Hedge funds in emerging markets

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The paper outlines hedge fund activities in Asia and Hong Kong based on data from the Securities and Futures Commission in Hong Kong and private research firms specialised in hedge funds.

In terms of growth, investment strategies, use of leverage and investor base, hedge funds in Hong Kong display characteristics similar to those of hedge funds investing in Asia's emerging markets. Various financial sectors' exposures to hedge funds remain small across the region and certain Asian markets are observed to be at the forefront of an international movement to enhance the oversight of hedge fund activities.

However, the paper has highlighted the need for regulators to be aware of the potential concerns on hedge fund activities including the systemic risk on financial stability, investor protection challenge and the risk of settlement failure. Finally, the paper proposes to enhance the effectiveness of regulating hedge fund activities in the region through continued vigilance on counterparty risk management, enhancement on collection of data, improvement on cross-border and cross-market sharing of information as well as regulatory cooperation.

This paper provides an overview of hedge fund activities in the emerging markets[1] within the Asia Pacific region and the potential implications for financial markets, followed by a brief review of the current regulatory approaches in these markets and issues in relation to the oversight of hedge funds. As data on hedge fund activities in the region are very sketchy, our analysis is predominantly based on Hong Kong figures[2] as well as data from private research firms specialised in hedge funds.

1| DEFINITIONS

Since its inception in 1949 by Alfred Winslow Jones, hedge funds have become a very heterogeneous group of funds which in some cases have some common characteristics but do not necessarily hedge.[3] The term "hedge funds" is not legally defined in many jurisdictions but generally understood to be any investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public. In this paper, funds that exhibit the following characteristics are regarded as hedge funds:[4]

• use of alternative investment strategies such as long/short exposures, leverage (including leverage embedded in financial instruments such as derivatives), use of derivatives for trading purpose, and/or arbitrage techniques;

• pursuit of absolute returns, rather than measuring investment performance relative to a benchmark;

• charging performance-based fees in addition to a management fee based solely on assets under management; and

• having investment mandates that give managers more flexibility to shift strategy.

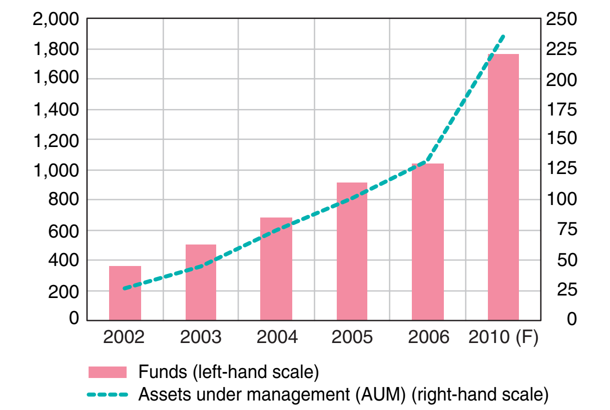
For the purpose of our discussion, the term "hedge fund managers" include those fund managers that manage hedge fund assets as well as those that advise hedge funds. The term "assets under management" (AUM) refers to the value of assets managed and/or advised by such hedge fund managers.

2| RECENT DEVELOPMENTS OF HEDGE FUND ACTIVITIES IN ASIA'S EMERGING MARKETS

The assets of Asia-focused hedge funds have grown more than six times from around USD 20 billion in 2002 to over USD 130 billion by the end of 2006.[5] Some industry analysts have projected that the total would reach USD 250 billion by 2010[6] (Chart 1). According to Eurekahedge, the number of hedge funds currently investing and/or located in Asia stood at 1040,[7] an increase of over 15 per cent compared to 2005. These funds managed some USD 132 billion worth of assets. Excluding funds with a Japan, Australia and New Zealand or global mandate, however, only 335 of these hedge funds have a mandate for investing in Asia's emerging markets. Together, these 335 funds managed about USD 50.8 billion worth of assets, approximately 4 per cent of the estimated USD 1.2 trillion[8] asset portfolios managed by hedge funds worldwide. The figure jumps to around 8 per cent if hedge funds with a mandate for investing in Japan, Australia and New Zealand are included but is still far below the 15 per cent global share enjoyed by Asia's capital markets. In other words, Asia Pacific hedge funds still make up a smaller proportion of the world's hedge fund market capital than the capitalisation of the regional markets might indicate. Most industry players expect this gap to narrow quickly and indeed a trend of continued growth of assets and number of funds investing in Asia has been observed.[9]

