

# SWISS HEDGE

1<sup>st</sup> Quarter 2002

A Review on Developments in the Hedge Fund Market



## Asia

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**HARCOURT**  
Investment Consulting AG

## Impressum

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SwissHedge | 1<sup>st</sup> Quarter 2002

Published by

Harcourt Investment Consulting AG

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Visual Concept & Layout by Christian Forrer

Printed by OK-Druck | Zurich

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Cover

«OTSU» Japanese Train  
Jungfrau Railways  
Canton of Bern | Switzerland

Photographer  
Christian Forrer

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## SwissHedge ... introducing our new focus on strategies!

***The new SwissHedge celebrates the emergence of hedge funds as a legitimate asset class and the increasing sophistication of investors. The success of «skilled based» strategies has accelerated in recent years to the point where invested assets amount to USD 500 billion – a doubling of assets over the last five years. An increasing proportion of investors are now institutions and they are aware that hedge funds strategies are not homogenous but have different risk/return profiles and varying exposures to market risk, credit risk and operational risks. It seems somehow natural to me that at this stage in the development of our industry that we should start providing investors with more specialized material to deepen their understanding of the merits and limitations of the various hedge fund strategies.***

Consequently each issue of the SwissHedge will focus on a particular strategy. By the time you have finished each quarter's issue, I hope you will have gained a solid understanding of the particular strategy, its environment and the rationale for investing. This initial issue focuses on Asia-linked strategies, in part because Harcourt is convinced that Asia will experience the largest growth of managers over the next 24 months, and in part due to informational inefficiencies in the Asian financial markets.

In this issue, Christophe Gruenig introduces the Asian market and presents Harcourt's view on the region. An article by Ted Uemae provides an informative view of the forces shaping the demand side of the Japanese market. Our roundtable includes managers from renowned Asian hedge fund management firms Martin Currie Investment Management Ltd., Speedwell Advisors and Ward Ferry Management Ltd. They generously offer their insights into the current and expected strategy market conditions in the



region. Jim Brandon's academic literature review offers comfort to investors concerned that currency hedge funds might spark a future Asian currency crisis. And we continue with Philipp Cottier's quarterly review of past performance, important industry issues and our views as of the short and long term evolution of the industry.

Future issues this year will focus on convertible arbitrage, fixed income arbitrage and European long-short equity.

I sincerely hope that you find the new SwissHedge to be a useful resource in your hedge fund related activities and would appreciate hearing your comments.

## General market environment in the Fourth Quarter of 2001

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By Dr. Philipp Cottier | Harcourt AG

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The fourth quarter of 2001 was dominated by the rebound of global stock markets in the aftermath of the tragic September events. Over the whole quarter, the MSCI World gained +8.37%, the S&P 500 increased by +10.29%, the NASDAQ was up +30.13%, the MSCI Europe up +12.45%, and the SPI up +7.28%. Even the Nikkei was up +7.86%.

With respect to fixed income markets, the US Fed cut rates another three times during the quarter, reducing the Fed Fund rate further from 2.75% to 1.75%. Simultaneously, USD 3-month interest rates decreased from 2.3% to 1.75%. Long term rates, however, did not move accordingly. USD 30-year rates increased slightly from 5.3% to 5.5%

and the yield curve continued its steepening. In Europe, short term rates decreased from 3.5% to 3.2% while 10-year rates increased by 20 bps to 4.94%. The JP Morgan Global Bond Index lost -3.18% in the fourth quarter and the Pictet Swiss Bond Index was down -0.26%. The DLJ High Yield Spread Index decreased from 990 bps to 860 bps over Treasury.

The US Dollar strengthened over the course of the third quarter. The Euro decreased from 0.91 to 0.88, the CHF weakened from 1.62 to 1.68, and the JPY continued its fall from 119 to 131. Gold finished the third quarter at 277 per ounce, breaking its uptrend. Brent Crude Oil continued its downtrend from USD 22.8 to USD 20.4.

## Hedge Fund Industry in Year 2001

The hedge fund industry moves in cycles. 1994 was a bad year, sparked by the Fed's surprise interest rate raise. 1998 was another one, triggered by the Russia and LTCM crisis. And 2001 was yet another bad year for the industry. The falling stock markets and very high volatility made it difficult for most strategies to perform, with the exception of convertible arbitrage, distressed securities and MBS arbitrage.

Supply side of the hedge funds industry: Big is not beautiful anymore in strategies where a lot of flexibility and an opportunistic approach is needed. One example is the long/short equity strategy where some big players like Zweig DiMenna, Bowman and FLA have not done very well in 2001. Bowman Capital has actually decided to give all money back to investors and stop trading investor money. To counter their capacity problems, many of the larger hedge funds have started to diversify into other strategies and to lock in investors as long as possible with redemption fees and lock-up periods. The other interesting news was that Monroe Trout is retiring after many years of successful trading.

2001 was the year of the Asian hedge funds. The universe now probably contains around 150 managers, of which as a

very rough guess approximately 30 are located in Tokyo, 30 in Hong Kong, 20 in Singapore, 10 in other Asian cities, 35 in Australia, and 80 in Europe and the US. Asia-based hedge funds and overseas hedge funds pursuing Asian strategies currently manage in excess of USD 12 billion in assets. The largest firms include Joho, Sparx, Penta, Platinum, Whitney, Grinham and Sofaer. The strategy diversity among Asian hedge funds is increasing, with more firms pursuing strategies outside of the typical long/short equity arena, such as Japanese convertible arbitrage, Japanese event driven, Asian debt, property stocks, commodity arbitrage, and CTA futures trading.

Demand side: Demand for hedge fund products continues to be strong in the US, Europe and Japan. According to TASS, the third quarter of 2001 saw new inflows that were only slightly below those of the second quarter. The most desired strategies were long/short equity, convertible arbitrage and distressed securities while CTAs and emerging markets hedge funds were faced with net outflows. Macro hedge funds saw net inflows for the first time since early 1998. European and Asian hedge funds (particularly long/short Japanese equity funds) continued to feel strong investor interest.

Funds of funds: With +2.46%, the performance of funds of funds was rather low in 2001. They continued to underperform their hedge fund indices, albeit by a lesser margin than in the past. The reasons for the difference are probably not poor selection but rather the additional fee layer, survivorship bias, the lower bull market bias of most funds of funds, and a potential selection bias in the databases. We strongly believe that in our still quite inefficient industry, active hedge fund picking ought to be more successful than passive index investing or «dart throwing», especially when top-down asset allocation and bottom-up hedge fund selection are done in a sophisticated way. What might increase in the future is the turnover of manager inside the funds of funds. The reason is that investors are increasingly looking at smaller funds with shorter track records as the larger funds with longer track records are often closed or have become too big and inflexible. The new game of the industry is therefore to detect hedge funds early enough - actually, sometimes before they start trading - and invest with them before they grow too big and start limiting new asset inflows. The shorter track records, however, might mean a higher turnover of the fund of funds portfolios.

