Hedge funds
Q&A: Why look at Asian hedge funds?

Chief Investment Office GWM | 09 May 2019 3:41 pm BST
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• Question: Why look at Asian hedge funds?
• The short answer: to diversify geographically, get access to attractive risk-adjusted returns and potentially benefit from a rich alpha opportunity set.
• Evidence: Survey data suggests that hedge fund allocators increasingly search for managers with an investment focus in Asia, especially China. For instance, a report by Deutsche Bank points out that APAC is the most sought-after region in 2019, with ca. 40% of respondents planning to increase their exposure to the region. Similarly, a Barclays survey suggests that ca. 40% of allocators want to increase to APAC-based managers. Some allocators highlight as a reason the need to diversify their holdings across regions, whereas others see a bigger potential for alpha generation in Asian markets on top of an expected healthy beta contribution.
• Investment conclusion: Using hedge funds as a tool to invest in Asia is attractive, in our view. Asia’s higher market volatility requires an emphasis on risk management, which is typically a focus area of hedge funds. At the same time the environment in Asia bodes well for active management and hedge fund alpha generation.

Our CIO hedge fund series seeks to answer topical questions on the hedge fund industry. Each issue offers a mixture of innovative quantitative research, an interrogation of academic and industry papers, and engaging graphics to provide answers to pertinent hedge fund questions.

The last page of every Q&A report is a “What you need to know” section – a bite-size digest of recent performance and positioning statistics and news on the hedge fund industry.

As always, feedback and thoughts on our reports are encouraged. We look forward to sharing our ideas and working with you.
Asia and especially China offer attractive long term investment opportunities with limited correlation to other markets. However, market risk can be elevated and local expertise is required. Investors often see in Asia-focused hedge funds an efficient way to get exposure to the region while at the same time achieve attractive risk-adjusted returns.

Chinese markets are still very fragmented and dominated by retail investor flows. In addition, while the number of listed companies is on the rise, sell-side analyst coverage remains limited and information asymmetry is high. This creates pricing inefficiencies that hedge fund managers can capture.

The hedge fund industry in China is still maturing. But with markets becoming more accessible and liquid (for instance for building shorts) as well as increased manager professionalism and discipline in the way they approach risk and capital allocation, investors are becoming more familiar and comfortable with allocating to domestic managers.

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Regional net allocation plans by investor type

38% of investors surveyed plan to increase their hedge fund allocation to Asia-Pacific and China.

Three reasons why investors allocate to Asian hedge fund managers:

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2. Chinese markets are still very fragmented and dominated by retail investor flows. In addition, while the number of listed companies is on the rise, sell-side analyst coverage remains limited and information asymmetry is high. This creates pricing inefficiencies that hedge fund managers can capture.

3. The hedge fund industry in China is still maturing. But with markets becoming more accessible and liquid (for instance for building shorts) as well as increased manager professionalism and discipline in the way they approach risk and capital allocation, investors are becoming more familiar and comfortable with allocating to domestic managers.

Turn for "Chinese hedge funds in detail"
Chinese hedge funds in detail

**Hedge funds in China**

Number of private security funds in China

25k

Source: Asset Management Association of China (AMAC)

- China’s private fund industry (hedge funds, private equity, venture capital) represents about 25,000 firms and 12.7 trn yuan in assets (~1.9 trn USD).
- Asset concentration is high with top 20% of the funds holding 90% of the industry’s AuM. About 240 funds have AuM of more than USD 1.5bn.
- The majority of funds are long/short equity managers, followed by macro and relative value funds. Investors can choose between onshore or offshore funds.

