Asia takes off

«News behind the news» | Author Matthias Knab edits Alternative Market Briefing (published by Opalesque Ltd), a daily premium news service on hedge funds and alternatives. In this column, exclusively available to swissHEDGE readers, he reflects and analyses what is behind current topics that dominate the industry and the media.

Asian hedge fund managers are being chased by Western money. I spent most of December 2004 in Japan and Korea. The editor of swissHEDGE asked me to report some of my observations and experiences on the current hedge fund developments in Asia for this issue of the magazine.

On this trip, a prime brokerage executive told me of a funds of hedge funds (FOF) manager who flew into Japan and asked for help to allocate USD1b «to about 10 good Japanese hedge funds» – an exorbitant amount even when spread over a larger number of funds. This little episode shows how little international FOF managers seem to know about local markets and exemplifies the current dynamics and asset flows: According to Eurekahedge, the Singapore-based consultancy, investments in Asian hedge fund strategies have nearly doubled in 2004, mostly due to a growing inflow of US capital after years of reduced exposure to the region. Total assets have jumped to about USD 60b in mid-December from USD 34b at the end of 2003. London-based AsiaHedge even believes that assets have reached in excess of USD 70b by the end of 2004. Today, there are roughly 500 hedge funds in Asia, compared with some 160 five years ago.

Bloomberg columnist William Pesek thinks this is an ironic turn of events in a region that just seven years ago blamed speculative trading for its worst financial crisis in decades. It's no mystery why hedge funds find Asia attractive. Since markets here are less researched and liquid than western ones, there is an abundance of inefficiencies available to hedge funds. Asia's stock and bond markets also are widely seen as undervalued relative to larger ones.

Spotlight on Japan: Cultural change fosters hedge fund launches

Stanley Howard, President Asia/Japan from Investor Select Advisors, says that Japan currently experiences cultural as well as management philosophy changes that leads more Japanese financial professionals to become independent and set up their own firms. While, historically, it was the most common path to seek employment in one of the big Japanese conglomerates, the young generation, supported by Government incentives, has started to show interest in developing their own enterprises. Howard says that this is one of the reasons for the offspring of Japanese managers, whereas in the past, Japan's hedge funds were mostly run by «Gaijins», as foreigners are called here. The Japanese hedge fund industry has now grown to approximately USD40b in the first 6 months of 2004, with 80% coming from institutions.

Prime brokers operating in Japan are delighted about the amount of business that 2004 brought them, and all indications are that this trend will continue in 2005. Some prime brokers say that they have already lined up 25 funds to launch in this first quarter. According to Howard, the quality of the managers is «surprisingly good», although he expects that the current upsurge will see the emergence of mediocre managers as well. Japanese investors feel very comfortable with the «Made in Japan» touch of local hedge fund products. Howard feels that Asia offers increasing investment opportunities that reach as far as directional investments in countries like Vietnam or even Cambodia.

According to Howard, apart from the entrepreneurial trend of setting up local hedge funds, there is a second trend setting the stage for change and opportunities. These days, business owners have started to turn away from «just building empires», increase their conglomerates or just add on to their balance sheets. Business owners increasingly *focus on return on investment and return on equity*, thus driving a new shareholder value paradigm that will create capital market opportunities resulting from spin-offs, event driven situations, and other capital actions. Reuters just confirmed this[1] by writing that Japan's bankers expect more merger and acquisition deals this year after the country's M&A activity already rose by 42% in 2004. Heightened competition and a drive to protect local industries from foreign takeovers are providing good M&A opportunities, prompting companies to seek mergers to raise their price tags, or sell off excess operations in order to boost business efficiency.

[1] January 7th, 2005

Japanese assets made up almost 30% of inflows to the top 10 global FOFs in 2004. Apart from Western money chasing Asian hedge funds, there are highly significant asset flows from Japanese investors into the global hedge fund industry. Ferenc Sanderson, Director of Research at Daiwa Securities America, wrote in a report on the Japanese hedge fund industry that Japanese FOF investors make up almost 30% of the asset inflows to the top 10 global FOFs – six of whom are already soft closed. Sanderson also identified the annual growth rate of hedge fund investments from different Japanese investor groups:

- HNW 50% pa.
- pension funds 30-35% pa.
- insurance companies 25% pa.
- banks 20% pa.
- others 20% pa.

These are growth rates which result in huge numbers; Sanderson estimates that five years from now, hedge fund capital will represent 25% of adjusted Tokyo stock exchange market capital. Japanese financial institutions are also believed to begin to actively seed and incubate managers.

Japanese Government Pension Fund draws map to first hedge fund investments

All of (financial) Japan has long been anxiously awaiting the first hedge fund investment by one of the world's largest pension funds (the Japanese Government Pension Fund, «JGPF»), whose assets are actually larger than the Swiss GDP. A touch of disappointment was in the room at a recent conference, when Noboru Terada (Executive Investment Officer of JGPF) warned about typical pitfalls or disappointments for hedge fund investors who may not be aware of backfills or the exact nature of the available investable indeces (e.g. equal weighted/asset weighted).
Citing findings of his «good friend» Roger Ibbotson from Ibbotson Associates, Terada cautioned institutional investors to be aware that strategies like Equity Market Neutral yielded 12.3% (1995 - 2004) on paper, whereas in reality (fees, backfills), net returns were «only» 8.6%. According to Terada, the alpha within this strategy proved to be «a mere» 3.6%, with 5.1% stemming from beta. He also voiced his opinion that investing through a FOF would negatively impact alpha. Some of the financial globetrotters, going from conference to conference, have heard this from Professor Ibbotson himself at a recent conference in Lausanne.