Research: A very interesting and readable research piece on hedge funds called «Understanding Hedge Fund Performance» has recently been published by Lehman Brothers. The research was done by Prof. Tom Schneeweis and looks at several performance related issues such as survivor bias and alpha, as well as the impact of certain factors like size, vintage, performance fee, lock-up and domicile on performance. The study can be ordered via [jpescato@lehman.com](mailto:jpescato@lehman.com).

## Performance of Hedge Fund Strategies in the First Quarter of 2001

From October to December 2001, the equal-weighted HFR Composite was up +5.95%, the HFR Fund of Funds Index up +2.46%, and the asset-weighted CSFB/Tremont Index up +2.18%. The quarter was positive for all strategies

The ISMA Center of the University of Reading in the UK has recently published a study that looks at the attrition rate of hedge funds and comes up with an estimate of 5-12% pa. According to the study, the attrition rate has been increasing steadily from 1994 to 2001. It is based on the number of funds dropping out of databases. Now, we think that the

***“We estimate the survivorship bias to be much lower than the above 5-12% pa. Harcourt’s inhouse research indicates that the survivorship bias inherent in hedge fund indices is roughly 1.5% pa, or between 1.0-2.5% depending on the strategy.”***

assumptions are flawed as only a tiny part of the hedge funds that stop reporting to databases do that because they went bankrupt and lost 100% of their capital. The largest part are hedge funds that stop reporting because they have no more capacity and are closed to new inflows; because they don’t feel like reporting anymore (such as Harcourt who stopped reporting to one database, which means that technically, we have attrited ourselves); or because they retire. Another part are

hedge funds that close shop not because of poor performance but rather because they could not raise sufficient assets to support their trading operations. And even of the hedge funds that close because they had dismal performance, many did not lose all of their capital but rather -20% to -50%. In other words, we estimate the survivorship bias to be much lower than the above 5-12% pa. Harcourt’s inhouse research indicates that the survivorship bias inherent in hedge fund indices is roughly 1.5% pa, or between 1.0-2.5% depending on the strategy. Now, of course the attrition rate of very small and young hedge funds must be higher than 1.5% pa, but for more established hedge funds, or on an asset-weighted basis, the bias should not be significantly above this figure. To put this in context, 1.5% pa is about twice the survivorship bias of stock indices, in other words not unusually high - ever heard of Swissair, Enron, Kmart?

except for short-sellers, CTAs and market neutral equity. Obviously, long/short equity funds benefited most from the strong rebound of global stocks.

Hedge Fund Strategy	Return Q4 2001	Return YTD 2001	Return pa 1994-2001
HFR Funds of Funds	2,46%	2,88%	7,86%
HFR Hedge Funds	5,95%	4,75%	12,96%
CSFB/Tremont Hedge Funds	2,18%	4,41%	11,63%
Emerging markets	13,94%	10,82%	6,01%
Sector specialists	10,90%	-4,20%	17,18%
Fund market timing	8,68%	5,09%	13,62%
Long/short equities	5,78%	0,37%	17,77%
MBS arbitrage	5,78%	21,16%	10,09%
Macro	5,48%	7,95%	10,42%
Statistical arbitrage	4,50%	1,19%	9,51%
High yield	3,72%	5,32%	5,95%
Reg D arbitrage	3,25%	-2,81%	16,77%
Distressed securities	3,02%	14,37%	10,86%
Merger arbitrage	1,79%	2,61%	12,62%
Convertible arbitrage	1,60%	13,50%	11,44%
Fixed income arbitrage	1,35%	4,54%	5,20%
Market neutral equity	-0,17%	6,41%	10,30%
CTAs	-1,07%	1,03%	5,84%
Short-selling	-12,55%	10,99%	1,20%
MSCI World	8,36%	-17,84%	8,14%
JPM Global Bonds	-3,18%	-0,78%	4,80%

Source:Hedge Fund Research Inc., Barclay Training Group Ltd.

**Directional Equity Strategies:** In the last quarter stocks continued the rally which had started in the second half of September (MSCI World +8.37% in Q4). As usual, the recovery was initiated by the US, but then embraced all major equity markets worldwide. The strong market rebound in Q4 from its September lows was mainly driven by the technology sector (MSCI World IT +32.22% in Q4). This is also underlined by the strong performance of many NASDAQ stocks (NASDAQ +30.13% in Q4). Index heavy-weights like Cisco Systems (+49%), Intel Corporation (+58%) and Yahoo (+101%) rose significantly and approached their record valuations of early 2000 again, measured by P/E etc. There were plenty of reasons for this. During the whole year we have seen unprecedented levels of monetary stimulus by the Fed with 11 Fed rate cuts resulting in a decrease of 475bps, and unprecedented levels of fiscal stimulus in the US (ie USD 38 b of tax reductions). This combined with lower energy prices and a retrenchment of excess inventories in some cyclical industries such as semiconductors finally produced a strong upside momentum for the equity markets worldwide. The «earning seasons» in Q1 will show if this recovery is sustainable or if the worldwide synchronous recession will last longer than we all hope. On average long/short equity managers produced positive results in Q4 (up +5.78% to +10.90%). For many

long/short equity funds however, the comparatively low market exposure which had successfully protected them during the September turbulences proved to be a real performance drag, especially in October and November. In addition, some of the typical short candidates with high valuations were among the strongest rebounders in Q4 which lead to a negative short side contribution for long/short equity funds. Overall, the dedicated short-sellers lost -12.55% in Q4. While on average the long/short US equity managers underperformed their European and Japanese counterparts in the first three quarters, most were able to catch at least a part of the rebound in the fourth quarter (Harcourt L/S US Index +5.77%) while European (-0.24%) and Japanese (+0.23%) long/short equity managers were basically flat. The dispersion of returns within these long/short categories continues to be significant.