... creates a richer alpha opportunity set

Top reasons for investing in Chinese and Asian funds, % of respondents allocating to Asia in 2019

<table>
<thead>
<tr>
<th>Reason</th>
<th>% of Respondents Allocating to Asia in 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher opportunity to generate alpha</td>
<td>76%</td>
</tr>
<tr>
<td>Growing talent base</td>
<td>25%</td>
</tr>
<tr>
<td>Undervalued market</td>
<td>23%</td>
</tr>
<tr>
<td>Diversity &amp; increase international exposure</td>
<td>18%</td>
</tr>
<tr>
<td>Lack of alpha in other regions</td>
<td>13%</td>
</tr>
<tr>
<td>Strong historical performance</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Morgan Stanley Prime Brokerage, UBS, as of May 2019. Data: Survey of ~200 institutional investors representing about USD 520 bn in hedge fund assets

- Such pricing inefficiencies in Chinese financial markets are arbitrage opportunities that a hedge fund manager can take advantage of to generate alpha.
- In an MS survey, 76% of investors allocating to China cited ‘the higher opportunity to generate alpha’ as a primary motivation to seek exposure.
- Winning strategies typically rely on a strong local network to source investment ideas. Poor data quality also puts emphasis on collecting, cleaning, and using accurate information especially for more quantitatively-orientated managers.

**Chinese stock market structure ...**

Chinese market inefficiencies in numbers

![Graph showing inefficiencies in Chinese stock market](image)

Source: Bloomberg, Thomson Reuters, UBS, as of May 2019

- The Chinese stock market is the second largest in the world by market capitalization and turnover is close to that of US markets.
- Yet, it exhibits large information asymmetry and a range of inefficiencies.
- 80% of A-shares companies are covered by less than five analysts (vs 27% in the US). Only 40% of A-shares beat expectations (vs 76% in the US). 80% of the flows are dominated by retail investors.

**Due diligence however is essential**

# of funds that failed to renew AMAC registration in 2017/2018 due to operational reasons among others

>400

Source: Asset Management Association of China

- Risk management and operational robustness of Chinese hedge funds is often not at the same level as their western peers.
- Transparency, compliance, risk of fraud are areas investors need to pay particular attention to when selecting a fund.
- Trusted local advisers and a well-diversified portfolio are often an efficient approach to mitigate the impact of some of these risks.

Turn to for "what you need to know" from May/June
What you need to know: May/June

1.6% in April

Performance numbers from Hedge Fund Research for April point at a strong month for the industry (1.6% m/m, 7.2% YTD through April), ranking in the 83rd percentile since 2010.

Winners and losers

EH funds charge ahead

Equity hedge funds have regained last year’s losses YTD through April and are up 9.4%. Other directional equity strategies also fared well this year, such as activists (12.3%) and special situations managers (9.2%).

Positioning

93rd percentile

China L/S ratio near peak

Hedge funds net bought Chinese equity since late 2018 and the China L/S ratio is now at 2.8. This is in the 93rd percentile since 2012. A sizable portion of this increase can be attributed to net buying of A-shares.

Fund openings and closures

Japan as a potential growth market for hedge funds

Hedge funds may become more prominent in Japan. Firstly, Japanese pension funds are moving to non-traditional assets, in search of the returns required for their beneficiaries as they struggle with near-zero bonds yields at home and a fast aging population. Secondly, Tokyo officials plan to set up their town as a financial hub. In an attempt to attract hedge funds, the registration process was eased and an emerging-manager program to aid new firms with some of their initial expenses was created. Slowly, this seems to be bearing fruit as eight new funds launched in the past 12 months and established hedge funds plan to open offices in Japan.

Reported by bloomberg.com on 2 April.

Activism has a new incumbent while it becomes more mainstream

In the first quarter of 2019, 57 activist campaigns were launched globally, in line with multi-year averages. Of these, Starboard Value launched the most, targeting a total of seven companies as diverse as eBay, Bristol-Myers Squibb (BMS) and the pizza chain Papa John’s. By number of campaigns they overtook Elliot Management which was the most prolific activist for the previous seven quarters. Meanwhile, the strategy is increasingly getting support from traditional asset managers, with recent examples including Wellington Management who spoke out against BMS’s planned acquisition of Celgene and M&G Investments that argued for refreshing the board of directors of the chemicals company Methanex.

Reported by ft.com on 26 March and 10 April and by Lazard’s Review of Shareholder Activism Q1 2019.
Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk:** There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-U.S. securities and illiquid investments.
- **Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.
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