EVOLUTION AND TRENDS IN ASIA’S HEDGE FUND INDUSTRY

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ASIAN HEDGE FUNDS

Classic hedge fund structure:

- Open-ended company
- Domiciled in the Cayman Islands, Luxembourg, Dublin, BVI and similar jurisdictions
- Corporate governance compliance – independent directors, independent fund administrators, independent auditors, etc.
- Monthly or quarterly dealing
- Heavy equity orientation
- Directional
ASIAN INDUSTRY CHARACTERISTICS

• Low barrier to entry
• About 1,000 funds, managing $138 billion; peaking at $200 billion
• 40% have only $25 million under management
• Mainly in Hong Kong & Singapore (Japan has collapsed)
• China has huge hedge fund industry
• Increasing regulation
• Growth of homegrown talent
Historical timeline of the Asian hedge fund industry

Pre-history
- Developing capital markets, few investment mavericks

Beginning
- 1990s: Dominated by long-only absolute return funds

Growth
- Critical mass: Recovery of capital market and assets, entry of global allocators followed by inflows

Contraction
- Liquidity crisis: Widespread redemptions, Madoff, numerous fund closures and exit of global hedge funds

Consolidation
- Transformation: Overall stagnant picture masks structural change

Adjustment
- The “New Norm”: Lethargic fund raising, uncertain markets, investor preference for size over performance/transparency

-----|-----------|-------|-----------|-----------|-------

SOURCE: GFIA
THE GLOBAL FINANCIAL CRISIS

2000 hedge funds liquidated (25%), industry benchmarks lost 20%
Industry AUM down $1.2 trillion (42%), massive risk & leverage reduction
Huge loss of investor confidence and lots of litigation

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Worst Month</th>
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<tbody>
<tr>
<td>Equity Market Neutral</td>
<td>-40%</td>
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<tr>
<td>Emerging Markets</td>
<td>-23%</td>
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<tr>
<td>S&amp;P 500</td>
<td>-20%</td>
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<tr>
<td>MSCI World</td>
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<td>Fixed Income Arbitrage</td>
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<td>Convertible Arbitrage</td>
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<td>Distressed</td>
<td>-12%</td>
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<td>Event Driven</td>
<td>-12%</td>
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<td>Global Macro</td>
<td>-12%</td>
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<td>Multi-Strategy</td>
<td>-12%</td>
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<tr>
<td>Long/Short Equity</td>
<td>-11%</td>
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<tr>
<td>Dedicated Short Bias</td>
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<td>Managed Futures</td>
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<td>Broad HF Index</td>
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<td>Multi-Strategy</td>
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<tr>
<td>Risk Arbitrage</td>
<td>-6%</td>
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</tbody>
</table>
THE GLOBAL FINANCIAL CRISIS

Drawdown Analysis - Hedge Funds vs Equities

Peak
-20%

Trough
-53%

End of the Year Drawdown
-5%
-27%

Hedge Funds: Credit Suisse / Tremont Hedge Fund Index
Equities: MSCI World Index
GLOBAL HEDGE FUND – GROWTH OF ASSETS/NET ASSET FLOW

SOURCE: HFR Q4 2012 REPORT
GLOBAL FOHF – GROWTH OF ASSETS/NET ASSET FLOW

SOURCE: HFR Q4 2012 REPORT
GLOBAL # OF FUNDS: HEDGE FUNDS VS. FUND OF FUNDS

SOURCE: HFR Q4 2012 REPORT
GLOBAL HF LAUNCHES/LIQUIDATIONS

SOURCE: HFR Q4 2012 REPORT
By # of funds

- < $10 million: 57.33%
- $10 to $25 million: 7.83%
- $25 to $50 million: 7.16%
- $50 to $100 million: 7.03%
- $100 to $200 million: 5.72%
- $200 to $500 million: 6.2%
- $500 to $1 billion: 3.24%
- >$1 billion: 5.48%

By fund AUM size

- < $10 million: 0.15%
- $10 to $25 million: 0.45%
- $25 to $50 million: 0.92%
- $50 to $100 million: 1.76%
- $100 to $200 million: 2.84%
- $200 to $500 million: 6.86%
- $500 to $1 billion: 7.95%
- >$1 billion: 79.07%

SOURCE: HFR Q4 2012 REPORT
GLOBAL HF COMMUNITY – 4Q 2012

Geographic location of funds

- Americas: 43.38%
- Asia: 14.35%
- Europe: 10.85%
- Other: 26.42%

Geographic location of assets (AUM)

- Americas: 39.76%
- Europe: 7.19%
- Asia: 3.92%
- Other: 49.14%

Source: HFR Q4 2012 Report
ASIA PACIFIC HEDGE FUNDS – 3Q 2012

**Strategy Mix**

- Long Short Equities: 51%
- Multi-Strategy: 11%
- Fixed Income: 7%
- Long only: 12%
- Relative Value: 2%
- CTA/Commodities: 1%
- Currency: 1%
- Distressed: 2%
- Event Driven/Special Situations: 3%
- Others: 2%
- Managed Futures: 2%
- Macro: 4%
- Market Neutral: 2%

**New Launches**

- Long Short equities: 72%
- Long only: 12%
- Multi-Strategy: 6%
- Fixed income: 5%
- Macro: 11%
- Market neutral: 6%

**Closures**

- Long Short Equities: 59%
- Event Driven/Special Situations: 4%
- Fixed Income: 4%
- Long only: 4%
- Macro: 8%
- Multi-Strategy: 13%
- Others: 4%
- Relative Value: 4%