1 *For Asia, emerging markets refer to the markets in the region excluding Japan, Australia and New Zealand.*
2 *Figures for Hong Kong are based on the "Report of the survey on hedge funds managed by SFC licensed managers (for the period 31 March 2004–31 March 2006)", issued by the Securities and Futures Commission (SFC) in October 2006.*
3 *See Hui (Hong Kong Monetary Authority), Mori (Bank of Japan) and Persson (Sveriges Riksbank) (2007)*
4 *These characteristics of hedge funds are used in the SFC survey on hedge funds.*
5 *Baddepudi (R.)*
6 *Gray (2006a)*
7 *Based on Eurekahedge's data as at 22 February 2007.*
8 *Source: SFC's Report.*
9 *McCafferty (2006)*

Chart 1
Growth of hedge funds in Asia Pacific



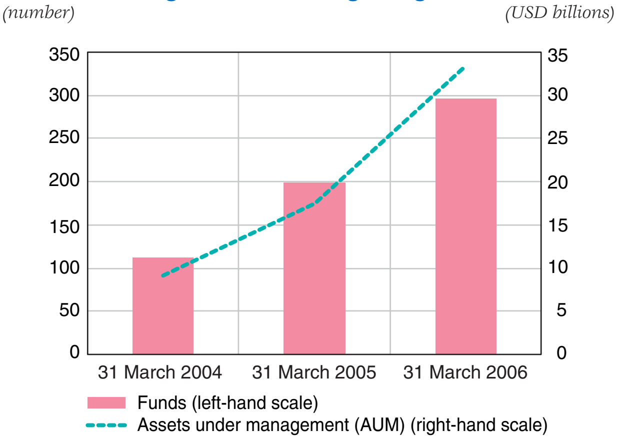
Source: Eurekahedge.

This impressive growth rate, observed by Simon Gray, has been assisted by a convergence of factors, notably the emergence of China as an economic power and the rebirth of Japan after a slump lasting more than 15 years, amid a general economic rebound across a region that now appears fully recovered from the financial crisis that afflicted many East and South East Asian countries in 1997.[10] In Hong Kong, the growth rate of hedge funds between 2004 and 2006 also resembles that of the Asia Pacific (Chart 2).

As shown in Charts 3 and 4, smaller hedge funds (i.e. with AUM of USD 100 million or less) make up a 60 per cent majority of the hedge fund industry in the emerging markets within Asia. One should expect this to change, however, as more and more large hedge funds in the overseas are attracted to the region. Take Hong Kong for instance, larger hedge fund managers made up 46 per cent of the market in 2006, up from 34 per cent in 2004. As reported by the SFC, the average AUM of hedge funds also increased by 40 per cent from USD 81 million to USD 113 million between 2004 and 2006.

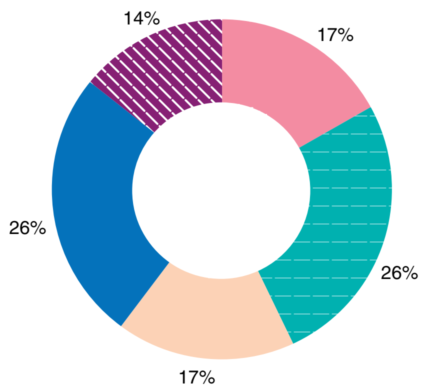
Long/short equities, employed by more than 60 per cent of the hedge funds (Chart 5), is still the most popular investment strategy in Asia's emerging markets. Such a high popularity of a relatively less sophisticated strategy might indicate that the hedge fund industry in Asia's emerging markets is still in the early development stage. This might also reflect the fact that equity trading predominates in the capital markets of Asia's emerging markets.

Chart 2
Growth of hedge funds in Hong Kong



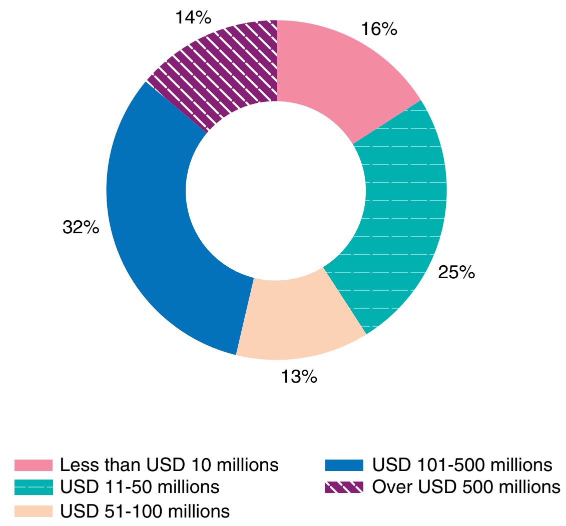
Source: SFC's report

Charts 3 and 4
Assets under management (AUM)
Per individual hedge fund in Asia Pacific



Source: Eurekahedge.

