Asia offers attractive opportunities for hedge fund investors

By Christophe Grünig | Harcourt AG

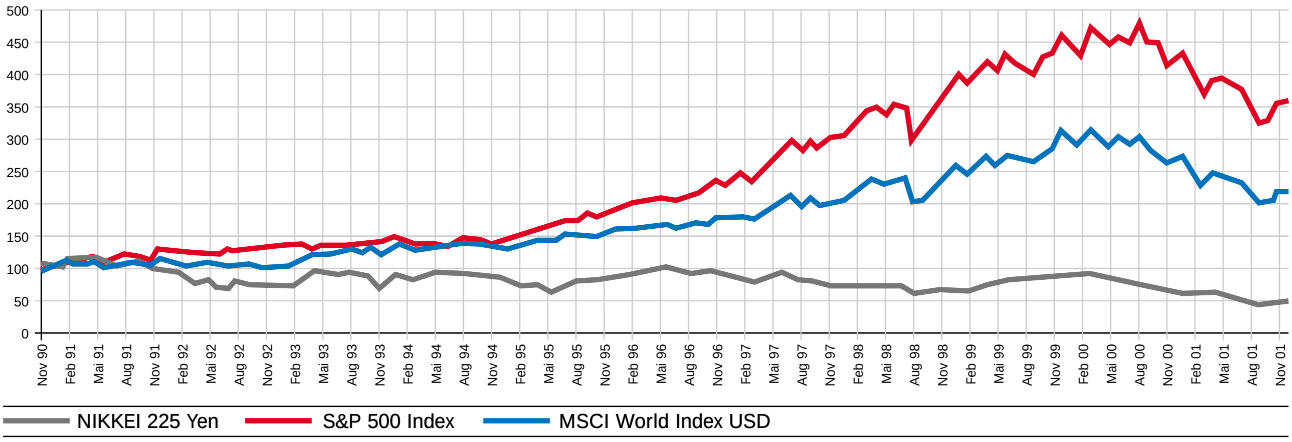
Less than ten years ago, hedge funds were synonymous with a secretive, highly intransparent usually New York based limited partnership. Not only have we seen a general increase in transparency in the last years, but also hedge funds operate from all angles around the world, investing in all possible markets. In the meantime, we count a few thousand hedge fund managers in the US and additionally around 500 hedge fund managers in Europe and interestingly enough around 150 in Asia. While in terms of assets under management the industry in Asia compared to the US and Europe is still small, the growth rate in Asia is overwhelming. Critical readers could wonder why Asian hedge funds are growing in number and assets while the underlying markets generally produced negative returns over the last decade.

Asia is a challenging region

Talking about Asia, one has to focus on Japan. Japan is currently the third largest single market in the world after the US and the UK and nearly twice as large as the developed and emerging Asian countries combined. Japan remains a very important trading partner for most Asian countries and leads economically the way for the whole region. However that Japan has basically been in a recession for the last ten years and the NIKKEI 225 more than halved since the beginning of the 90'ties.

Asian countries market cap (%) of MSCI World Index Free $

Country	Weight (%)
Japan	7.72%
Australia	1.49%
Hong Kong	0.79%
Korea	0.77%
Taiwan Free	0.66%
Singapore Free	0.37%
Malaysia Free	0.29%
India	0.26%
China Free	0.25%
Thailand Free	0.08%
New Zealand	0.05%
Indonesia Free	0.04%
Philippines Free	0.03%
Pakistan	0.1%



Worst of all Japan still has major structural problems. Everyone knows that Japanese banks have a large amount of bad debts that need sorting.[1] For a long time, banks, which have been under the protection of the ministry of finance, were immune from bankruptcy. Banks created affiliation (so called «keiretsu») groups in flagship industries in Japan, and strengthened the relationship among group companies through cross shareholdings. Now, unwinding these cross shareholdings is not a trouble-free process. The price of reform will be a massive destruction of wealth, because the banks and other institutions have not marked their investments to market prices and if they did, many would be bankrupt. Even though we have seen a general increase in bankruptcies lately[2] and some of these concerned prominent institutions (e.g. Mycal Corp. and Kotobukiya, two major retailer, or Aoki Corp. and Fujiko Co., two major building companies), the major clean up still lays ahead. Another important point is that investments made by Japanese institutions and private households over the last decade have mostly been very unprofitable. The Japanese put half of their financial wealth into banks or the post office as deposits and the rest into insurance and pension reserves. These institutions have lost over one third of this money, because they invested in the Japanese stock market and in real estate, where prices have been falling, or they have lent the money to the government or to unprofitable Japanese corporations, where it was squandered. Even though the saving rate of Japanese households is about four times higher than in the US, they did not accumulate more wealth in absolute terms than their US counterparts over the last ten years. However, the biggest issue for Japan today is how to restore its economic productivity. Over the last ten years, there have been repeated claims that structural reform is required for economic recovery. But so far, we have not seen any clear improvements. The problem is that the wealth distribution function is controlled by the national government and the decision of the distribution has been guided and influenced by the Liberal Democratic Party (LDP) and bureaucrats. As long as this power structure is sustained, economic recovery and structural reform in Japan will be an extremely slow process. Therefore we assume that Japan will most probably struggle with its internal problems for the next couple of years.

