



Not for tourists: hedge funds in Asia

A roundtable of leading industry professionals hosted by *AsianInvestor* discusses the challenges facing the hedge-fund business today.

Managing a hedge fund, as either a business executive or an investment professional, used to be considered an easy way to get out of investment banking or long-only fund management. It seemed to offer plenty of freedom, juicy fees and an entrepreneurial cachet.

That changed in 2008 when the industry suffered huge losses. Many funds or their allocators threw up gates to investors who were scrambling to redeem, often to the detriment of managers with better performance.

Since then, market volatility has posed both investment risk and opportunities, particularly now that the easy beta enjoyed by long-only competitors has disappeared. But the industry hasn't gotten easier. It's gotten harder and more serious – and more professional as well. Hedge funds aren't for tourists.

For those with the nous, the experience and the right infrastructure, opportunities remain, and absolute return is back in vogue among global investors. Our roundtable brought together hedge-fund managers, industry repre-

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Joanne Murphy, Triple A Partners

sentatives, third-party marketers and service providers to understand what business and markets will look like as we enter the fourth quarter of 2011.

Simon Osborne: How will economic events in Europe play out?

Andrew Ballingal: It's a multi-act affair. There still hasn't been a full accounting for the global economic crisis, and there remains balance-sheet weakness in financial institutions that should have been dealt with, but they were not permitted to recapitalize themselves in the good times.

We're now back in difficult times and that makes recapping and sales of assets at sovereign level virtually impossible.

Eddie Tam: Europe's key structural issue will be to support their banks, because for better or worse, banks are still at the nexus of the economic system. Perhaps authorities felt they could resolve the problem by delaying any resolution. We're now facing the music as a result of issues being passed from the corporate bal-

ance sheet to the taxpayer's balance sheet.

How does it end?

Ballingal: A solution may be banks being recapitalized by governments and for the European Central Bank to set out on a resolute path of euro devaluation – which it hasn't done so far. That's the way to get levels of nominal GDP up to a point where the whole thing can be bailed out.

Is that going to happen?

Tam: I think Germany and France may have the ability to shore up their banks but have my doubts about banks elsewhere. For some countries though, like Italy and Spain, the scale of the banks' balance-sheet problem is so great that external help will still be needed even if the government nationalizes those banks. I don't know who will be the white knight for them.

China?

Tam: I don't think it will be China.

Shipman: If Andrew and Eddie are right about their prospects for Europe and European banks, and I hope they are not, this then presents a real opportunity for the alternative funds industry to provide much needed credit to businesses outside the regular banking system. Either because the latter can't or won't lend, or possibly because banks look to sell distressed opportunities from their balance sheets as they shore up their capital position, for example to comply with Basel III.

The questions that arise from this is whether hedge funds have the right people with the right skills to be able to carry this out – certainly the banks are losing talent in this area, in part driven by regulatory change as well as employee compensation restrictions. How do they structure themselves to be able to offer loan origination on a term basis, will investors buy in to such a structure, and how do they price the credit?

Would regulators allow hedge funds to participate in this?

Shipman: I don't think governments can afford to regulate something like this out of existence; economies will need it. In any event, with things like AIFMD and Dodd Frank, most fund managers will in fact be regulated – which of course is nothing new in Hong Kong.

Potentially there is an opportunity here for those alternative fund managers that want to seize it.

How do these events affect Asian hedge funds?

Joanne Murphy: From a fund-raising standpoint, I think the European allocators will stay focused closer to home. Sure they'll look opportunistically to grab any available alpha if they are nimble enough – but for many, they have more than enough to be currently active with closer to home. It's going to be a while before we see a large pool of that available money accelerate its flow towards Asia.

Also, finding alpha in Asia by existing Asia-based managers is going to get harder, as more arrivals have been setting up shop locally and we will most certainly see increasingly crowded trades.

Mark Shipman: But Asian hedge-fund managers are going to be looking to a greater extent to Asian wealth and moving away from European capital, which is either too hard to access or not there.

Will eurozone problems lead to European regulation of Asian funds?

Shipman: There is going to be pressure applied to Asian regulators to emulate European regulators, in order to avoid regulatory arbitrage, and to prevent funds considering relocating to Asia to take advantage of more relaxed regulation – even though Asia hasn't had a banking crisis.

There's a lot of competing tensions throughout this recent European issue, but the irony is that you simply must have healthy institutions out there lending money.



Eddie Tam, Central Asset Investments

Is Asia's relative strength an advantage for local investors?

Christophe Lee: I agree with Jo that European investor money may stay at home for now, as Asia is going to be impacted further if Europe deteriorates more. Over the long run global investors will still be attracted to Asia's growth prospects and I believe investors will return to the region.

A significant factor for the growth of Asian hedge funds is the further development of capital markets here. The key driver in Hong Kong is its status as the offshore RMB market.