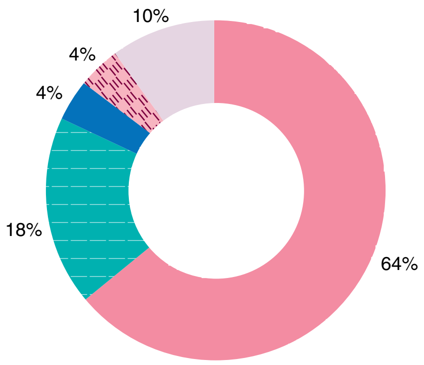
Per individual hedge fund manager in Hong Kong



Source: SFC's report.

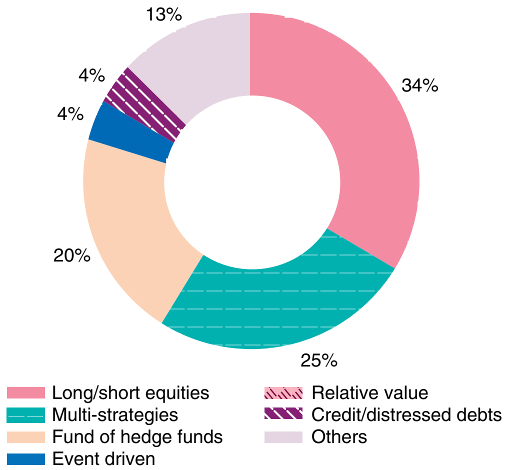
10 Gray (2006a)

Charts 5 and 6
Distribution of hedge funds by investment strategies
In Asia Pacific



Source: Eurekahedge.

In Hong Kong

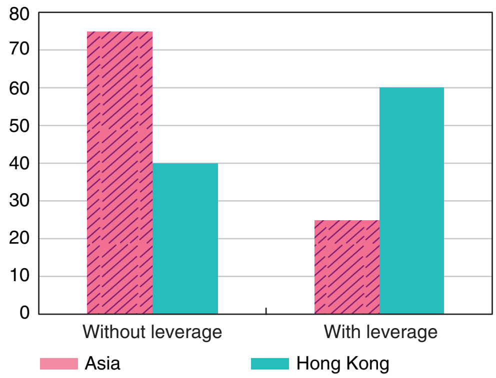


Source: SFC's report.

As shown in Chart 6, the picture in Hong Kong is similar but somewhat different. Only about one third (34 per cent) of the hedge funds in Hong Kong adopts equities long/short investment strategy which might imply the hedge fund industry in Hong Kong is relatively mature. There is a significant proportion (25 per cent) of hedge funds employing multi-strategies. Also worth noting is that about 20 per cent of the hedge funds in Hong Kong adopts fund of hedge funds investment strategy. This might reflect the growing interest of investors in these products as they are perceived to be less risky than single hedge funds due to more diversification of portfolio.

On the use of leverage, results from the SFC's survey indicated that 40 per cent of hedge funds (Chart 7) in Hong Kong do not use any leverage. While this is considerably lower than the average of Asia Pacific in which 75 per cent of hedge funds have no leverage, the level of leverage in Hong Kong is not excessive given that majority of those which used leverage had a leverage of less than 200 per cent of its net asset value.

Chart 7
Use of leverage by hedge funds
in Asia Pacific and Hong Kong
(%)



Sources: Eurekahedge and SFC's report.

Traditionally, the investor base for the hedge fund industry was confined to high net-worth individuals. In the past decade, institutional investors have increasingly dominated the investment flowing into the hedge funds in Asia's emerging markets. In Hong Kong, the SFC's report concluded that majority of investors investing in hedge funds were institutional investors. This, argued by Hui *et al* (2006), is due to a combination of reasons including search for higher yield at the benign interest rate environment, portfolio diversification benefits, improved asset-liability management and growing public acceptance of hedge funds by institutional investors as alternative investment options.[11]

Statistics on various financial sectors' exposures to hedge funds are not readily available. However, based on the limited information we gathered, the levels of various financial sectors' exposures to hedge funds remain small across the region. According to the Monetary Authority of Singapore (MAS), the exposures of Singaporean banks to hedge funds amounted to less than 1 per cent of total assets. In Hong Kong, according to an informal survey conducted by the HKMA in late 2006, the level of the banking sector's direct and indirect exposures to hedge funds was only 0.2 per cent of total assets.