**Relative Value Equity Strategies:** Convertible arbitrageurs were up +1.60% for the quarter, but the figures hide a slightly contrasted picture. Implied volatilities fell to 37% in the US, causing losses that were compounded with widening credit spreads and fewer re-hedging opportunities. In Europe however implied volatilities increased slightly in an environment of high realized volatility and narrowing credit spreads, enabling managers to mark the value of

their positions up. Deal flow continued to be attractive. The US saw a large USD 2.2 bn Fiat into GM exchangeable bond top up a record year of new issuance (USD 100 b), even though the credit of the issuer was not attractive. Europe saw several smaller and more attractive deals, such as Lufthansa and France Telecom into ST Micro, bringing total European issuance for the year to more than EUR 50 b. The Japanese convertible market was hit hard in December when the Chugai issue was called due to the takeover bid by Roche, and the whole market subsequently repriced their bonds to account for callability risk. Merger arbitrageurs moved back into positive territory with +1.79% for the quarter. There was some deal shake out, most notably Enron/Dynegy, Compaq/HP, Cooper/Danaher with concerns over asbestos litigations, and NextWave/Verizon with the settlement over NextWave wireless licenses being adjourned. However, the markets' return to a more normal environment helped the arbitrageurs. December winners were Williamette/Weyerhaeuser whereby Weyerhaeuser increased its offer by 10%, and C.R.Bard/ Tyco with the market getting confident that antitrust approval would be won and the deal would close in the first quarter. Statistical arbitrageurs were up +4.50% for the quarter, with most September market dislocations being reversed and markets returning to a more normal environment. Market neutral equity managers were down -0.17%.

Relative Value Fixed Income Strategies: Fixed income arbitrageurs suffered from the strong reversal of US interest-rates during November and generally had difficulties coping with the dislocations in the USD yield curves toward the end of the year. They were up +1.35% for the quarter, benefiting partly from the Fed's massive pumping of liquidity into the markets. In the mortgage-backed sector, the high interest-rate volatility and the steepening yield curve created many mispricings in mortgage derivatives markets resulting in strongly positive returns (up +5.78%). The widening OAS spreads provided continuing opportunities for carry trades. In addition, the falling interest rate environment accelerated prepayments (albeit at a rate below the one predicted by many prepayment models), and hence new mortgage-backed security issuance. For the first time, more business was created out of new issues than from secondary market. 25% of these new issues were

CMOs. There was also huge demand for floaters from banks, leaving the other tranches underpriced.

Directional Fixed Income Strategies: After the sharp dislocations in the high yield market in September, prices of high yield and distressed paper readjusted during the last quarter. High yield credit spreads recovered over 150 bps from their September highs and so high yield managers bounced back, ending the quarter up +3.72%. The supply of distressed paper continued to provide good opportunities on both the long and the short side. Distressed funds ended the quarter up +3.02% despite a negative ruling in the NextWave case.

CTAs lost -1.07% in Q4 2001, bringing YTD performance to a meager +1.03%. The CTAs performed strongly in October with profits primarily made in the interest rate markets which rallied because of global economic worries. In November the unexpected reversal of short-term and long-term rates significantly reversed the profits made the previous month. With -4.44% it was actually the worst month in CTA history since February 1996. In December, CTAs moved back into more positive territory, benefiting from gains in the currency sector as the JPY tumbled to a three-year low and trended down against all major currencies. Macro hedge funds were up +5.48% for the quarter.

Going forward, we are bullish on MBS arbitrage, distressed securities, high yield, long/short Japanese equities, and multi-strategy funds. Fixed income arbitrage should be positive but only with single digit returns in view of the low level of Libor rates. Long/short US equity managers will continue to face difficult equity markets. Particularly in Europe, bottom-up stock pickers should do better than in 2001 going forward. We remain bearish on merger arbitrage, Reg D arbitrage and short-sellers.

***“Going forward, we are bullish on MBS arbitrage, distressed securities, high yield, long/short Japanese equities, and multi-strategy funds.”***

## Performance of hedge fund strategies in Year 2001

2001 was the year of the convertible arbitrageurs. It was also the revival of distressed securities. Major disappointments, on the other hand, were market neutral equity funds and short sellers who did not manage to benefit from the falling markets, and encountered difficulties dealing with the high volatility and the frequent sharp market rebounds.

**Directional Equity Strategies:** With +0.37%, the long/short equity managers underperformed their long term absolute return targets significantly. Sector specialists were down -4.20%. Most managers reduced their market exposure considerably to cope with the turbulent markets. This helped to limit the losses in the first nine months, but prevented them to participate in the fourth quarter rally.

Disappointingly, a lot of managers were not able to add value on the short side even though markets fell substantially. The sharp liquidity induced rebounds in April, October and November made shorting very difficult. Based on our internal databases, long/short US equity funds (+1.23%) and long/short European equity funds (+1.20%) did worse than their Japanese counterparts (+4.50%), which is very interesting to note given the

Nikkei's underperformance of US and European stock markets. In general, managers who were able to opportunistically adapt their exposure, did often better than the pure bottom-up value players.

**Relative Value Equity Strategies:** Convertible arbitrageurs thrived on the unusually high volatility and ended the year up +13.50%. The convertible new issue market virtually replaced the traditional stock IPO market, and of course the abundance of new issues helped the hedge funds. According to industry estimates, hedge funds now hold some 40% of outstanding convertible issues. 2001 was a mostly disappointing year, however, for merger arbitrageurs who had in earlier years become accustomed to steady double digit returns. The major reasons were deal flow falling 50% compared to 2000, shrinking deal premiums, as well as general market uncertainty, accompanied by a high

number of deal breaks, most notably Honeywell/GE. With the exception of August 1998, September 2001 has been the worst month for merger arbitrageurs since 1990 (-2.79%). European merger arbitrage outperformed US merger arbitrage, and will probably continue to do so given the ongoing Euro induced consolidation. Statistical arbitrageurs did not do well in 2001, up +1.19%. Similar to their market neutral equity counterparts, they had difficulties coping with the high volatility and the many market dislocations in an environment where fundamentals played a lesser role.

**Relative Value Fixed Income Strategies:** The dominant theme in the USD interest rate markets in 2001 were the aggressive rate cuts by the Fed and the huge amounts of

liquidity pumped into the market after the September 11 events. The yields dropped across the curve until a sharp reversal in November brought long-term rates back to where they had been at the beginning of the year, thereby significantly steepening the curve. Although volatility is usually welcome in the arbitrage business, fixed-income arbitrage outside the mortgage-backed sector was positive but not extraordinarily

high (up +4.54%). MBS arbitrage, on the other hand, had a superbe year, thriving on the steeper yield curve, high volatility and the supply of new issues. The low interest rate environment triggered a huge refinancing spree of mortgages and consequently new issues of MBS of which about a quarter in the form of collateralized mortgage obligations (CMO), or mortgage derivatives. The enormous demand from financial institutions for CMOs created many arbitrage opportunities for hedge funds, partly because these end buyers were not always able to correctly price the more complex securities in the volatile interest rate environment.

