Paradise postponed for Asian hedge fund industry

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Asia's economies have emerged much more speedily than those of Europe and North America from the global financial crisis and economic downturn, so one might expect the continent's hedge fund industry to have capitalised upon the rebound in investor confidence and in market performance over the past year.

However, Asian managers have yet to win back much of the international capital that fled at the height of the crisis, and this in turn has implications for the future development of the alternative investment management industry in a region that is expected to generate above-average growth in the years and decades to come. Nevertheless, industry members believe the return of international investors will not be too long delayed.

The continent has been a prime beneficiary of the increased interest in emerging markets among investors in alternative products as well as traditional financial assets over the past few years, exemplified by the presence of China and India among the much-feted 'BRIC' quartet of emerging economies that have garnered an outsized share of global investment flows.

Alongside the long-established financial hubs of Tokyo and Hong Kong, Singapore has emerged in recent years as an important centre for hedge fund managers, especially for up-and-coming entrants to the industry, thank in part to the open and flexible approach of the financial regulator, the Monetary Authority of Singapore.

The emergence of China as a regional and global economic juggernaut has also boosted the role of Hong Kong as the country's traditional internal gateway, although it has also prompted the development of a domestic hedge fund management sector based in Shanghai and to a lesser extent Beijing. And these trends are part of a broader dynamic that has seen a steady shift toward the management of money within the region rather than in the global hedge fund management clusters of London and the US East Coast.

But all the enthusiasm for Asia as an investment destination among global asset allocators and the development of local management talent did not spare the continent the effects of the global financial and economic turbulence – even though it was largely free of the debt-fuelled imbalances that affected Europe and the US, having learned painful lessons during the debt crisis that afflicted much of Asia in the late 1990s. And for a number of reasons the hedge fund industry has not recovered at the same speed as the broader regional economy.

According to Singapore-based consultancy and data provider Eurekahedge, its Asian Hedge Fund Index (which currently contains 377 constituents) slumped by 20.6 per cent in 2008, including monthly declines of 5.4 per cent in September and 6.5 per cent in October. That year brought to a juddering halt a run of outsized returns that reached double digits in each of the five years starting in 2003, and have averaged an annual 9.6 per cent since the index was launched at the beginning of 2000.

Eurekahedge says Asia's hedge fund industry peaked in size at the end of 2007 with USD176bn in assets and just under 1,200 funds (a nearly sixfold increase over seven years). A combination of performance-based losses and investor redemptions then saw assets dip to just USD105bn in April 2009 before recovering to UD117.4bn at year-end, helped by an average return last year of 26.8 per cent (and of 37.5 per cent if Japan-focused funds are excluded).

The firm's Greater China Hedge Fund Index gained 45.6 per cent in 2009, a figure comparable with the 50.4 per cent performance gain recorded by Hedge Fund Research's HFRX China Index. According to HFR, Asia-focused hedge funds now represent more than 15.1 per cent of all funds worldwide, although their significantly smaller average size means they account for just 4.8 per cent of the industry' global assets, and China is now home to nearly 24 per cent of all Asia-focused hedge funds.

Variations in the numbers reported by Eurekahedge and HFR reflect the firms' different measurement criteria, but they both chart substantial investor withdrawals, especially during the second half of 2008 and the first four months of last year, that were only partially offset by the industry's return to positive performance. The withdrawals also contributed to performance losses due to forced selling and liquidating positions, Eurekahedge noted in its latest assessment of the industry.

Last year's industry performance reflected at least in part Asia's advantages over other parts of the world, says Peter Douglas, founder and principal of Singapore-based hedge fund consultancy and advisory firm GFIA. "As with a lot of emerging markets, Asia bounced back, because the whole world had a P&L problem, but the developed world had a balance sheet problem too that Asia didn't," he says.

"Generally speaking, sovereign, corporate and personal balance sheets in Asia were fairly bullet-proof, except possibly for sovereign in Japan and retail in Korea, so while people lost money, very few were taken out. Then, as the developed world tackled its cash-flow problem, last year saw a period of virtually free capital, which was designed to fix a problem Asia didn't have."

Douglas says the Asian hedge fund industry was hit particularly hard by redemptions in part because of managers' ability to liquidate assets comparatively quickly, but also because of the attitudes of international investors. "As Asian managers tend to run fairly liquid strategies, fund investors were able to get their money back," he says. "In addition, the dominant investors in Asian hedge funds were based mostly outside Asia. When they're nervous, people pull back stuff that's furthest from home first."

That relatively few hedge fund firms in Asia closed down altogether, even though many managers closed marginal funds, Douglas attributes to the relatively low cost of doing business in the region's main centres for the industry. In fact, he says, the economic dislocation has prompted a significant number of individuals within the industry to strike out on their own, in the same way as they did in the wake of the Asian financial crisis more than a decade earlier.

But his expectations that international capital would start flowing back to Asian managers have so far remained largely unfulfilled, perhaps because investors remain nervous about the durability of the recovery. "At the end of last year, my bet would have been that the first quarter of this year would see a fairly substantial wave of global allocators putting money back into Asian hedge funds," Douglas says.

"Last year we saw a pipeline of substantial allocators coming through Asia last year, clearly looking at the opportunities ahead. We expected that to hit the ground at the beginning of the year, but it hasn't really happened. A very small number of the most popular funds have been attracting assets. Perhaps four or five got back to capacity and closed last year, but generally assets are increasing only very slowly. We see no wave of capital."

However, Douglas is confident that the return of international investors is delayed temporarily rather than shelved indefinitely. "I believe a consensus exists to get back into Asia," he says. "The mindset of many allocators has changed from 'Asia is an interesting warrant that we will play from time to time' to 'Asia is strategically important and we need to be there, the question is how'. That's a fairly substantial shift. But I suspect that the abrupt reversal of the markets in January spooked a few people who were on the verge of allocating."

One consequence of the continuing hesitation on the part of international investors has been to increase the weight of local investors for managers in the region. Says Douglas: "Local investment has become significantly more important relative to the industry's total assets under management. That's partly because in 2008 it was international capital that left, while the local capital was more sanguine and probably knew the managers better. They didn't run as quickly, and therefore became a larger proportion of total investment. In addition Asian investors' confidence has come back significantly anyway. In general they are out there buying assets, and some of that is coming into hedge funds."

Meredith Jones, managing director and head of global marketing with PerTrac Financial Solutions, which provides software solutions for hedge fund firms, other asset managers and institutional investors, says Asia was a growth area for the firm last year. "A lot of that has to do with growing interest on the part of Asian investors and more willingness by those investors to invest directly into hedge funds," she says.

Another factor, Jones argues, is that institutional investors and managers are equipping themselves with a wider range of tools. "Institutional investors are certainly taking more control and are focused on the tools they need to succeed in their manager selection and due diligence process," she says. "With China's economy booming and emerging markets remaining an area of interest for many institutions, including those in the US, that has been an important factor in our business growth."

HFR is convinced that Asia remains firmly in the sights of international investors. "Global investors are continuing to allocate to the Asian hedge fund industry as a way of accessing strong secular growth and diversification of investment strategies," says president Ken Heinz. "Recent developments in China, including the government's approval of stock index futures in the Chinese capital market, will allow investors more flexibility in accessing this growth and are likely to contribute to significant growth in the Asian hedge fund industry in the coming years."

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