a lot of inquiries from such people who have heard we're setting up and are interested in being part of our plans. So that's something very positive because the level of analysis and work done for US situations is very high.

*Christophe Lee:* From a local manager perspective you can say good and bad things about it. More players is a good thing. It adds liquidity on the up and downside of the market, and having the big US guys here also has the effect of justifying the hedge fund industry as a whole in the region.

To take the side of the local manager, you can't assume that just because the US funds are big they will come and eat our lunch. I think we do have a local edge. If there is money chasing a stock, a local manager may take the other side of that global view. A lot of the strategies outside of long/short, like distressed, require a great degree of local knowledge. The US funds might have an edge in fund raising, however.

*Michael Nock:* I think you have to look at the hedge fund's style. Is it more about active trading, or investment? If it's more deep investment knowledge and understanding of the region I'd say an Asian-based man-



Paul Smith

ager has more advantage over a US one, and that's why groups like Henry's are setting up here so they can create that advantage. But a lot of that talent is going to come from the long side so there is learning process that they have to go through to understand how to manage the portfolio construction on the short side.

**Eliza Lau:** That's the differentiation between the good quality managers and some of the others that we see setting up. We think it is very positive that all these big houses are setting up in Asia. They transfer talent and train up the local back office as well as the front office and integrate an institutional way of thinking into the industry.

**With 100 new launches annually for the past few years, should we now expect consolidation?**

**Christophe Lee:** From a practical running-the-business perspective there will be consolidation. Although money continues to come in, about 60% of Asian hedge funds have assets under \$50 million. Some of these will grow, but some won't and those will either have to shut or merge. Right now many of the funds are still new and are building their magical two-year track record, but while I'm still very bullish about the industry growing as a whole, it is inevitable that there will be some consolidation.

**Michael Nock:** That's right, I think that while we've had explosive growth in the industry, we haven't yet had a consolidation or setback. I think there are some managers out there who think they are entrepreneurs but if they go through two or three years and they are still sitting on \$20 million, without adding to assets, growing the team or reaching critical mass, we might have a pause in the industry. Particularly if the tough market conditions continue.

**Paul Smith:** True, but the empirical evidence globally shows that surprisingly few hedge funds do close even though they are, as you say correctly, below an economic break-even point. The problem is the barriers to entry and the barriers to staying in the industry are quite low. Apart from what you pay yourself, everything else is either softened, given for free or not very expensive. So hedge fund managers can actually continue their businesses for far longer than they ought to continue their businesses.

**Eliza Lau:** It depends on the risk appetite from the investor's point of view, and how willing they are to assume the back-office operational risk that smaller funds present.

**Is that driving more Asian funds to become more institutionalized, or partner with institutional players?**

**Paul Smith:** I wouldn't say they are necessarily teaming up with institutions, although there are plenty of hedge funds that start up with a sugar daddy of one source or another. What has changed is that we rarely see the one-person hedge fund shop. Most funds start with a four or five man team at a minimum, and that is obviously an expensive structure.

**Christophe Lee:** We're in the sugar daddy business so I'll make a pitch for that. We saw this increasing emphasis on

back-office risk as a trend. The fact that we're a locally listed company behind the compliance and risk management for our hedge funds gives investors a lot of comfort.

Two or three years ago people thought that because they were good traders they would run a good hedge fund. Maybe now this point is repeated enough, or they see the experience of other hedge funds, they realize that its probably just 50% about the investment process and 50% about everything else, including risk management, operations etc. There is a lack of people out there who have the non-investment part of the experience to running a hedge fund. So even a manager who has the resources to launch on his own will think about joining a large US fund, a platform like ours, or an established boutique like Doric, which already has that infrastructure in place.

**Global hedge fund performance has been flat this year; can the industry continue to create alpha?**

**Peter Ryan Kane:** There are plenty of managers who have forgotten the difference between alpha and beta. A large part of hedge fund return is alpha, so there's much more intense focus on the skill level at the individual manager level. For beta managers, when beta is working for them they can afford to carry relatively less investment talent and still make good returns. For clients that we advise, we do articulate to them the clear choice between alpha and beta. Alpha is inherently more difficult because it is skill based. You can't rely on your hedge fund manager being saved by the market, but you can at times you can rely or hope that some other parts of your portfolio will be saved by the market.