**Directional Fixed Income Strategies:** Overall, 2001 has been an interesting year for distressed and long/short high yield funds. During the year we saw credit spreads and corporate default rates reach historic levels not seen since 1990. The flood of low quality paper issued in the high yield

***“2001 was the year of the convertible arbitrageurs. It was also the revival of distressed securities. Major disappointments, on the other hand, were market neutral equity funds and short sellers”***

market during the euphoric years of 1997-2000 provides today a flood of opportunities for distressed securities players, on the long side as well as on the short side. In September 2001, distressed and high yield managers had to book mark-to-market losses due to a sharp repricing of lower-grade securities. The price dislocations have however corrected since then. European high yield looks increasingly interesting.

CTAs: 2001 was a difficult year for most CTAs (up +1.03%). Some trend-based CTAs did well, with returns highly dependent on the interest rate sector, however. The short term CTAs performed mixed in 2001. Most were caught in erratic market movements such as the one caused by the September 11 events. The currency managers were also affected by this event, ending the year flat.

## Are hedge funds here to stay?

Yes, of course. Our vision of the asset management industry is that hedge funds will become a 'boring' mainstream investment within a few years, and merge with the traditional long-only asset management industry. Why? Because the value chain in asset management will increasingly be segregated into beta and alpha. Let us illustrate this: Today, an institutional investor is normally faced with the choice between allocating to active or passive mandates. The often frustrating outcome in the past has been that the active mandates underperform their passive benchmarks particularly in more efficient markets. What will happen in the future therefore is that portfolios will be separated into a BETA exposure part, acquired via low cost index certificates and ETFs, and an active ALPHA part, produced by very active, hedge fund-like mandates. In other words, traditional semi-active long-only mandates (and mutual funds, for that matter) will have to evolve into either low cost index trackers; or high added value, high fee, active mandates with maximum flexibility looking like hedge funds. To repeat my Q3 comment: «we will be faced with a financial industry where investors buy index certificates to gain market beta exposure and then add a basket of hedge funds for the active alpha part». Over time, the regulators will catch up with this trend, with the result that the traditional asset management world (incl mutual funds) will become more flexible, and hedge funds will become more readily accepted across the world.

This is good and bad news for today's hedge fund industry. The good news is that the current 25% annual growth rate will continue and might even accelerate. The bad news is that the large inflows might have an impact on returns over the long run. Also, capacity will become scarcer. Capacity will actually become the buzzword of the future. There will

be more and more capacity 'gurus', intermediaries who buy up capacity with long lock-ins, and broker the fund shares on the secondary market with hefty fees but better liquidity conditions. Nevertheless, I think that capacity should not be a problem in the next 3 years for most strategies for the following four reasons:

- ▶ Hedge funds still account for less than 1.5% of global stock markets and 9% of global mutual funds.
- ▶ Investment banks continue to reduce their proprietary trading desks. While the slack is being taken up by hedge funds – they have in fact become the new providers of liquidity to the global market place (eg convertible arbitrage) – the overall trading and market making volume has remained more or less stable
- ▶ Some strategies such as long/short equity have per definition unlimited capacity, in the sense that any semi-active stock mutual fund could be looked at as an index with a long/short overlay
- ▶ Hedge funds are much better prepared for the next bubble than in 1998, and are positioned accordingly. They have less leverage, a lower net exposure, more sticky investor capital, more stable funding, and monitor their capacity much closer.

In other words, while returns might be a bit lower going forward and the odd hick-up can never be avoided, hedge funds will continue to grow and to provide comparatively attractive risk-adjusted returns.



## 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.

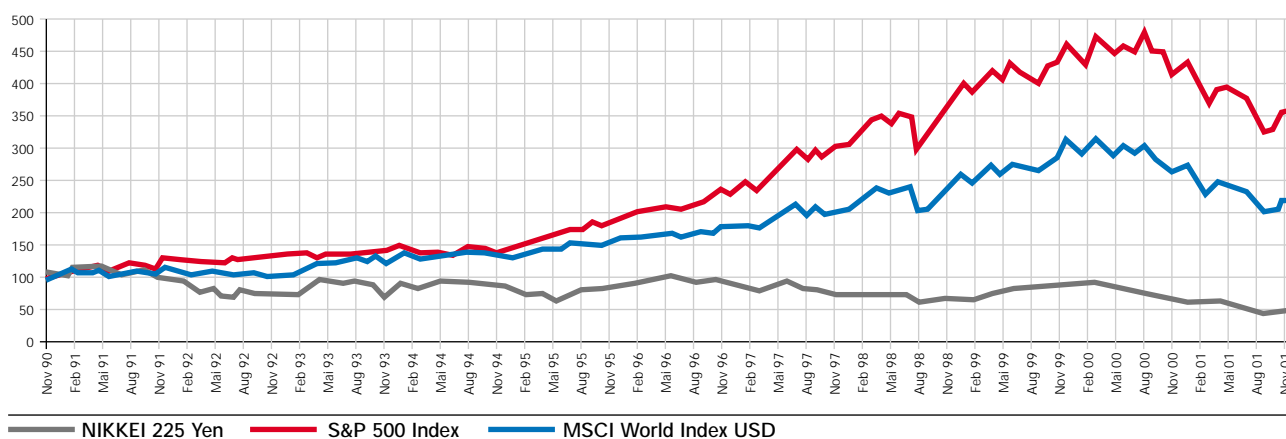
### Asia is a challenging region

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.<sup>1</sup> 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<sup>2</sup> 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.

<sup>1</sup> 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.

<sup>2</sup> 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 143<sup>rd</sup> 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**

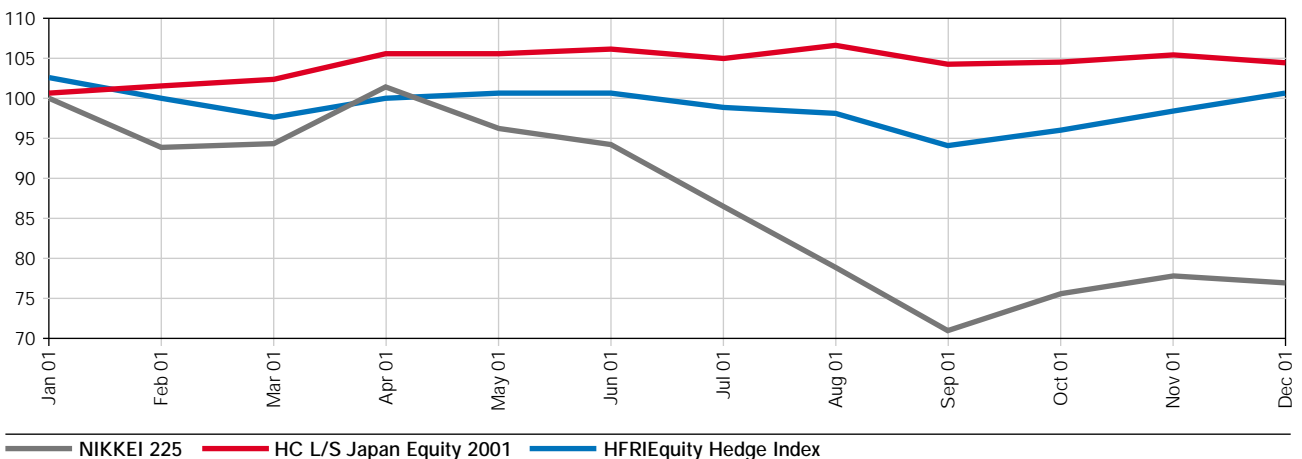
Generally, hedge fund managers, like all active money managers, require market inefficiencies to potentially produce above average returns in the long run. Market inefficiencies are mainly created by information asymmetries and conflicts of interest. While the source of such inefficiencies can be multifaceted, 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.**<sup>3</sup> 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<sup>4</sup>:

% 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.<sup>5</sup>

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

<sup>3</sup> There are around 3'500 publicly listed companies in Japan.