To give you a sense of the rapid growth, RMB deposits in Hong Kong are close to RMB600 billion, which is almost a five-time increase from a year ago. Recent policy initiatives announced by China's vice premier, Li Keqiang, tells us this development will accelerate. Over time the RMB bond market in Hong Kong will offer hedge-fund managers a multitude of investment opportunities.

Adam Wallace: One of the approaches that we're taking revolves around discerning exactly where Asian growth



Mark Shipman, Clifford Chance



Christophe Lee, Alternative Investment Management Association

will be invested – will it be invested in Asia or outside Asia?

It's an interesting question, and within this context, we believe more US and European hedge funds will move to either Hong Kong or Singapore. There is a bias towards equity long/short in Asia, and we expect to see a greater level of diversity and sophistication, such as more CTAs and more distressed debt funds.

Murphy: I'd agree with that. There's been a broadening of investment strategies represented across the region over the last few years and this is certainly set to continue which can only be a positive as greater investment flexibility is sought and returns hunted.

What are your views on China? Solid growth story of the future, or fragile giant?

Tam: One reason that China has been so resilient is that it is isolated from the rest of the world. If they open up too fast, they might be drawn into the mess. The Chinese economy may be bigger now, but it still isn't big enough to save the rest of the world. It can still give marginal help where necessary. The country has grown 50% in three

years and has evolved into becoming a lot less dependent on trade with the West.

But has that translated into good investment returns?

Tam: Equity strategies have been very hard in the last five years. Even in Asia, equity investors have been short-changed. In China, the equity market performance has lagged GDP. I'm confident that in the next five years well-chosen credit will way outperform equities.

What explains this disconnect?

Tam: Thanks to cultural misunderstandings, foreign hedge fund managers come and go into Asia, and I am sorry to say so, but they really don't understand China being a stable socialist country. People speculate about whether companies will endure there, but it is a false question.

The state is there to support the banks, and the banks are there to support almost all major state-owned enterprises, and even a lot of major private enterprises. For example, some of the major SOEs in the property sector are trading at over 400 basis points credit spread, and some of the major private ones which remain highly profitable are trading at over 1,000 bps. As an investor I find

that attractive, and that's thanks to the cultural misunderstanding.

Ballingal: We continue to think that China's cyclical economic management issues are more difficult than the market realizes, the inflation problem will take longer to fix, require more tightening.

Chinese markets have been underperforming Asia for two years, so clearly something is up. It does look cheap, though we envisage that corporate profits and earnings are going to disappoint in the medium term. There's also a bad-debt problem and if it wasn't China you'd say there was a banking crisis, as 20% to 25% of GDP has been lent to local authorities that have no recurring income and those debts won't be good.

But China's moved beyond bad loans before.

Ballingal: There has been a lot of lending to entities that can't pay them back.

That makes it a strain to get too immediately optimistic about China. The country has been a disappointment for equity investors. The only way you could have made money in China would have been with brilliant stock selection...

What's wrong with that?

...which you could have had in any market buying a stock at ten cents, or by hopping from lily pad to lily pad in the national champion-policy company privatizations in the 1980s. Apart from that nobody has made much.

Let's switch gears. The Volcker Rule and plans to ringfence retail banking from investment bank trading. How is the hedge-fund marketplace accommodating bank spin outs, new launches and global fund migration from the US and Europe?

Lee: We've had some big hedge-fund launches on the back

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Christophe Lee, Aima



Andrew Ballingal, Ballingal Investment Advisors

of spinouts from banks. We are seeing much tougher banking regulations in the US and in Europe, and in general it has been a difficult trading environment for banks.

So there could be a further exodus of banking prop trading talent into the hedge fund industry and more interesting launches in Asia.

Alternatively, they could be absorbed into some of the billion dollar-plus multi-strategy funds in the region. I see that as being a continuing trend rather than a one-off in 2009-2010, and this is a positive development for the industry.

Shipman: Yes, spinout-related new launches are definitely happening. We're seeing something of a polarised industry growing up. I hear from a lot of smaller start ups, and many of those are going to struggle to be able to invest enough to comply with regulations and build infrastructure.

What about bigger launches?

Shipman: Then there are a handful of significantly-sized hedge fund launches spinning out from existing banks and getting seeded, either by that bank or elsewhere, and they will be mega-sized in an Asian context, meaning



Adam Wallace, J.P. Morgan Worldwide
Securities Services

\$500 million to \$700 million. Those are the guys that are taking compliance and regulation seriously – they want to understand what they need to do under US legislation in order to be able to access US investors, or what EU directives for fund managers will mean for them. They are likely to go from strength to strength – as long as they can perform.

How do investors perceive local opportunities?