How does the situation look like for the other developed Asian countries and the so called emerging countries? In Singapore a comprehensive economic restructuring is needed to put the economy back on the sustainable growth path. Hong Kong's transition from a manufacturing to a service economy was pretty smooth, but without high levels of domestic demand, its prospects for economic growth highly depend on global demand and trade. For Taiwan the Asian economic integration and WTO entry accelerate a whole list of urgently needed structural changes (e.g. reforming the financial sector). The Australian economy and market proved very resilient in the global recession and bear markets 2001, but in 2002 a US recovery is very important for Australia as this would likely drive a global industrial production recovery.

[1] Based on recent estimates from the Mizuho Financial Group this includes 100% of the Yen 1.8trillion defaulted loans, 50% of Yen 33trillion uncollateralized risky loans and 5% of 60trillion collateralised loans which adds up to approx. Yen 20trillion (around $150bn) or approximately 4% of Japan's GDP.

[2] Based on data from the Japanese private credit rating agency «Teikoku» the number of bankruptcies increased in 2001 by 1.9% compared to the year 2000. In absolute terms there were 19'441 bankruptcies in 2001 which is the second highest yearly amount since World War II (in 1984 there were 20'841 company bankruptcies counted in Japan).

China became the 143rd member of the World Trade Organisation (WTO) last year. China's rapid growth in recent years has unambiguously created more opportunities for Southeast Asia and economic ties between the two have intensified, especially in trade and tourism. While in the short term Asian countries may profit from China's growth, it looks as if the relationship will be more a competitive one than a complementary in the mid- to long term. Finally, potential investors in Malaysia, Thailand, Indonesia and India have to put up with opaque or unfavourable political situations.

Overall, does this sound like an interesting investment case for Asia? Most probably not for long only investors. And for hedge fund investors? Before we can answer this question, we must clarify what kind of markets are generally interesting for hedge fund managers.

Asian markets offer a lot of opportunities – especially for hedge funds

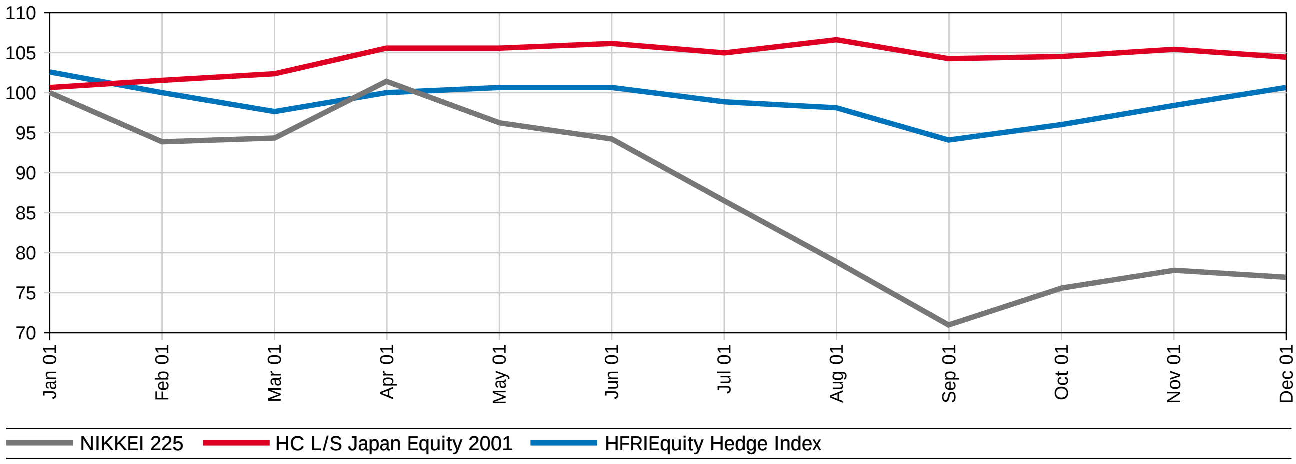
Generally, hedge fund managers, like all active money managers, require market inefficiencies to potentially produce above average returns in the long run. Market inefficiencies are mainly created by information asymmetries and conflicts of interest. While the source of such inefficiencies can be multifaceted, they always need to be supported by a functioning to give the active manager (e.g. hedge fund) the possibility to consistently exploit the investment opportunities emerging from them. Preferably, high barriers to entry prevent a lot of competition to enter and to minimize the inefficiencies over time. Do we find these market characteristics in Asia?