A much larger percentage of long-only funds survive compared to hedge funds, because over a long period of time they are consistently bailed out by beta. Whenever there is pressure on performance the market saves them. That doesn't and won't happen in the hedge fund space, by definition.



Eliza Lau

**Michael Nock:** That's the way it should be. If you are charging 1.5% and 20% in fees, you should be generating returns based on your talent.

**Peter Ryan Kane:** But if you think about the probability of a manager being highly talented and work yourself through three or four probability distributions of the total universe of skilled humans, the universe of those who have gone into hedge funds, and then the universe of those who are going to be given enough time to get it right, you'll come to a small percentage number.

**Tim Rocks:** Aren't the same people who couldn't add alpha in a beta fund the ones working in the hedge fund industry now?

**Paul Smith:** It wasn't that they weren't talented. It was because consultants, for instance, forced everybody to index so they didn't have the opportunity to add alpha.

I think the flip side of our conversation should be about what the traditional asset management industry is doing to respond to the challenge that hedge funds present.

**As the traditional managers clean up their act, will that in turn pressure the hedge funds?**

**Eliza Lau:** We are seeing hedge fund managers starting to look into the long-only space to set up their products. We've seen our hedge fund managers in the US and also in Asia look to long-only products to generate absolute return, instead of hedged product. They lock you in for a longer period of time with lower fees. If the investor is seeing that the market cycle is mostly generated by beta, why do we need to pay such high fees to get alpha?

**Paul Smith:** I'd go one step further than that. Even here in Asia we have some boutique long-only managers who are able to charge significantly more for standard long-only Asian equity product than some of the larger managers could charge, because these boutiques are specialists with a focus on small cap, Asia and alpha. In theory



Colin Lunn

they are adding alpha through their stock selection skills. A lot of boutique long-only managers are doing extremely well and picking up a lot of mandates through that type of marketing, and they are able to charge fees 30%-40% more than the big traditional houses.

**Peter Ryan Kane:** Some have worked out that a lot of what were called hedge funds were really low-beta equity products. You are getting what looks like hedge fund returns, but then when the market turns and runs they lag, they don't look like Libor-plus products. So a lot of these low-beta hedge fund products are trapped. They are neither an equity product nor are they an absolute return product. As a generalization those types of products we see as being in a fairly difficult position.

**Eliza Lau:** We've seen for many years hedge funds producing good, handsome returns, outperforming long-only managers. But going forward do we actually see that with all these new instruments being put into the market that hedge out all the risk and bring down the return? Peter, are you advising clients that the hedge fund industry will continue to produce the kind of returns it has historically?

**Peter Ryan Kane:** We have long-term assumptions for all the markets we operate on. We have hedge funds returning less than beta-only equity but with significantly lower risk and with moderate correlations between the hedge fund industry generically and beta-only equity. So to answer your question, in the long run we will see beta-only equity outperform hedge funds in an absolute return sense, with much higher volatility. That's the issue, when people say absolute return they tend to forget the volatility component.

You have to keep in mind that that beta is an important aspect of long-run returns for something like a pension fund. I can't think of any pension fund that would go to an environment of solely relying on alpha.

**Henry Lee:** That's backward looking, though. You are



Peter Ryan Kane

making the assumption that the long-run beta is positive. **Eliza Lau:** If you look at Asia from 1987 to now, there has been a cycle of boom and bust. This is quite a long run period, but if you had relied on beta from then to now your returns would be quite low. From an investor perspective in Asia, it's not clear that long-run beta helps. **Peter Ryan Kane:** But what is long-run beta? Primarily it is corporate profitability. If we think the China story is going to continue in one-way shape or form then we're talking about a positive story for corporate earnings and a positive story for profits. That's the key driver of beta.

**But does that beta argument hold true for Asian markets, which are less efficient than those in, say, the US?**

**Christophe Lee:** Some commentators would say that hedge fund returns are coming down in the developed markets because there are too many hedge funds doing the same trades. That's a positive for Asia, where there are more inefficiencies to be worked out.

Another positive development for Asia is that the industry growth is feeding on itself. When the industry was \$10 billion you weren't going to get a prop trader or investment banker skilled in distressed investing to start their own fund, because at that time the economic equation did not justify it. Now with the industry at \$80 billion, that skill set is being brought out of investment banks.