Soon after Terada's unpleasant revelation, the audience was relieved to hear that he called the CALPERS approach – first a USD 1b FOF investment, then some direct investments, then another USD 1b investment – a «good approach», indicating the likelyhood for his fund to follow a similar strategy. Japanese industry experts say that any action by the JGPF will pave the way for the rest of the country's pension industry. Terada also explained why «it always takes longer than you read in the press (to invest in hedge funds)»: the bottleneck is that the investment policy is set by government panel members who have to approve the investment plans. He says that the easiest way to their hearts and assets was to explain the portable alpha approach.
Mr. Terada also illustrated how hedge fund managers «can win him as an investor»:

- The style/stragety of the fund must be clear and consistent. Managers must be able to «articulate and strictly follow an investment philosophy». Terada explained that the requirements of the pension fund industry are more rigid than what foundations and endowments ask from managers.
- Liquidity: Although pension funds have a long term investment horizon, short term liquidity needs may arise and therefore he favours short lock-ups.
- Valuations MUST be done by a third party.
- It must be possible to separate alpha from beta and measure it. Otherwise, the portable alpha approach cannot be implemented.

On the ensuing panel discussion, representatives of Japanese institutions said hedge fund marketers should be aware that Japanese prospects will put them on test and verify the promises and statement they were given in meetings (e.g. about transparency, fund composition). In the end, the panel transported an ambiguous message: on the one hand, «don't send kids to Japan (to market your fund)», but also «be aware that the final decision maker may have no clue about investing», so it is advised to find out as much as possible in advance about the person a marketer is going to meet and who will be involved in the investment process.

Is Japan the promised land for hedge funds?

Mitch Fulscher, a financial consultant who has lived in Japan since 1987, says that there are two additional, mostly untapped markets of equal size, next to pension funds and

insurance companies. He points out that the Japanese commercial banks, regional banks and agricultural banks may be largely overlooked by Western marketers. Sure, there are the Tokyo Mitsubishi Bank, Sumitomo, Mitsui etc. who already have expertise – but behind them are the second and third tier banks facing the same misery like all Japanese institutions: yields of almost zero. On the retail side, asset management and even financial planning are still relatively new concepts in Japan, and as more people distrust banks, this will become a growing sector. So – Japan, the promised land for hedge fund marketers?

«Beware!», says a leading legal expert practising in Tokyo, who actually expects arrests of unlicensed marketers to happen in 2005. Charming prospects for the brash and bold; yet, manageable.

It can be argued that financial regulators all over the globe are slow in intelligently structuring and adapting national markets to financial innovations. This was and sometimes still is the case with derivatives and obviously with hedge funds as well. However, by the end of December 2004 the Japanese Financial Services Agency FSA launched a program for «further financial reform with the goal of becoming a Financial Services Nation». Thinking what Japan has accomplished after a similar declaration was made at the end of the 19th century when the country, coming out of the 250 year long isolation of the Edo period, declared to become an industrial nation, we can certainly expect a lot from that country.

Korea: the silent shake-up

Goldman Sachs, Morgan Stanley, UBS, Societe Generale, Fidelity, Credit Agricole – either they are already there or they have will have opened their Seoul office by January 2005. Western financial powerhouses are pushing into Korea to take a piece of the pension pie. Starting this year, new regulations will allow the outsourcing of pension mandates. This market opportunity can be measured virtually in hundreds of billions of dollars. The developments in Korea are nothing short of revolutionary, with the National Pension Fund having outsourced the management of international equities this summer and decided in November to outsource fixed income as well. In 2005, a decision could come to move into a broad range of alternatives, including private equity, hedge funds, real estate, and structured products.

Andrew Hwang, Product Specialist of Nonghyup CA Asset Management, a joint venture between Credit Agricole and a leading Korean bank, explains that the National Pension Fund alone has more than USD 100b in assets, and he reckons that probably about 99% of pension fund money is invested domestically, where yields are decreasing. A «gigantic pension fund market» is desperate for yields. On the domestic equity side, the national markets are highly volatile and near their all time highs. Investors are consequently nervous in respect of their equity exposures and are beginning to look for new approaches.

Hankooki.com reports that the presence of foreign banks in Korea's currency markets has significantly increased since the financial crisis, according to the the Korea Institute of Finance (KIF) in mid-January. In its report, Park Hae-Sik, a research fellow at the KIF, said that foreign banks controlled 53% percent of the overall currency trading market, against 47% for local banks. Foreign lenders also controlled 67% of the currency derivatives market in Korea as of the end of 2003, while Korean banks accounted for just 33%.

The local asset management market is likely to face a radical change in the immediate future, with Fidelity Investments, the world's largest fund management company, having launched its business there in January. Market analysts say that, given the growing influence of foreign firms in the local markets, the emergence of these giant asset management firms will change the landscape of the local market greatly. With foreign control in the domestic market increasing, small- and medium-sized local fund management firms are being marginalized. Therefore, these firms are expected to seek M&As to compete with their foreign counterparts. Moreover, the expected emergence of a large number of private equity funds is likely to intensify competition in the asset management market.

On the retail side, the private banking market takes off steadily: The Bank of Korea reported the number of accounts with deposits of more than 500m won (USD 480k) – excluding corporate customers – is approaching 60,000, having increased by 40% over the past four years. The race to attract VIP customers in Korea will likely become fiercer with the inroads of the world's No. 1, Citibank, into the list of eight major commercial banks by taking over KorAm Bank this year and the scheduled takeover of Korea First Bank in 2005 by HSBC, the world's No. 2.

swissHEDGE readers can get a free trial or use promotion code «swissHEDGE» for substantial discounts for Matthias Knab's daily Alternative Market Briefings on www.opalesque.com.