One thing all Asian markets have in common is that economic, political and social aspects must be reviewed as a whole to understand their current status. These complex and sometimes obscure market structures make it difficult for foreign, not fully dedicated money managers to access these markets. The result is that a lot of US and European money managers are very hesitant to dedicate resources to Asia, which leaves it comparably underresearched. Consequently, the Asian markets, including Japan, offer a lot of investment opportunities to those money managers who are experts in their field and do not shy away from the challenge. Additionally, the sustained requirement of restructuring creates a lot of opportunities. These opportunities are certainly bigger for money managers who have the flexibility to use all available financial instruments (e.g. stock borrowing for shorting), are free to choose the desired market exposure at any time and are free to use the available information without constraints. Due to their flexibility, hedge funds are therefore best suited to exploit the market inefficiencies and opportunities. Take Japan as an example: Japan's problems need to be addressed sooner or later. Structural changes in the corporate and stock market environment create bargains, because:

- Changes in competition create winners and losers
- Corporate bankruptcy will uncover weak business models
- Unwinding of cross-shareholdings create short opportunities

Additionally, the deregulation of various industries lead to both new business opportunities and increased competition, basically throughout all sectors. Finally, obvious conflict of interest of large institutional investors underlines the

Long/Short Japan managers outperformed their US and European counterparts and the NIKKEI 225 in 2001



attractiveness of Japan for hedge fund investors. The current structural problem offer investment opportunities as many companies are still not priced adequately by the market. Brokers and analysts focus on the top 300 companies in Japan, because these are mainly the stocks their (institutional) clients are mainly interested in. Therefore, **mid- small cap Japanese stocks remain widely underresearched and under-valued.**[3] And all these opportunities arise in a very liquid market where it is not a problem to short stocks and use various derivative instruments. These attractive investment conditions are underlined by the performance of the long/short Japanese hedge funds last year, which on average achieved better results than their US and European counterparts. Even in some Asian countries, where a high degree of political risk (e.g. India, Pakistan, Malaysia, Indonesia, Philippines) or illiquid markets (e.g. New Zealand, Taiwan) reduces their attractiveness significantly, we find market characteristics similar to those in Japan (e.g. restructuring needs). Therefore Asia is a more fertile ground for inefficiencies and investment opportunities than for instance the US, where we have a well functioning unified market with many well informed market participants – simply put, a more efficient market than Asia.

Looking ahead

Many investors have been scared away from Asia over the last decade. While we do not know where markets in Asia and particularly in Japan are heading to, we strongly believe that structurally Asia is one of the most attractive markets for hedge funds and hedge fund investors. And in the meantime the hedge fund industry in Asia is broad and deep enough in terms of styles, strategies, location and size to allow investors to construct their portfolio efficiently. The diversity of the approx. 150 hedge fund managers in Asia is underlined by the following numbers[4]:

% of all Asian H.F.	Style / Strategy
35%	Long / Short Japan Equity Strategy
25%	Long / Short Asia (incl. Japan) Equity Strategy
5%	Asian Multi Strategies
10%	Relative Value Asian Strategies
5%	Long / Short Australia Equity Strategy
10%	others

% of all Asian H.F.	Size / Assets under Management in $
60%	0 - 50mn under management
30%	50 – 100mn under management
10%	> 100mn under management

% of all Asian H.F.	Location of hedge fund managers
30%	Tokyo
25%	Hong Kong
10%	Australia
10%	Singapore
25%	Non-Asian based (mainly US and UK)

Obviously, this diversity of managers has increased substantially lately. In 2001 alone, there were around 50 Asian hedge fund managers who started trading, and roughly the same amount of hedge funds are planned to be launch in 2002.[5]

Many inefficiencies – and consequently investment opportunities – combined with market liquidity and significantly improved hedging facilities across various countries[6] should attract not only hedge fund managers, but also hedge fund investors on a much broader scale in the future.

[3] There are around 3’500 publicly listed companies in Japan.

[4] Based on indicative data from various prime brokers and internal resources.

[5] Based on estimates from AsiaHedge, HedgeFund Intelligence Ltd, London SW1E 6DY

[6] Apart from Japan, «shorting» is also possible in practice in Australia, Singapore, Hong Kong and partly through synthetics also in Korea, Taiwan and India.