Hedge funds

Q&A: Why look at Asian hedge funds?

Chief Investment Office GWM | 09 May 2019 3:41 pm BST
Karim Cherif, Strategist; **Georg Weidlich**, Strategist

- **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.

Source: gettyimages

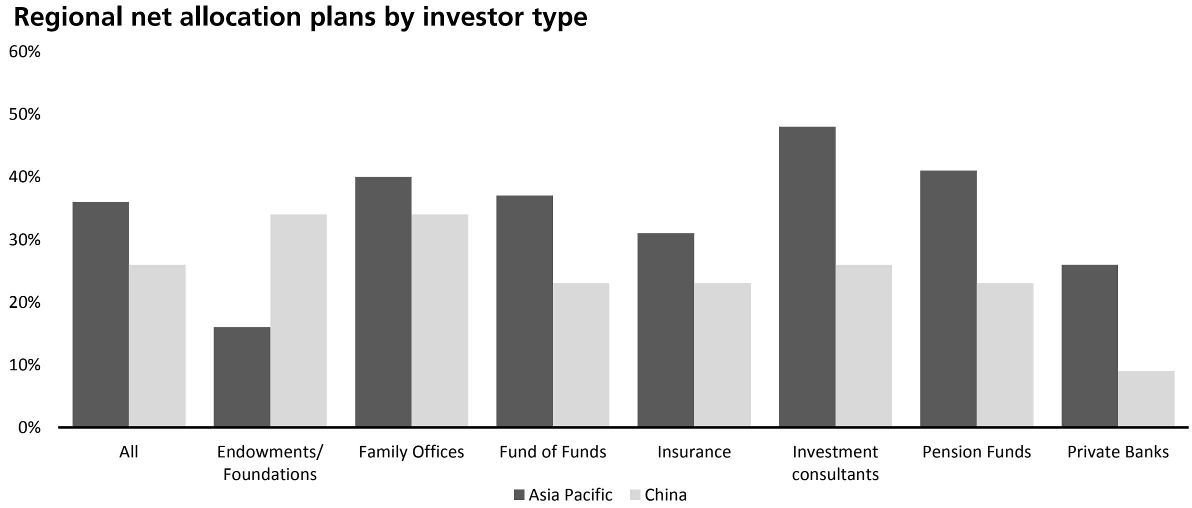
Our CIO hedge fund series seeks to answer topical questions on the hedge fund industry. Each issue offers a mixture of innovative quantitative research, an interrogation of academic and industry papers, and engaging graphics to provide answers to pertinent hedge fund questions.

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.

This report was written by Karim Cherif and Georg Weidlich, part of your dedicated UBS Global Wealth Management CIO Alternatives team.

Q&A: Why look at Asian hedge funds?



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

Source: Deutsche Bank Alternative Investment Survey 2019, UBS, as of May 2019. Data: A survey of 425 investors who invest or advise on $1.7 trn of hedge fund assets.

Three reasons why investors allocate to Asian hedge fund managers:

1

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.

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

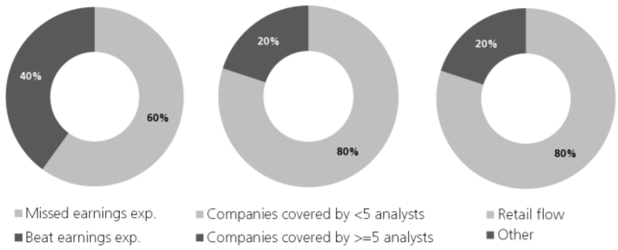
25k

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.

Chinese stock market structure …

Chinese market inefficiencies in numbers

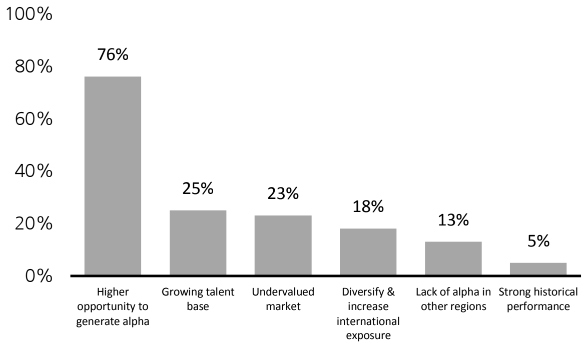


Source: Bloomberg, Thomson Reuters, UBS, as of May 2019

- 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.

… creates a richer alpha opportunity set

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



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.