**SOURCE:** GFIA
HFRI HEDGE FUND – WEIGHTED COMPOSITE INDEX
(QUARTERLY PERFORMANCE 1998 – 4Q 2012)

SOURCE: HFR Q4 2012 REPORT
HFRI FUND OF HEDGE FUND INDEX
(QUARTERLY PERFORMANCE 1998-Q4 2012)

SOURCE: HFR Q4 2012 REPORT
ASIA PACIFIC HEDGE FUNDS PERFORMANCE

Pre financial crisis performance

Post financial crisis performance

SOURCE: GFIA
COMMON MISCONCEPTIONS

- Deep local investor base
- Easy foreign funding sources
- High returns
- Low-cost operations
- No strategy
ISSUES FACING ASIA’S HEDGE FUND INDUSTRY

- Scalability
- Profitability
- Long-only Small Cap
CONSEQUENCES OF INSTITUTIONALIZATION

• Smaller number of larger tickets
• More single global portfolios, less regional and thematic portfolios
• Pension have very little appetite for high beta in their hedge fund portfolios
• Higher expectations for transparency and governance
• Higher expectations for infrastructure
• Fee pressure for larger tickets and longer lockups
• “Small” is $1-3 billion, which traditionally large for Asian managers

“Higher barrier to entry”
ASIA IN A GLOBAL PORTFOLIO

• Is Asian long short a differentiated alpha source?
  - With a few managers yes, but industry wide unproven
  - China – good; India – poor
  - Very correlated with global liquidity flows
  - Japan scores surprising well here

• Does Asia have more mispriced opportunities?
  - Yes, BUT
    o The ability to hedge is more limited
    o The stress in a liquidity shock is higher

• What does Asia offer that is unique?
  - Credit cycle – great opportunities in the illiquid space
  - Currencies and interest rates – differentiated macro opportunities
ASIAN MANAGER FUND FLOWS

• The big get bigger and smaller managers are overlooked. The industry has barely grown but the large managers are getting an increasing share.

• Lack of interest in high net (>50%) hedge fund managers. The market now prefers either a lower net (<50%) hedge fund or a boutique long-only manager.

• Smaller managers struggle to get institutional money and are subject to very fickle flows from financial intermediaries and smaller family offices.

• Even a large Asian manager can reach capacity very quickly as in a global context their capacity is a relatively small number.
HOW HAVE DUE DILIGENCE REQUIREMENTS CHANGED SINCE 2008?

• Increased scrutiny
• Increased fiduciary responsibility
• Increased time and resource requirements
• Increased regulatory burden
• Increased potential liability
• Increased accountability
• Increased cost

LEADING TO…
# DUE DILIGENCE REQUIREMENTS WHEN INVESTING IN HEDGE FUNDS

## Operational Due Diligence

- Compliance manual (including KYC checks, money laundering procedures, trade errors, soft commission policies etc.)
- Prime brokerage agreement
- Fund administrator agreement
- Investment management agreement
- Business continuity documentation
- Projected budget for the next 5 years
- Trading and portfolio management system verification
- Authorization, execution, confirmation, settlement, reconciliation and accounting policies. (need for adequate segregation of duties)
- Detailed valuation policies or a pricing matrix (maintaining transparency, consistency and oversight)
- Counterparty risk
- Key person risk and insurance

## Investment and Risk Due Diligence

- DDQ
- Prospectus
- Fund presentation
- Risk limits
- Kroll reports and character references
- Analysis of market and product liquidity, volatility and credit risks
- Modelling performance can be difficult: downside deviation, correlation, variance, volatility, VAR, Sortino and Sharpe ratios
- Back testing
- Scenario analysis
- Consistent approach to portfolio management
- Definition and measurement of risk to the portfolio
- Investment in non-listed instruments
- Best execution
- Conflicts of interest
- Stock borrowing
- Personal account dealing
- Investment decision-making process

## Risk Without Return

## Risk With Return
DUE DILIGENCE

On average, how long is your due diligence process?

How has this changed in the last 12-24 months?

“Two thirds of investors take between 3 and 6 months to complete due diligence on a manager whereas only a third did so in 2002.”

Need to regularly redo DD

SOURCE: 2012 DEUTSCHE BANK ALTERNATIVE INVESTMENT SURVEY
WHAT’S NEXT

• Launches will be bigger and will have a “fully-loaded” infrastructure as comparisons to a higher global standard will continue.

• Appointment of independent valuation agents for hard-to-value instruments will continue.

• Fees will maintain levels of a 1.5-2% management and 20% performance fee, except for:
  - Long-bias funds where beta delivery will not enjoy such riches (unless stellar alpha!)
  - Strategies requiring longer-term capital commitments

• Allocations to Asian funds likely – many investors continue to be underweight in the industry and the region.

• The fund of hedge funds industry needs to continue its recovery and differentiation.

• New capital will continue to remain tight and long lead times will continue.

• Asia-based investors will increase in importance – pension and sovereign wealth funds continue to emerge, cash rich and have undeployed capital to allocate
CHALLENGES AHEAD

• Darwinian culling of the industry continues
• Still a poorly capitalized industry
• Selling the dream
• Flows coming from institutions
• Rise of private investment clubs, institutional platforms
• Collision of two worlds
• Short selling in retail products will come
• Hedge funds to become alternatives again
CAREERS

• Different types of jobs in the hedge fund industry

• Skill sets required

• Where are the opportunities?

• How can candidates prepare themselves for a job in the hedge fund industry?

• CAIA vs. CFA