

## Yesterday, Today and Tomorrow for Hedge Fund Investments by Japanese Institutional Investors

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Hedge funds investments in Japan have been increased quite significantly since early 2000. The major investors in hedge funds in Japan are financial institutions, such as insurance companies, city banks and some regional banks. Japanese pension funds seem to be following soon. But «soon» in Japanese context could mean «2 -3 years».

### **Yesterday:**

A few Japanese financial institutions and trading houses started hedge fund investments through their New York or London offices in late 1995 through 1996. Having observed the higher performances, it was quite natural for the Tokyo main office of these institutions to start their own investments in hedge funds around late 1996 to 1997. Many Japanese institutional investors had obtained some knowledge about «so-called Hedge Funds» at that time, but only a few of them decided to take up such investments. They often started hedge fund investments with fixed income arbitrage, as they loved the constant returns with low volatility. It was not long before they added US long/short strategy as a result of the higher returns. A few Japanese and foreign securities companies introduced hedge fund products to the Japanese market in 1997, but in retrospect it was too early for the distribution market.

The Russian crisis followed by the LTCM <Long Term Capital Management> crisis in August 1998 was quite a shock to the early hedge fund investors in Japan. Most of them were forced to give up their hedge fund investments by the end of 1998. Other potential investors looked at all the negative news surrounding LTMC and

congratulated themselves for not having invested in hedge funds.

In 1999, Japanese equity markets started to rally and continued to rise until March 2000. Many institutional investors forgot about hedge funds during this period. Then came the collapse of Japanese IT shares in March 2000 and the start of a steady decline of the Nikkei 225 – both pushing Japanese institutional investors to resume their study on hedge fund investments. Some started very seriously but most of them remained at an evaluation level.

### **Today:**

Since mid 2000, hedge funds investments in Japan have enjoyed steady growth and increased popularity. However, many Japanese institutional investors are still in the evaluation stage and are quite cautious. Hedge funds have not as yet established a position as an asset class with most Japanese institutional investors. But it is true that most Japanese institutional investors have been fed up with the poor performance and high volatility of the Japanese equity market. They are definitely attracted by the higher returns of various hedge fund strategies. They appreciate hedge fund investments for their absolute return characteristic and low correlation

to the traditional asset classes. The level of disclosure has improved thanks to the institutionalization of the hedge fund industry in USA and Europe with the result that Japanese investors have diminished their allergy to so-called dangerous and secretive hedge funds. A few investors are also being influenced by their colleagues who have already invested in hedge fund.

The general concerns currently hindering investments in hedge funds are those of reputation risk, event risk or catastrophic loss. Japanese institutions do not want to be involved in any type of scandal which may result in their company being in the headlines. Their ongoing concerns after starting investment are how to evaluate performance and how to report performance to their bosses. Though most investors acknowledge hedge fund investments as absolute return investments, they still tend compare performance with traditional indices such as Nikkei 225, S&P 500, MSCI EAFE. Some do use various hedge fund indices, such as CSFB-Tremont Index. They also use risk-adjusted ratios for their statistical analysis, but these were developed for traditional long-only investments like mutual funds. They definitely need new and relevant tools their analysis and monitoring of hedge fund investments.

### **Tomorrow:**

Japanese institutional investors normally start their hedge fund investments with «funds of funds» or so-called «market neutral» strategies. They try to avoid strategies such as emerging markets and global macro because of the higher volatility. Most have also avoided managers for the Japanese equity market until very recently - this is because they already have enough exposure to the Japanese equity market through their proprietary investment desks where traditional long-only investment style is employed. Institutional investors in USA and Europe, on the other hand, have been looking for hedge fund managers for Japanese equity markets for the last few years. Recently, a few Japanese institutional investors have started searching for Japanese hedge fund managers in Japan or abroad. Why? Perhaps because they are convinced by past returns that they should switch from proprietary investment desks to outsourced investments even for the Japanese equity market. Or it could be that they have decided to establish their own Japanese hedge fund desks internally and they need to learn from existing hedge fund managers as quickly as possible.

Whatever the reason, Japanese institutional investors are definitely changing their investment policy even for the Japanese equity market. There are still only a few investors today but we are sure that the trend will continue and result in hedge funds becoming a permanent feature on the investment landscape of Japanese institutional investors.