<sup>4</sup> Based on indicative data from various prime brokers and internal resources.

<sup>5</sup> Based on estimates from AsiaHedge, HedgeFund Intelligence Ltd, London SW1E 6DY

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

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

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By: Ted Uemae | President Alternative Investment Products Co., Ltd. | JAPAN

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Ted Uemae established Alternative Investment Products Co., Ltd. (AIP) in August 1998 in Japan. AIP is a consulting firm which introduces research services, analyzing software and risk monitoring system related to hedge funds to 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.

## The Environment in Asia for L/S Equity.

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### Asian roundtable Introduction

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What do Asian hedge fund managers think about Asian markets and the developments of the local hedge fund industry? Harcourt invited three well established long/short managers to express their views on a few topics.

Michael Thomas, Jean Paul Temperley and Bill Orr from Martin Currie Investment Management Ltd give us insights on developments in Japan. Edinburgh based Martin Currie Investment Management Ltd has a long standing track record managing various Japan equity mandates. Martin Currie's long/short Japan fund has achieved positive and very stable returns since its inception in June 2000.

David Snoddy is the Chief Investment Advisor and principal shareholder of Tokyo based Speedwell Advisors Ltd. David's long/short experience includes positions with Soros Fund Management and Tiger Management LLC. In November 2000 he established his long/short Japan fund, which posted very attractive returns and grew substantially in 2001.

Scobie Ward and Peter Ferry are the founders of Hong Kong based Ward Ferry Management Ltd. Both were previously at Lloyd George Management before deciding to establish their own hedge fund. Scobie's and Peter's long/short Asia fund produced excellent returns in very difficult market conditions since inception in November 2000.

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### Market outlook

***Q: 2001 was a challenging year for Asia. What is your outlook for 2002?***

CURRIE: «We believe 2002 is likely to be an equally challenging year in Japan. There has been much talk of reform but little action. The economy remains beset by deflation, although there is the possibility of a cyclical bounce aided by corporate cost-cutting.»

SPEEDWELL: «Specifically for Japan, I suspect the industrial cycle will improve, which, combined with ample central bank liquidity, should provide some upside.»

FERRY: «We are constructive on emerging Asia and believe that Japan will likely face an inflection point this year under the weight of its banking crisis from which it will become either a major problem spot or a major investment opportunity should the reform process succeed.»

***Q: What would be the worst case economic scenario for your strategy?***

CURRIE: «The current worst case economic scenario would be a sharp sustained economic recovery. However, if this did occur we would immediately reposition the portfolio.»

SPEEDWELL: «Given that we are, in part, betting on an industrial recovery, the lack of that would obviously hurt.»

FERRY: «The worst case scenario for our strategy would be a major/sudden deterioration in Japan that we had not anticipated leading to an overall loss of investor confidence in Asian stocks and currencies. When we are constructive on markets we have significant net long exposure that can make us vulnerable to sudden shocks.»

***Q: We have seen a couple of bankruptcies in Japan's real estate and financial sector lately. Do you think the changes in Japan will be serious and substantial?***

CURRIE: «We believe we need to see more bad news before the government will be forced to act with meaningful reforms. The government have already said that the banking industry will be supported.»

SPEEDWELL: «The answer is yes, but we have had, by Japanese standards, serious and sustained change for 10 years. I suspect that the Japanese policy-making apparatus will continue to do what it has done for 10 years: make changes when forced, but otherwise not do very much. It remains to be seen whether they will have to finally «bite the bullet.» They will certainly have to pile up enough incremental change to enable them to avoid that.»

FERRY: «We are very concerned about the Japanese financial system and monitor it closely as a potential source of instability.»

***Q: How important will China be for the development of the whole region?***

CURRIE: «Very important, both as a competitor in the region and as a customer.»

SPEEDWELL: «Important. It will become THE manufacturing center for Asia.»

FERRY: «China's emergence is a great opportunity for investment throughout Asia as many companies in Hong Kong and Taiwan, for example, are expanding there. It is also a potential threat to many exporters in Japan and elsewhere in Asia who cannot match China's low costs.»

### **Growth of Asian hedge fund industry**

**Q: *We have witnessed an overwhelming growth of hedge fund managers in Asia recently. What is the impact of this growth for you?***

CURRIE: «The growth in hedge fund managers in Asia has obviously meant more competition but has also resulted in greater awareness of and interest in the whole sector. We have seen a number of investors invest recently in the region for the first time ever.»

SPEEDWELL: «We have seen and continue to see inflows.»

FERRY: «Long/short equity investment is increasingly recognized as a viable strategy in Asia. As a result we are seeing more and more interest in our fund and expect to grow our funds under management commensurate with this growth.»

**Q: *What is the immediate impact for your fund when competition from other hedge fund managers is around?***

CURRIE: «Growth in assets has been slightly slower, but there is a wide range of strategies and styles so investors are able to construct well diversified portfolios.»

SPEEDWELL: «Trades can get more crowded, and we've had to be careful about checking out how crowded trades are before we get in them. I've also noticed that the increasing sell side trend towards «hedge fund sales» exacerbates this problem, and where possible we do not talk to the hedge fund specialist brokers.»

FERRY: «The total free float of all major Asian stock markets is approximately USD2.4 trillion. The hedge fund community in Asia is broadly managing USD14.6 billion across all asset classes and strategies. There is little impact from competitors currently.»

**Q: *Will the growing competition make it harder to repeat attractive returns?***

CURRIE: «We do not think the growing competition has affected our returns so far and the Japanese market continues to offer plenty of good ideas and liquidity. Over time it may become harder in Asia, but no more so than the more established hedge fund markets in the USA and Europe.»

