

Trends in Hedge Funds in Asia

One thing that has become clear over the course of the last year is that capital movement is truly global. There is little doubt that the adverse economic situation unfolding principally in the developed west has impacted severely on the level of investment into hedge funds and also asset classes sought out by investors as they wait out this period of uncertainty. Markets are interrelated like never before. As the vast majority of hedge funds are offshore funds we off-shore lawyers tend to see the trends and issues affecting hedge funds unfold. This is what we see in Asia and more globally.

Counterparty Risk

Hedge funds have long confronted counterparty risk with a mixture of dread and indifference. Historically very little verification of a large prime broker's balance sheet or financial situation has been done prior to going into business with them. The past few months of collapses and near collapses of brokers throughout the financial world have changed attitudes and industry practices significantly. Hedge fund managers have a duty to be diligent and have a duty of care over the assets of their investors' funds. The only viable option in the shifting dynamics of the credit crunch appears to be that advocated since the inception of hedge funds and that is to encourage multiple broker relationships. In theory this should give hedge funds the opportunity to react to counterparty risk and to spread assets, but in practice it is less clear that it provides much of a solution. Notably, it is unlikely that a manager would be aware of an imminent failure. It can also be argued that splitting up broker relationships means that the full picture regarding exposure, collateral and positions held by various brokers with a single hedge fund counterparty becomes opaque and this increases market risk. Multiple broker relationships are also often only entered into once the hedge fund has sufficient scale to justify the relationships.

Nonetheless it is a topic much spoken about and every manager must be aware that investors will require detailed information about the prime brokers and what steps have been taken to minimise counterparty risk.

The Return of Absolute Return

After several long years of boom time and accelerating upward slanting charts the term hedge fund began to take on a different meaning entirely. No longer were managers expected to hedge all of their positions and indeed a long bias was almost essential just to keep pace with skyrocketing equity markets. Looking back it is evident that hedge fund managers must all consider ruefully how the events of November through January 2008 exposed that unfortunate shift in the industry which has to an extent damaged the brand. China's indices have fallen off

some 45%, the HSI is down 25% and markets around Asia have generally suffered double digit declines. Hedge fund losses were severe and a shake out has ensued bringing the true meaning of the term 'hedge fund' bumping back to earth. Benchmarking is popular for some market segments (particularly pension funds and the like) but for the absolute return adherents it is a word they tend to look down on. Absolute return strategies by their very nature do not adhere to any benchmarking and while investors may suffer some volatility in the short term the strategy tends to attract those that like to see positive returns irrespective of market conditions.

The current economic climate has rekindled amongst investors a desire to invest in absolute return strategies, which aim to post a positive monthly performance, a return above LIBOR or perhaps volatility that is lower than equities, for example, rather than beat a benchmark such as the HSI, for example, over the defined period.

Compression of the Market

Hedge Fund Research reports that since the onset of the credit turmoil in the US\$2.65 trillion industry, the number of hedge funds winding down operations has jumped. Figures suggest that closures are up about 20% in the first quarter of 2008 alone and start ups are at their lowest levels since 2000. The numbers point to a reality in the market and that is that there is compression in the market as nervous investors turn away from risk and seek perceived shelter with larger, more established operations. A cynical view might be, as the saying goes, "no-one ever got fired for buying IBM". But in fairness, in times like these, investors will express a preference for funds with strong and established tracks records and significant infrastructure.

Along with facing the economic whirlwind, investor confidence in hedge funds is at an all time low and many hedge funds face closure. With new money flowing into hedge funds declining it is the smaller funds that are suffering most, even the high fliers. Sign of compression in the hedge funds space is clearly evidenced by the decline in overall numbers of funds launched globally in 2007, which is down by nearly 50% on the 2005 peak. Expectation is that the consolidation may be at or close to an end but it is sobering to note that the largest 100 hedge funds accounted for three-quarters of total industry assets in 2007, up from 54% in 2003. The largest 3% of hedge funds accounted for four-fifths of total industry assets in 2007. These numbers speak volumes about what has been taking place in the hedge fund market.

While opinions vary it appears clear that hedge funds in Asia are pretty much as afflicted as those in New York or London. New money is hard to come by and cash (or

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private equity!) is a popular choice. Growth in emerging markets such as Asia has been rather more muted than one might expect and in gross terms assets under management have increased only marginally from 5 to 7% over a five year period. Although activity seems at times frenetic in Asia, Hong Kong, long regarded as the most viable and largest of the asset management bases in the region, has not managed to keep pace with or catch up with the traditional centres such as London and New York, who together claim about 60% of global assets under management.

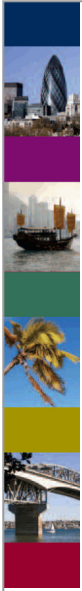
Considering the health of the industry and the speed with which it has ballooned, one might feel that a little consolidation and introspection might be a good thing, and indeed this may be correct.

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