Hedge Fund Investing Comes to Asia - 2002

By: Scott A. J. MacDonald
Regional Managing Director of Van MacDonald Global Partners Pty Ltd
Email: scott@macassetconsulting.com
Tel: +612 9252 8829 – July 10, 2002.

With what is believed to be the world's largest dedicated hedge fund database, tracking over 4,000 funds, the Van Group have been monitoring hedge fund manager performance for 14.5 years. The Van database was originally used exclusively for the Group's private investments. But, since 1992 has been used by substantial USA and offshore institutional investors, and Fortune 500 families and individuals to identify superior hedge fund investments.

Now Van MacDonald Global Partners offer the same resources and services to Asian institutional and ultra-high net worth investors. The Group has offices in London and Sydney, as well as the USA, and agents in most major cities. An SEC Registered Investment Adviser, Van is quoted extensively on Nexis and Dow Jones Interactive media scans and produces the acclaimed monthly Van US and Offshore Hedge Fund Index.

Although some institutional and ultra-high net worth investors in Asia have known of hedge fund investments for some time, and have been known to invest in them since the mid 1990s, the practice has been limited.

Fund-of-hedge-funds promoters have sold their fund-of-fund products with a caché of exclusivity and secrecy, relying on the old adage "ask no questions and be told no lies".

In the main, investors were encouraged not to be inquisitive. The sales pitch often running along the lines of – "how many of you ask the pilot of the jet you are about to fly on where he did his flight training?" Naturally most of us rely on the airline to ensure their pilots are qualified, competent professionals.

Unfortunately with hedge fund managers they are not all trained at the same 'flight training school', likewise not in the same investment styles. In fact, successful hedge fund management is a focussed skill demanding significant investment expertise and it is this strength being actively sought by astute hedge fund investors. But such skills are often hard for the traditional institutional investor or asset consultant to consistently and accurately access.

Luckily, however for investors, a few specialist hedge fund researchers exist and have become quite good at monitoring, choosing and combining proven managers in specially tailored fund-of-hedge-funds portfolios. These consultants are now reaching out from their traditional, high net worth client bases into the global institutional market place.

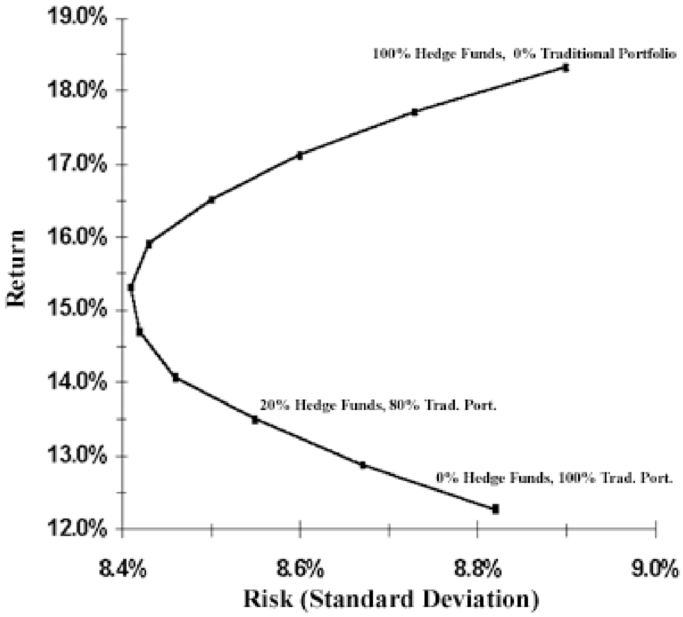
Until now, institutional investors have, quite correctly, found the task of researching, identifying, categorising and objectively analysing the performance of thousands of hedge fund managers a daunting task. So daunting, in fact, it has rendered institutional decision-making for this category virtually moribund. Issues of transparency, a lack of consistent due diligence, along with high fees, has caused hedge fund investing to be problematic with few traditional investor groups being able to confidently make informed hedge fund investment decisions.
So what has changed? The foremost is that information on hedge funds is now being more widely reported, in response to an intensifying demand for positive investment returns. This dissemination of knowledge about the multiplicity of investment styles employed by hedge fund managers is providing renewed confidence. When equity markets were running at 30-40% p.a., funds-of-hedge-funds offering 20% p.a., albeit with lower risk, were sometimes 'laughed at' by some investors.

Now, in the face of almost three years of negative equity returns, those same investors are aggressively reviewing their risk strategies and asset allocations.

Second the fundamental investment style of Asian investors is changing. Asian investors are rapidly moving from the European investment model, of overweight bonds, to a more USA-influenced, universal approach of investment and portfolio construction.

'Universal asset allocation' favours a greater exposure to offshore investments and a greater overall exposure to equities and alternative investments. These are predominately private equity investments and hedge funds, although futures funds, CTAs (Commodity Trading Advisors) and the like also comprise this definition. This shift in investment thinking recognises that capital is global and that global capital markets dominate any single domestic market. Investors adopting the universal asset allocation approach are achieving greater diversification and superior returns.