SPEEDWELL: «There are two issues here: ideas, and borrow availability. Investment ideas may get somewhat more crowded over time than they are today, raising the value of fundamental research at the same time as it lowers the value of momentum investing. Being early will matter more. Regarding borrow, it seems to me that supply has been growing as fast as demand, and we have only had significant problems borrowing names where we compete with the CB arb world.»

FERRY: «We do not view this as an issue presently.»

**Q: *What do you think is the key driver for the growth of the Asian hedge fund industry?***

CURRIE: «The poor performance of global stockmarkets and the relatively inefficient Japanese market.»

SPEEDWELL: «Returns.»

FERRY: «One of the key drivers for the growth of the Asian hedge fund industry is continued deregulation of the Asian capital markets, especially on the equity borrowing/shorting area.»

### **Manager skills**

**Q: *Significant market draw downs can never be ruled out. How do you manage your fund so that it will survive market turbulences unharmed?***

CURRIE: «We have developed a comprehensive, tailored risk management system giving both ex post measurement, ex ante management and daily VaR. The result has been the recent conservative use of the balance sheet and a well diversified portfolio.»

SPEEDWELL: «We have stop loss system which we employ religiously.»

FERRY: «We monitor our portfolio daily for exposure risk. This ensures that we maintain broad country and industry exposure at all times. We closely monitor the net long exposure of the portfolio as well. We stress test the portfolio and monitor the overall liquidity of the portfolio to ensure they are maintained within our guidelines. Finally, we have found that our stop loss policy has helped us in controlling risk in the overall portfolio.»

**Q: In your view, what will be key for a successful hedge fund manager in Asia next year?**

**What should be the particular skills that a hedge fund manager needs in Asia?**

CURRIE: «Good stockpicking skills and a particularly good understanding of the technology and financial sectors.»

SPEEDWELL: «You probably need a better familiarity with macro issues than is the case in the West. But at the end of the day the ideas drive the portfolio, and while I firmly local experience helps you pick better stocks, the basic tools of analysis are similar.»

FERRY: «Stock selection and risk control.»

**Q: Are there still cultural and technical difficulties in shorting stocks and generating good shorting ideas in Asia?**

CURRIE: «In Japan it is generally easy to short stocks. At Martin Currie we have the added advantage of managing a further \$1.7 Billion in long only money in Japan, which means most Japanese companies are happy to meet with us. These meetings ensure a good supply of both long and short ideas.»

SPEEDWELL: «Not in Japan.»

FERRY: «We have not experienced any cultural or technical difficulties in shorting stocks. In fact, borrowing stocks in Asia continues to improve, as Korea will soon be an additional market that foreign investors can short.»

## Meeting investor expectation

**Q: What kind of investors should invest in L/S Asia/ Japan managers and who should not?**

CURRIE: «There are a wide range of different styles, strategies and risk profiles so most hedge fund investors should be able to find a Japan/Asian hedge fund which matches their needs. The Martin Currie ARF – Japan Fund offers investors low volatile, steady and uncorrelated returns with a focus on preserving initial capital.»

SPEEDWELL: «Well it has been our experience that Europeans are, all other things being equal, more interested in Japan than are Americans, which may result from them having to look outside their home markets for a lot longer. But at the end of the day, good adjusted returns are good adjusted returns and if they continue to come out of Asia money will continue to pursue them.»

FERRY: «Investors in Asia typically have higher risk/return profiles. Hedge funds can mitigate the risk side of the profile and attract a wider universe of investors.»

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# Hedge Funds and the Asian Currency Crisis of 1997

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By: Stephen J. Brown, William N. Goetzmann and James M. Park | Journal of Portfolio Management Summer 2000  
 (Please note that this is a review of a working paper version. The version in the Journal of Portfolio Management may differ.)  
 Reviewed by Jim Brandon | BAAM GmbH

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## Introduction

If you are currently considering whether to invest in an Asian long-short equity hedge fund, you are probably wondering about the risks in Asia. The Asian currency crisis of 1997 is still fresh in the memories of investors but, curiously, there is still not a clear consensus on the causes of the crisis. Broadly speaking, some argue that the economic fundamentals were weak in Asia, e.g. poor lending controls and excessive short-term USD borrowing. Others argue that the economic fundamentals were solid. Instead, speculative attacks on Asian currencies led to an erosion of economic fundamentals and therefore became self-fulfilling.

No one argues that speculative attacks are impossible. George Soros famously made £ 1 billion in a less than a month by betting that the United Kingdom would drop out of the ERM in 1992. Even if Soros did not cause the devaluation of the UK pound, he may have hastened it. (The MIT economist Paul Krugman has suggested the term «Soroi» for global macro hedge funds that have sufficient assets and access to leverage to successfully attack an over-valued currency.) The central question here is whether hedge funds contributed to the Asian currency crisis. Some have conjectured that Soroi fingerprints are all over the sudden decline in the value of Asian currencies in fall 1997. If the Soroi are able to cause a collapse of a currency in a country with solid economic fundamentals, they would be a risk for their Asian long-short equity hedge fund cousins.

Brown, Goetzmann and Park (hereafter BGP) offer evidence that the Soroi were not involved in the collapse of Asian currencies in 1997. As BGP state: «We test the hypothesis that the dramatic negative returns to these currencies versus the dollar were correlated to large positions,

short or long, taken by the (top eleven global hedge) funds. The answer is No.» However, before breathing a sigh of relief, Asian long-short equity investors might want to evaluate their methods and the strength of the evidence.

## Method and Estimation Problems

Briefly stated, BGP use a two-stage regression method to estimate whether Soroi currency holdings affect the value of the currency. A first regression estimates the size of the currency holdings and a second regression estimates the impact on the value of the currency. Roughly speaking, BGP want to know if the Soroi dramatically increased their short positions in Asian currencies just before they fell in price. Their task is complicated because Soroi currency positions are not available. BGP do have monthly data on returns and assets under management for the eleven largest Soroi from September 1993 to October 1997. They first report results for one currency, the Malaysian ringgit, since the Malaysian Prime Minister Mohamad Mahathir has widely claimed that hedge funds were responsible for the fall in the value of the ringgit from July 1997 to September 1997.

In the following brief explanation of the BGP estimation procedure, I alter their notation for the sake of clarity. In equation 1, for each Soroi they estimate the ringgit holdings each month by regressing the Soroi monthly return on the monthly return of the ringgit (expressed as ringgit/dollar) for the four prior months. Equation 1 is the hedge fund version of the Sharpe style regression, so  $b$  is an estimate of the portfolio weight of the ringgit in each Soroi portfolio.

$$(1) R_{HF} = a + b \cdot R_{MR} + e$$

$R_{HF}$  is the Soroi monthly return;  $R_{MR}$  is the ringgit/dollar monthly return

A separate time series regression is estimated for each Soroi for every month

For each month's estimate of  $b$ , the regression uses the four prior months

To understand equation 1, consider a Soroi that invests all of its assets long in the ringgit with no leverage. The estimates

in equation 1 will be  $a=0$  and  $b=1$ . More realistically, consider a Soroi that employs leverage and shorts the ringgit. With an equity of USD 100 million as margin and a short position of USD 1 billion in ringgits, the estimates in equation 1 will be  $a=0$  and  $b=-10$ . Equation 1 is estimated for each Soroi fund for every month, using the four prior months. (The estimate of the January 1994 portfolio weight is based on the four observations from September 1993 to December 1993. The estimate for February 1994 is based on observations from October 1993 to January 1994. And so on.)