11 *Hui* et al *(2006).*

3| Potential concerns on hedge fund activities in Asia

At the time of the Asian financial crisis, the main concern shared by many Asian regulators was for the highly leveraged positions incurred by macro hedge funds that could destabilise currencies in small and open emerging markets. This is the so-called "Elephant in the pond" issue. However, with the reduction in the number of macro hedge funds in recent years, their significance has largely reduced. Major credit providers and counterparties of hedge funds have generally improved counterparty risk management while hedge funds have downsized and become less leveraged. The collapse of Amaranth in September 2006, however, has again aroused concerns on the activities of hedge funds, particularly the systemic risk they pose to financial stability.

The concern on systemic risk is that a large number of hedge funds employing similar strategies in the markets would increase the volatility of financial markets through momentum trading. Recent episodes[12] seem to support this argument although Hui *et al* (2006) has pointed out that this concern should not be restricted to hedge funds or absolute return portfolios but are probably more an externality of relative portfolios, i.e. index portfolios and mutual funds, that track a benchmark index. However, it is clear that hedge funds, as frequent and aggressive traders in the emerging markets, are becoming the biggest clients[13] in generating brokerage business. Fierce competition for hedge funds' business could force some banks and securities firms to relax their risk management measures, allowing hedge funds to increase their leverage and exert an even bigger influence on the volatility and liquidity of the financial markets.

Another concern is that investors may not fully understand the risks involved in hedge funds as they are largely unregulated and there is a general lack of transparency of their investment strategies and portfolio composition.

It should also be noted that fantastic growth of derivative markets and hedge funds of the last few years has taken place in benign times. The resilience of the valuations, the diversification of portfolios, the depth of liquidity and firms' risk management have not been tested by a severe shock. Potential rationalisation of large number of small funds into a smaller number of large funds could also affect the short-term stability of the financial markets. Recent empirical studies on tail risk have also revealed that the perceived diversification benefits of hedge funds do not extend to periods of extreme market conditions and that the true market risk of hedge funds has been underestimated.[14] The regulators must be aware of these risks and strive to understand, assess and mitigate these risks.

The growth of hedge funds and over-the-counter (OTC) derivative trading also raises concerns on settlement. With confirmation of complex OTC derivatives being decentralised and non-standardised, backlogs of unconfirmed trades might be built up among market participants, especially in times of significant market volatility. Such backlogs of trades, coupled with market volatility, are likely to intensify the overall systemic risk of financial markets.

4| Regulatory approaches

It is important to note that the US, UK and other major regulators hold the view that direct regulation of hedge funds is inappropriate. The oversight of hedge fund activities has mainly taken the form of counterparty risk management.[15] In particular, regulated financial institutions have been reminded to aggregate their exposures to hedge fund counterparties on an institution-wide basis and demand sufficient margins for such positions. Regulators have also begun to monitor more closely financial institutions' exposures to hedge funds to ensure that sufficient capitals have been set aside against these risks.

12 *For instance, the sell-off in global equities in mid 2006.*
13 *As reported in Hedgeweek Special Report February 2006, hedge funds with offices in Singapore and Hong Kong generated 30 per cent of all reported commissions earned by brokers over the past 12 months on trades of Asian stocks.*
14 *Studies have shown that hedge fund returns tend not to follow a normal distribution but ones that are characterised by fat tails. This means that contagion between hedge funds and the market (traditional assets) cannot be adequately diversified, particularly in extreme market conditions. In other words, funds with low correlation with the market can still collapse when the market collapses. Please refer to Hui* et al *(2006) for more in-depth discussion on tail risk.*
15 *See for instance the Hong Kong Monetary Authority's Circular of 9 March 1999 on "Basle Committee on banking supervision's report on banks' interactions with Highly Leverage Institutions (HLIs) and sound practices for banks' interactions with HLIs".*

While efforts in the United States to subject hedge fund managers or advisers in the United States to registration have so far been unsuccessful,[16] some Asian markets such as Hong Kong and Singapore require hedge fund managers[17] to register with the relevant regulators, regardless of whether the funds they manage are authorized or not. This registration requirement subjects the hedge fund managers to the relevant codes and regulations. Hong Kong and Singapore are also among the first and the few jurisdictions to, for investor protection reasons, require all hedge funds offered to the public to be authorized. Some of the mandatory investor protection measures include reporting requirements on the funds' performance, leverage, risk measure (e.g. Value-at-Risk) and concentrated exposures as well as the qualification and experience requirements for the personnel in charge of managing the funds.

