

Hedge funds

Hedge funds play an important role in promoting financial innovation and increasing market liquidity by offering investors many investment styles.

However, in most countries, unlike retail funds, hedge fund managers are prohibited from marketing to investors who are not professional investors or individuals with insufficient private wealth. As a result, hedge fund managers often have little incentive to release information relating to the investment strategies they use, and have acquired a reputation for secrecy.

Over the years, as the hedge fund universe has grown into a trillion-dollar industry, it has become the focus of increased attention from investors and regulators.

This year, the sector was rocked by several high-profile blow-ups of firms caught in the credit crunch, which prompted a threat of tightening regulatory practices from European governments worried about the risks hedge funds posed to economic stability.

In the wake of the near collapse in June of two Bear Stearns funds in the United States, Hong Kong's Monetary Authority chief executive Joseph Yam Chi-kwong said he was not comfortable with the asymmetry in transparency concerning hedge funds. But a survey by the Securities and Futures Commission (SFC) in October last year noted that direct regulation of hedge funds in Hong Kong was extremely difficult and probably impractical because the funds were often based overseas.

The SFC survey revealed that among Hong Kong's 20 largest hedge funds by assets under management, 13 were offshoots of hedge fund managers in the US, Britain and Japan.

Karen Tan, head of alternative investment and fund solutions for Deutsche Bank PWM in Asia, says alongside equities, bonds and cash, hedge funds have become a requisite asset class.

"Among investors there is still some suspicion concerning the hedge fund industry, but greater investor sophistication and better understanding of what hedge funds are designed to achieve is helping to expand the industry

Living on the hedge

The asset class is not for the timid as it is easy to walk into a trap, but regulators want more transparency, writes **Chris Davis**



American flags fly outside the New York Stock Exchange. Hedge funds are becoming more mainstream due to some recent high-profile funds in the US listing on the New York Stock Exchange.

Photo: Bloomberg



Greater investor sophistication is helping to expand the industry

KAREN TAN
HEAD OF ALTERNATIVE INVESTMENT
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and generate better understanding,” Ms Tan says.

To maintain a balanced portfolio of diversified strategic investments, she says Deutsche Bank recommends that clients assign about 20 per cent of their assets to hedge funds.

Ms Tan says Deutsche Bank acts as a client gatekeeper by ensuring the hedge funds it offers are subject to rigorous due diligence processes.

“There is little that can be done to defend against deliberate fraud, but by using stringent research and due diligence, we are able to select hedge funds that suit our platform of investment tools.”



Hedge funds

Volatility and risk vary largely among different hedge fund strategies. A risk-adjusted fund providing an 8 to 12 per cent return may operate with 3 to 4 per cent annualised volatility, while a fund trying to seek higher returns may operate with twice the amount of volatility.

JPMorgan Private Bank executive director Pang Shun-tak says despite strong growth in hedge fund assets, the asset class only represents about 5 to 8 per cent of the market capitalisation of the MSCI World Index.

"Hedge funds are certainly occupying a lot more attention of late in clients' minds, though we have been using alternative investment in the portfolio construction process for a number of years."

He says there are 9,000 to 10,000 hedge fund managers globally in the investment space and the performance dispersion can be huge in a risk- or non-risk-adjusted basis.

"Hence, the headline news about the weak performance for the past two years probably does not apply to all managers. The key is clearly the due diligence work on manager selection which is vitally important and should be a full-time job. We don't think an average investor would have the capacity to perform such analysis," Mr Pang says.

Strategically, he will recommend a 20 per cent asset allocation for alternative investment in his client's portfolios. "Tactically though, we are allocating close to 30 per cent to the alternative investment sector," Mr Pang says.

With the recent credit dislocation on the back of US subprime woes, his firm is seeing opportunities on alternative investment strategies focusing on distressed market space.

Mr Pang sees a more active allocation to single strategies versus the traditional diversified strategies. "While we are allocating about the same overall amount to hedge funds, we are changing the nature of our risk exposure. For instance, in June the single/diversified split was 51/49. Now the split is 62/38."

Jon Dingley, managing director of independent financial advisory firm TTG (HK), also sees a growing interest in hedge funds among investors.



Dispersion

Number of hedge fund managers globally

10,000

"Hedge funds are becoming more mainstream due to some recent high-profile funds in the US listing on the New York Stock Exchange," Mr Dingley says.

This may mean hedge funds need to increase transparency,

which may lead to lower returns. Also, hedge funds were only accessible to the ultra high net-worth. However, they are now more accessible to retail investors due to lower minimum-entry levels.

"Over the past five years we have seen larger exposure to hedge funds in the asset allocation process, particularly from institutions. Allocations have increased from low single digits to 15 to 20 per cent as investors look to diversify portfolios. In certain circumstances, and if appropriate, we will look at allocations in

hedge funds of up to 50 per cent," Mr Dingley says.

He says as the industry becomes more transparent this may affect returns because fund managers may be less willing to adopt speculative strategies. Also, the high performance of equity markets has in some cases reduced the attraction of hedge funds.

"Equities have performed well in a low interest rate environment and in an equity bull market, hedge fund returns in some cases will be below that of traditional long only [equity] funds, so it can be misleading to look at hedge fund performance over a short-term time frame. To best view hedge fund returns, they should be viewed over a full economic cycle that includes periods of equity bear markets and differing economic conditions."

Mr Dingley says there is an increase in hybrids and strategies concentrating on clean energy, water and emissions. Activism is also becoming popular.

"The problem going forward is gaining access to high-quality managers and typically, these managers have longer lock-ups which may not suit all investors. Relative value trading strategies investing largely in commodities is another area where we see opportunities.

"Other 'spaces' that are popular include distressed debt and event driven, particularly after the subprime and credit issues we saw in July and August," Mr Dingley says.



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