**Paul Smith:** I think we're in a very interesting spot. In some ways we're in a virtuous circle in that you've now got Asian investors investing in Asia. You've got American hedge funds investing in the region and drawing talent into Asia, and you've got more issuance in the market as well. These are all good conditions for continued growth. There are always global shocks and political issues that could derail global growth, but given a fair wind from a global macro and political perspective, the Asian hedge fund industry has all the conditions of explosive growth over the next few years.

**What constraints might hinder this virtuous circle?**

**Michael Nock:** If you look at how easy it is to set up a hedge fund and how seductive the sell side makes it to take their ideas, one of the risks Asia faces is a possibility that you get a convergence on one particular trade. This is why I think one has to genuinely think about your own process and sticking to the disciplines of that process rather than simply taking what's handed out from an easy source of ideas.

Another risk is that with the greater difficulty of generating returns in this market environment the pressure is on, especially when you hit that mid-point and are just trying to get to critical mass. The danger is that you do have a blow up of a fund that throws risk management to the wind and gets a big trade wrong or misprices a derivative.

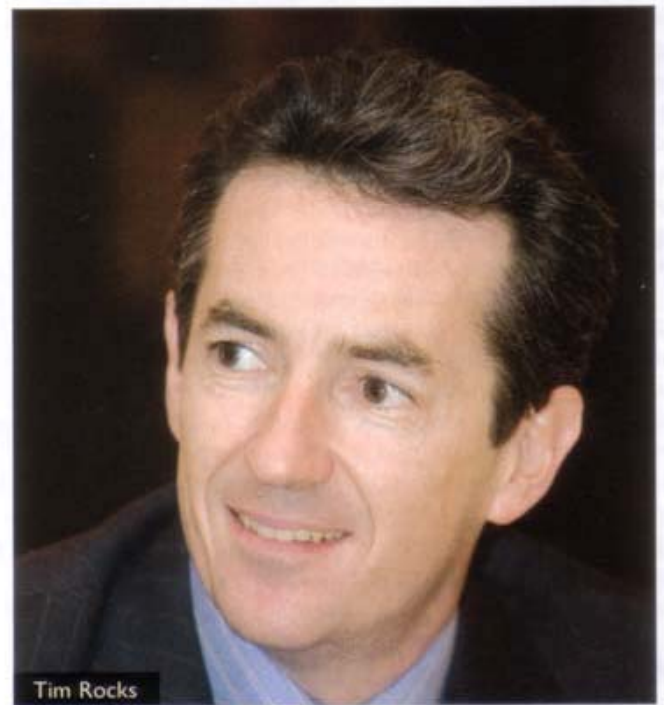
**Tim Rocks:** There is still a perception problem out there about hedge funds. People still don't understand the low-risk aspect, and the difference between alpha and beta.

**Paul Smith:** One of the potential risks for Asian hedge

funds is a five-year bull run, although I'm not sure this is very likely. In that circumstance investors may move themselves to more direct market exposure rather than paying a performance fee to their hedge fund manager.

**What about the value of Asian hedge funds as a diversification for a global hedge fund portfolio?**

**Peter Ryan Kane:** We do think that fishing grounds here are deep enough for diversification value. The latest risk, however, is the opaqueness among managers about whether they are a high-risk/high-return proposition, or whether they are more of an alpha-reliant, Libor-plus product. I'm not sure the industry has articulated this difference clearly. It's been combined with a period of low absolute returns, where hedge funds have looked like they are the high-yielding, low-risk alternative. That's not sustainable. There is room for disappointment for those that have gone in thinking that hedge funds are a panacea to all the investment problems they suffered. If investors went in for the wrong reasons, they are more likely to be disappointed.



Tim Rocks

**Eliza Lau:** We do see Asia as an important diversification tool for a global hedge fund portfolio. The risk for us when looking at Asian products is the depth of the market and whether it is ready to take on that much capital. That leads us to question whether fund inflows to the region are sustainable, or whether they will reallocate elsewhere.

**Paul Smith:** The problem and the beauty of the hedge fund industry is that it defies categorization. Every single fund is charmingly different and does things differently. This puts an immense burden on the investor to really understand the hedge fund manager and determine what they want to get out of the investment. Everyone always tries to generalize about the hedge fund industry, but actually by definition, you can't. ■