BGP emphasize that the standard error of the estimate of  $b$  in equation 1 is quite large for three reasons. First, the exclusion of other Soroi investments in equation 1 means that those terms are included in the error term. Second, with only four observations the standard error is quite high. Third, the absolute value of  $b$  is upwardly biased if the Soroi invests in the same direction in other currencies that are positively correlated with the ringgit. (If the ringgit return is down then the Soroi return is positive for two reasons: for being short the ringgit and for being short other Asian currencies. And vice versa.)

Because BGP need a time series of monthly  $b$  estimates for their second regression, they have no alternative to equation 1. BGP mitigate the problem of the high standard errors by estimating the second equation once for all eleven Soroi combined. Since  $b$  is an estimate of the portfolio weight of the ringgit in each Soroi portfolio (for each month), BGP multiply the estimated  $b$  for each fund-month times the fund's equity each month to get an estimate of the fund's dollar exposure to the ringgit. (Using the example above, if  $b=-10$  and the fund equity is USD 100 million, then the fund's estimated dollar exposure to the ringgit is USD 1 billion.) BGP then estimate equation 2 using the average of the eleven Soroi's dollar exposure to the ringgit, which I label  $\$E_{11HF_s}$ .

(An aside. Instead of mitigating the high standard errors of  $b$  by using an average  $\$E_{11HF_s}$ , BGP might have created a portfolio of the eleven Soroi and run a single version of equation 1. The precision of  $\$E_{11HF_s}$  would be higher since it is based on one estimate instead of eleven and because information about the changes of the equity for each Soroi (during the four months used in the regression) would be included in the estimate of  $\$E_{11HF_s}$ . The BGP estimates of  $b$  assume that the equity of each Soroi was unchanged during the four months.)

(A second aside. BGP understand that by combining the eleven Soroi in the estimate of  $\$E_{11HF_s}$ , they are testing whether the eleven Soroi together caused the ringgit to collapse, not each Soroi individually. The former conjecture could be rejected even if the latter conjecture were true, since the ringgit exposures of some Soroi may be long while others are short. BGP present the time series of the estimated individual exposures to the ringgit for each of the eleven Soroi. The exposures vary significantly over time, but in all cases the exposures are low in fall 1997.)

Now BGP have estimated a time series of  $\$E_{11HF_s}$  from January 1994 to October 1997 for the combined eleven Soroi in their sample. Remember that BGP wish to test whether Soroi dollar exposure to the ringgit caused the crash in the ringgit in fall 1997. They argue that, if this were true, then the correlation between  $\$E_{11HF_s}$  and the return on the ringgit/dollar rate would be positive. (The logic is straightforward. Sometime after the Soroi increase their shorts of the ringgit, its value falls. Note that even if poor economic fundamentals caused the ringgit to crash, the Soroi might nevertheless trigger the crash and still profit.) BGP test this conjecture with equation 2. A significantly positive estimate of  $d$  is evidence consistent with the conjecture that the Soroi caused the ringgit to crash. A zero estimate of  $d$  is evidence that the Soroi were not the cause.

$$(2) R_{MR} = c + d * \$E_{11HF_s} + u$$

$R_{MR}$  is the ringgit/dollar monthly return

$\$E_{11HF_s}$  is the monthly combined Soroi dollar exposure to the ringgit

One time series regression is estimated for January 1994 to September 1997

BGP also carefully discuss estimation problems in equation 2. They point out that  $d$  is upwardly biased if there is a positive correlation between the current month  $R_{MR}$  and the estimate of  $\$E_{11HF_s}$  based on the prior four months. While they are not explicit, this positive correlation could be the result of investors other than the Soroi attacking the currency at the same time. Another estimation problem arises because the estimate of the current month ringgit exposure,  $\$E_{11HF_s}$ , is based on returns for the prior four month. If the Soroi can trigger a currency collapse in less than 1 or 2 months after taking short positions, then equation 2 will have little power to detect it. As discussed below, BGP offer additional evidence using weekly data.



George Soros

## Results

BGP report the estimate of equation 2 for the ringgit. The result is encouraging for investors fearful of economic instability triggered by Soroi in Asia. The estimate of  $d$  is 0.000 with a t-stat of 0.453 for the period January 1994 to September 1997. If the estimation problems discussed above have not harmed the power of the test, then this evidence supports the view that Soroi currency positions do not influence the value of the ringgit. (BGP run equation 2 using a  $R_{MR}$  lagged one month and get the same results.)

To consider the evidence during the fall of 1997 specifically, BGP chart the estimated combined Soroi exposure to the ringgit,  $\$E_{11HF_s}$ , for each month from January 1994 to September 1997. The chart also shows the value of the ringgit each month. (Keep in mind that  $\$E_{11HF_s}$  is a trailing four-month estimate of the current month exposure.) Starting in November 1996,  $\$E_{11HF_s}$  was increasingly net long, peaking at over USD 100 billion but going back to zero by February 1997. The ringgit value remained stable during the period. Starting in March 1997,  $\$E_{11HF_s}$  was increasingly net short, peaking at about USD -100 billion in June 1997. Again the ringgit value remained stable for the period. The ringgit crashed from July 1997 to September 1997. During this period the Soroi appear to be unwinding, rather than holding or increasing their short position. This is striking evidence against the conjecture that the Soroi caused the Asia currency crisis, since the Soroi appear to be buying ringgit as its value fell. Rather than concluding that the Soroi cushioned the collapse of the ringgit, BGP more cautiously suggest that the Soroi lacked the power to affect the value of the ringgit one way or the other.

BGP repeat the same chart, but estimate  $\$E_{11HF_s}$  as exposure to an Asian currency basket rather than just the ringgit. Again the chart also shows the value of the Asian currency basket for each month. These estimates allow for the

possibility that the Soroi are invested in other Asia currencies than the ringgit. The results are very similar to the ringgit chart. There is a striking brief increase in  $\$E_{11HF_s}$  to a long position of USD 1500 billion during December 1995 followed by a sudden swing to a short position of USD 300 billion during the next three months. Again no movement in the value of the Asian currency basket value is visible during the period. And after May 1997,  $\$E_{11HF_s}$  is only slightly short and unchanged while the Asian currency basket value fell.