Due diligence however is essential

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

>400

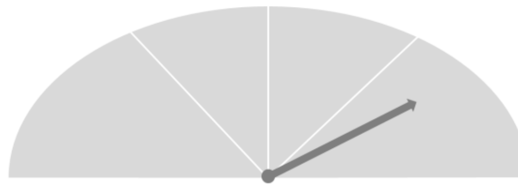
Source: Asset Management Association of China

- 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

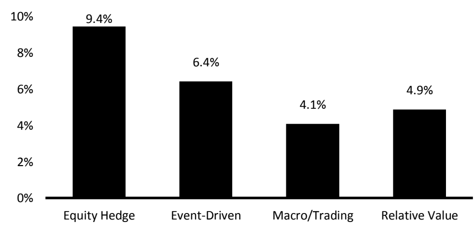
Performance



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

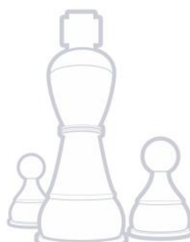


Source: Bloomberg, UBS, as of May 2019

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



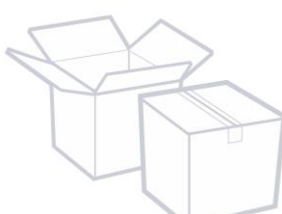
93rd percentile

Source: Morgan Stanley, as of May 2019

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 a 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.

In the news

All images: UBS

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.

Appendix

UBS Chief Investment Office's ("CIO") investment views are prepared and published by the Global Wealth Management business of UBS Switzerland AG (regulated by FINMA in Switzerland) or its affiliates ("UBS").
The investment views have been prepared in accordance with legal requirements designed to promote **the independence of investment research.**
Generic investment research – Risk information:
This publication is **for your information only** and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any forecasts, estimates and market prices indicated are current as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria.
In no circumstances may this document or any of the information (including any forecast, value, index or other calculated amount ("Values")) be used for any of the following purposes (i) valuation or accounting purposes; (ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or (iii) to measure the performance of any financial instrument including, without limitation, for the purpose of tracking the return or performance of any Value or of defining the asset allocation of portfolio or of computing performance fees. By receiving this document and the information you will be deemed to represent and warrant to UBS that you will not use this document or otherwise rely on any of the information for any of the above purposes. UBS and any of its directors or employees may be entitled at any time to hold long or short positions in investment instruments referred to herein, carry out transactions involving relevant investment instruments in the capacity of principal or agent, or provide any other services or have officers, who serve as directors, either to/for the issuer, the investment instrument itself or to/for any company commercially or financially affiliated to such issuers. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is not suitable for every investor as there is a substantial risk of loss, and losses in excess of an initial investment may occur. Past performance of an investment is no guarantee for its future performance. Additional information will be made available upon request. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. Tax treatment depends on the individual circumstances and may be subject to change in the future. UBS does not provide legal or tax advice and makes no representations as to the tax treatment of assets or the investment returns thereon both in general or with reference to specific client's circumstances and needs. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein.
This material may not be reproduced or copies circulated without prior authority of UBS. Unless otherwise agreed in writing UBS expressly prohibits the distribution and transfer of this material to third parties for any reason. UBS accepts no liability whatsoever for any claims or lawsuits from any third parties arising from the use or distribution of this material. This report is for distribution only under such circumstances as may be permitted by applicable law. For information on the ways in which CIO manages conflicts and maintains independence of its investment views and publication offering, and research and rating methodologies, please visit www.ubs.com/research. Additional information on the relevant authors of this publication and other CIO publication(s) referenced in this report; and copies of any past reports on this topic; are available upon request from your client advisor.
Important Information about Sustainable Investing Strategies: Incorporating environmental, social and governance (ESG) factors or Sustainable Investing considerations may inhibit the portfolio manager's ability to participate in certain investment opportunities that otherwise would be consistent with its investment objective and other principal investment strategies. The returns on a portfolio consisting primarily of ESG or sustainable investments may be lower than a portfolio where such factors are not considered by the portfolio manager. Because sustainability criteria can exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. Companies may not necessarily meet high performance standards on all aspects of ESG or sustainable investing issues; there is also no guarantee that any company will meet expectations in connection with corporate responsibility, sustainability, and/or impact performance.
Distributed to US persons by UBS Financial Services Inc. or UBS Securities LLC, subsidiaries of UBS AG. UBS Switzerland AG, UBS Europe SE, UBS Bank, S.A., UBS Brasil Administradora de Valores Mobiliarios Ltda, UBS Asesores Mexico, S.A. de C.V., UBS Securities Japan Co., Ltd, UBS Wealth Management Israel Ltd and UBS Menkul Degerler AS are affiliates of UBS AG. UBS Financial Services Incorporated of Puerto Rico is a subsidiary of UBS Financial Services Inc. **UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate. The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere. UBS Financial Services Inc. is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule") and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule.**
External Asset Managers / External Financial Consultants: In case this research or publication is provided to an External Asset Manager or an External Financial Consultant, UBS expressly prohibits that it is redistributed by the External Asset Manager or the External Financial Consultant and is made available to their clients and/or third parties. For country disclosures, click here.
Version 04/2019. CIO82652744