But the greatest challenge to the supervision of hedge funds is arguably the lack of data as hedge funds, being unregulated, are not obliged to disclose information to regulators. The problem is more acute in the OTC derivatives markets, where participants are not required to report their open positions to regulators. In the collateralised debt obligations market, where hedge funds are active traders, regulators have little information about the size of hedge fund positions and the level of leverage that the prime brokers are providing to support these positions.

Similar to their overseas counterparts,[18] some regulators in Asia, such as the SFC in Hong Kong and the MAS[19] in Singapore, are trying to fill the gap by collecting more information about hedge funds' activities from the prime brokers (i.e. banks and securities firms) to monitor their potential risk exposures to hedge fund counterparties. There are also attempts to improve the transparency of the OTC markets in which most hedge funds operate. With the growing share of hedge funds in the financial markets and their broadening investor base, more and more regulators within the Asia Pacific region and in overseas are reviewing whether hedge funds should be placed under a more well defined regulatory and disclosure framework.

It must however be noted that certain regulators within the emerging markets in Asia share the view of the Bank of England[20] that the growth of hedge funds is not the major source of vulnerability in the financial systems. In Singapore, for instance, some industry practitioners have observed that the Government is taking a number of initiatives to make the country more attractive as a hedge fund destination, perhaps in recognition that there is a place for hedge funds in the market, and that regulators should focus on systemic risk to the market rather than actual investments.[21] And it is hard not to recognise the benefits hedge funds could bring to the local financial systems. In Hong Kong, for instance, latest SFC's data showed that 30 to 40 per cent of the daily turnover on the stock market comes from hedge funds. In other words, over 30 per cent of market liquidity is provided by hedge funds. And this trend is expected to continue.

Indeed, the growth of hedge funds should not be viewed as necessarily bad for stability. From a systemic point of view, the growth of hedge funds and the derivative markets they feed off is part of a shift from bilateral negotiated banking finance to arms length finance through asset markets. In the long run, the active trading of hedge funds makes markets more liquid and facilitates genuine hedging activities. This should be good for the stability of financial market. Increasingly, hedge funds have become an important part of the risk transfer process, providing liquidity to evolving structured derivative markets. So hedge funds can be positive for market efficiency, particularly in the emerging markets.

16 *In 2004, the Securities and Exchange Commission made an effort to subject hedge fund managers or advisers to mandatory registration through an amendment of rules. But a federal court in June 2006 has overturned that 2004 amendment on technical grounds, and the ruling gives rise to a wave of withdrawal of registration by hedge fund managers.*

17 *In Hong Kong, all hedge fund managers are required to be licensed regardless of whether the related fund is privately or publicly offered. In Singapore, hedge funds offered only to institutional investors are not subject to any authorization or recognition requirements.*

18 *The Financial Services Authority in the United Kingdom, for instance. There have also been debates in the United States on whether the OTC futures market should also be subject to the regulation of the Commodity Futures Trading Commission.*

19 *In May 2005, the Monetary Authority of Singapore conducted a survey of the Singapore banking sector's exposure to hedge funds, covering all commercial and merchant banks in Singapore. In addition, a few financial institutions identified by the industry to have significant prime brokerage businesses were short-listed and surveyed on their prime brokerage activities in Singapore.*

20 *Speech by Sir John Gieve, Deputy Governor, Bank of England (2006)*

21 *Gray (S.) (2006b)*

Hedge funds are here to stay, with increasing influence and impact on the financial systems of the emerging markets in Asia. They have helped to increase market liquidity and enforce market efficiency but the systemic risks they pose to the stability of financial markets needs to be managed. There are different views regarding regulation of hedge funds, but a common agreement is that focus should be on the hedge funds' counterparties –particularly the systemically-important institutions– being able to manage their risks.[22] In other words, regulators should continue to be vigilant on counterparty credit risk management by regulated entities. To foster market discipline on hedge funds, regulators should, as suggested by The President's Working Group on financial markets[23] in the United States, clearly communicate to regulated entities their expectations regarding prudent management of counterparty credit exposures. To enhance the overall effectiveness of regulating hedge fund activities in the emerging markets, however, financial regulators in the region would also need to improve collection of data on hedge funds and their activities, increase cross-border and cross-market sharing of information with other regulators, and develop some form of regulatory cooperation to avoid regulatory arbitrage.

22 *Hui* et al *(2006).*
23 *The President's Working Group (PWG) on Financial Markets (2007).*

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