Using weekly returns for two unnamed funds, BGP estimate  $\$E_{11HF_s}$  for each fund, using the Asian currency basket. The weekly estimates of equation 1 will have lower standard errors than the monthly estimates because the number of observations is 4 times higher and because returns for other currencies can be added (UK, Germany, Japan and Mexico). Nevertheless, the results are unchanged. For both funds, estimated exposures to Asian currencies are occasionally quite high, but the exposures during fall 1997 are modest.

## Conclusion

It's the old «good news and bad news» story for the Soroi. BGP are encouraged that their results suggest that developing country currency markets are sufficiently deep to be unaffected by even the largest positions taken by the Soroi. One might imagine that the Soroi are delighted by evidence contrary to the accusations that they destabilized Asian currency markets. But the bad news is that the same evidence suggests that the Soroi were unable to profit during a period of extraordinary opportunity. In fact, funds managed by George Soros were either flat or down from June 1997 to September 1997. The Asian long-short equity fund investors need not worry, but perhaps the Asian currency fund investors should.



## UPCOMING CONFERENCES 2002

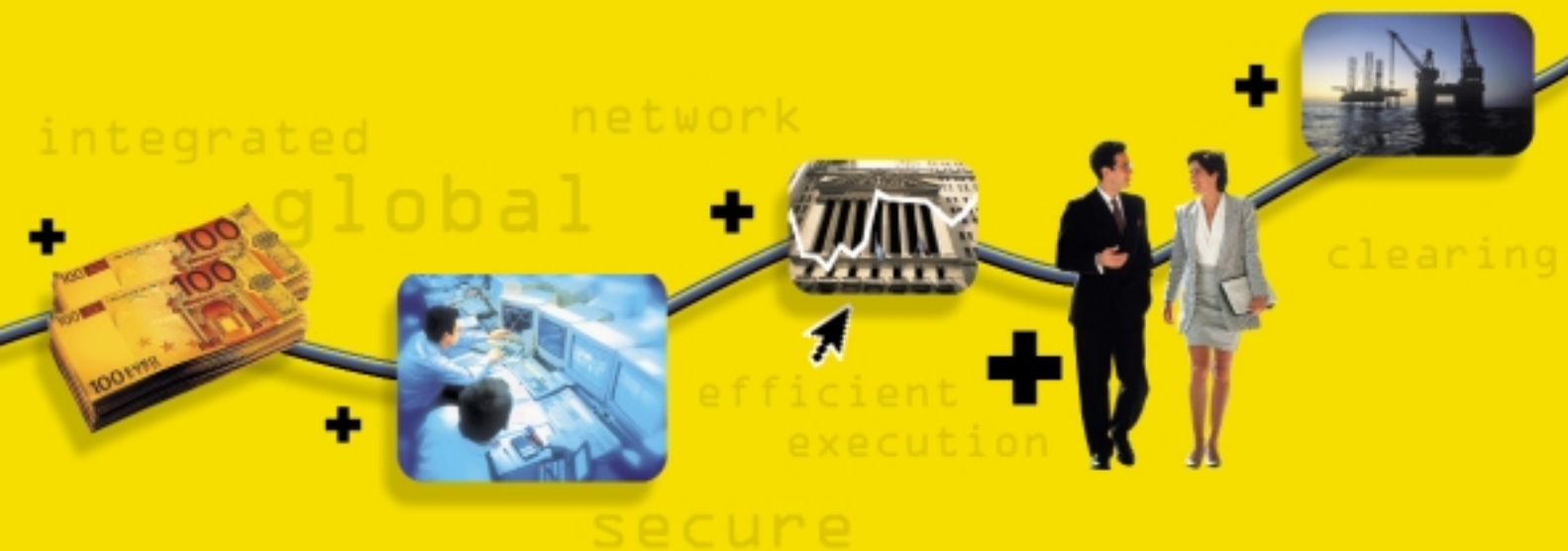


February	25 - 27	MAR/Hedge 7th European Conference on Hedge Fund Investments Hotel Intercontinental Geneva <a href="http://www.marhedge.com">www.marhedge.com</a>
March	7	Exploring the Latest Opportunities in Funds of Hedge Funds Excelsior Hotel Gallia, Milano <a href="http://www.abc-financial.com/BL1179">www.abc-financial.com/BL1179</a>
	7 - 8	Guaranteed & Capital Protected Products The SAS Radisson, Brussels <a href="http://www.abc-financial.com/bi1180">www.abc-financial.com/bi1180</a>
	12 - 13	Funds World China 2002 Hotel Inter-Continental Pudong Shanghai <a href="mailto:rani.kuppusamy@terrapinn.com">rani.kuppusamy@terrapinn.com</a>
	18 - 19	Alternative Investment Markets: Structuring and Documenting Alternative Investment Funds Central London, UK <a href="http://www.euromoneytraining.com/legal">www.euromoneytraining.com/legal</a>
	21-22	Hedge Fund Services Summit Crowne Plaza, London <a href="http://www.moneyseminars.com">www.moneyseminars.com</a>
May	22 - 24	Funds World Asia 2002 Island Shangri-La Hotel, Hong Kong <a href="mailto:rani.kuppusamy@terrapinn.com">rani.kuppusamy@terrapinn.com</a>

## HARCOURT EVENTS 2002

Topic: Asia	12 February 13 February 14 February 15 February 19 February	Breakfast Seminar Breakfast Seminar Cocktail Seminar Breakfast Seminar Cocktail Seminar	Geneva/Lausanne Zurich/Basel Milano Lugano Stockholm
Topic: Merger/Convertible Arbitrage	7 May 8 May 9 May 10 May 14 May	Breakfast Seminar Breakfast Seminar Cocktail Seminar Breakfast Seminar Cocktail Seminar	Geneva/Lausanne Zurich/Basel Milano Lugano Stockholm
Bürgenstock Hedge Fund Seminar	20-22 June		Bürgenstock
Topic: Fixed Income Arbitrage	3 September 4 September 5 September 6 September 10 September	Breakfast Seminar Breakfast Seminar Cocktail Seminar Breakfast Seminar Cocktail Seminar	Geneva/Lausanne Zurich/Basel Milano Lugano Stockholm
Crans-Montana Hedge Fund Seminar	2-5 October		Crans-Montana
Topic: Europe	5 November 6 November 7 November 8 November 12 November	Breakfast Seminar Breakfast Seminar Cocktail Seminar Breakfast Seminar Cocktail Seminar	Geneva/Lausanne Zurich/Basel Milano Lugano Stockholm
Raclette boat trip	4 December		Zurich

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