Shipman: A number of investors we see want to put \$20 million to work, with that sum not accounting for a more than a quarter or a fifth of the fund. It is not worthwhile for them to go through all the due diligence procedures unless they can put a sum of that size to work.

A lot of the local managers that were treated as ATMs for investors after 2008, seem to be going along quite happily, however, increasingly they seem to be happier just running friends' and family money rather than deal with funds of funds' non-sticky investors. Admittedly a lot of the fund of funds folks were also facing redemption requests of their own.

Ballingal: Yes, but some fund-of-funds money is very friendly and sticky. So it's a bit unfair to stereotype funds of funds. Some of the worst-behaved money was pulled by unexpected sources and some of the best behaved stayed from investors who you might have thought might do otherwise. However, I agree that we want to run friendly money where the investor is aligned to what the manager is trying to achieve.

Will the biggest funds win all the money?

Ballingal: There was a flight to quantity after the crisis, with big swinging non-Asian investors thinking that something big means over a billion dollars. There's only about ten of those in Asia, and some are closed.

Murphy: For some investors, certain hedge funds haven't done the right thing by their clients. They've made investments, and indeed triggered redemptions, on the back of their own career requirements.

The cost a business has to absorb in order to raise capital has gone up enormously in the last couple of years too. I know of a manager who, to win a US\$50 million ticket, took him over two years to negotiate the deal. On the basis of the projected fees paid, compared to the costs and time spent winning the business, he'll have to run the money for seven years to break even.

How much money do local funds need to thrive?

Murphy: To ensure an effective business, the sweet spot for funds starts at around \$100 million, and if you can't get that under management from day one, then I would really recommend that one doesn't bother. There's increasingly no point if they can't assemble \$100 million together to launch. If this isn't possible, they might as well go home.

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Adam Wallace, J.P. Morgan Worldwide
Securities Services

Is start-up activity mainly among local boutiques?

Murphy: No, it's across the board. In fact there are some groups which are represented here – running the Asia book of a US or European shop for instance who are basing themselves in either Hong Kong and Singapore, and for some that left or down-sized during the last crisis, they're now coming back and for sure, that migration will continue.

Wallace: We have seen an increase in hedge funds offering managed account structures for institutional investors, and that isn't showing up on any of the databases.

Adam, what does the minimum infrastructure tick-box look like today?

Wallace: The kind of things that are important for us to see as a service provider include the governance structure put in place and the division between front and back office, the systems that are put in place and the counterparties plus service providers that are appointed. Also funds have to have a capital raising plan.

Murphy: It's a lot more than simply providing adequate TLC (transparency, liquidity and controls) to investors. Simply put, they demand much more and won't allocate without it.

Do all new hedge funds tick all of those boxes?

Wallace: Investors are increasingly committed to kicking the tyres. From our perspective, we have therefore seen fund managers place a greater emphasis in ensuring the engine is up to scratch and running smoothly.

Who's investing in Asian hedge funds now?

Lee: In Aima we've witnessed a lot of interest from hedge-fund managers, big and small, wanting to learn more in our seminars about best practice in business operations. We've recently published a report that clearly explains institutional investor preferences for fund infrastructure, and it touches on all the main operational issues.

Wallace: Presently global markets are extremely volatile, and investors, especially institutional, are increasingly cautious and risk averse. However as the saying goes nothing ventured, nothing gained – and institutional investors are continuing to increase capital allocations to hedge funds in the constant search for above-market returns.

The seismic shift from before the global financial crisis of 2007 / 2008 to now is that investors no longer use risk-adjusted returns or short successful track records as a dominant factor in choosing what funds to invest in. Christophe mentioned Aima's recent publication in relation to institutional investors' preferences around fund infrastructures, and our observations are similar.



Simon Osborne, AsianInvestor

Adam, what conclusions do you draw from all of this?

Wallace: Fund managers must build for success from day one, ensuring that the necessary high quality infrastructure and technology is in place as trying to manage positions on a home-grown spreadsheet no longer cuts it.

Institutional investors demand that funds have a strong governance structure in place, with appropriate risk controls, a division between front (trading) and back (operations) functions. Technology infrastructure is also critical, especially around order and risk management systems. Another area of increasing focus (especially post-Madoff) are the counterparties appointed by the fund; reputable legal and audit firms, administrators that offer more than just simple NAV production, and top-tier custodians and prime brokers.

Another area that is particularly crucial in Asia is the strategy of the fund: the equity long/short space is overcrowded, so managers need to deploy more varied and sophisticated strategies and be ready to evidence that these strategies are repeatable in varied market conditions. Lastly, we're seeing funds that are willing and able to provide some variety of managed accounts attracting ever increasing proportions of institutional investor capital, with customisation around transparency, fees and liquidity all proving important. ■

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As investors demand more transparency and regulatory requirements increase, hedge fund managers are faced with new challenges from staffing resources to reporting processes and technology.

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