The efficient frontier below demonstrates the use of hedge fund allocation when combined to a traditional portfolio of 60% Equities and 40% Bonds and the effect on and risk and return that results.



Third, Singapore and Hong Kong, and their regulators have recognised that hedge funds are a legitimate investment sector. By providing new, enabling regulations for hedge funds, they are tacitly endorsing the growth of the category. These regulations provide the mechanism for investors to enter hedge funds via domestically compliant, feeder fund structures. Other Asian nations are also broadening their investment horizons, relaxing restrictions that have inhibited pension funds and statutory funds from accessing hedge funds and other offshore investments. Certainly these changes are being welcomed in Japan by pension fund beneficiaries and insurance companies alike.

The Singapore Exchange is a leader in the region in terms of derivatives and equity execution, compliance and administration. Their excellent platform is enabling hedge fund managers to base their operations in Singapore with the knowledge that they are able to trade from a global communications platform specifically tailored to the requirements of local investors. The Singapore derivatives exchange has introduced products consistent with the requirements of hedge fund traders and institutional investors with the latest addition being MSCI Japan Index Futures Contract.

US and Offshore Hedge Fund Net Returns[1]
January 1, 1988 - December 31, 2001

Style/Strategy	Net Compound Annual Return	Van Ratio	Sharpe Ratio	Standard Deviation
VAN US Hedge Fund Index	18.3%	2.0%	1.4	8.9%
VAN OS Hedge Fund Index	15.4%	4.9%	1.1	9.3%
MSCI World Equity	6.9%	32.7%	0.2	15.4%
S&P 500	14.4%	15.6%	0.7	14.2%
Morningstar Average Equity Mutual Fund	10.9%	23.5%	0.5	15.1%
Lehman Brothers Aggregate Bond Index	8.5%	2.9%	0.8	4.5%

[1] Please see Explanatory Notes under Legal Considerations section.

These changes along with the continued emergence of consulting firms like Van MacDonald are helping to drive these recent shifts in attitudes towards hedge funds. The Van group has been tracking the hedge fund industry worldwide for 14.5 years and their wealth of high quality in-depth data, is being welcomed by investment professionals in Asia. Van's detailed and statistically valid hedge fund reviews are leading traditional investment professionals and their clients to surprising conclusions. Table A begins to show the facts regarding hedge fund investing.

Over the past 13+ years hedge funds on the whole have out-performed Bonds; average USA Equity Mutual Funds; the S&P 500 index; the MSCI World Equity index and most other benchmarks. And the industry in aggregate has achieved this out-performance with much less 'traditionally measured' risk. For investors in a world where equity returns look like being negative for years to come hedge funds may well be part of their investment solution going forward.

Certainly in Asia, institutional portfolio managers, from government to the private sector, agree on one thing - returns from traditional investment management do not look encouraging for the medium term. Stakeholders and beneficiaries that rely on income are becoming nervous and the solution may need to be an aggressive re-weighting into offshore hedge funds that offer consistent positive returns at lower levels of 'traditionally measured' risk.

This then poses the question … "How should investors engage in this, difficult to research and master sector, collectively known as hedge funds?"

The problem is … 'who's who in the zoo'? How does one go about assessing funds-of-hedge-funds promoters and managers? Are funds-of-hedge-funds the correct mechanism and who can objectively assist institutional investors in the selection and deployment of financial resources to this sector? Are funds-of-hedge-funds really the best solution? It is a known fact that traditional equity asset managers find it very hard to beat the stock indices they track using active management? Should this not therefore also be true in hedge fund investing?

Groups like S&P, Morgan Stanley and Zurich Capital Markets, along with many others are seriously considering these questions. Problems most face are that they do not have the reliable, long standing hedge fund data, due diligence expertise, or manager selection and investment experience necessary to create statistically robust investable indices.
Some would argue that the best way for an institution to enter the hedge fund arena would be to buy the global index of hedge funds. This reduces direct fees and the subjective manager, and market timing, slippage that occurs with many fund-of-hedge-funds managers.

If an investor is still nervous about a hedge fund – they should ask their 'friendly global bank', or hedge fund consultant, to provide a capital guaranteed note for the portfolio.
Such options ensuring exposure to the whole alpha contribution of the hedge fund market with down side protection. A five/eight year lock-up with certainty of capital return, and a high probability of out-performing world equity and bond markets, sounds like a career-enhancing strategy for any investment advisor or fund manager!

So who to turn to in Asia in such a time of need? Certainly hedge funds specialists such as Van MacDonald Global Partners would be able to provide more information. With hedge funds advisory skills, investors can obtain assistance in manager searches, portfolio construction and other services. Asian investors, when exploring alternative instruments, therefore need not be subjected to product pushing only and this is great news.