

# Investing in Asia

A hedge fund perspective

March 2020

Institutional hedge fund portfolios that allocate to Asia-focused hedge fund strategies — most of which are physically located in Asia — typically allocate less than 10%. With the market broadening and deepening, the opportunity set has expanded, strengthening the foundations for Asia-focused strategies to enhance risk diversification and thereby the risk-adjusted return potential of hedge fund portfolios.

Historically, the range of scalable Asia-focused hedge fund strategies has been limited by the maturity of the underlying markets and local regulations. Thus, Asian multi-strategy products, which invest across multiple areas, have been the principal beneficiaries of inflowing capital to the region.

Today, however, the opportunity set has expanded, especially in the areas of equity long/short and Asian macro, where some aspects of the market, such as high retail investor activity, can still generate high levels of alpha. As the unconstrained pursuit of alpha through specialized approaches expands across the region, we believe this may present an opportunity for investors.

**Figure 1. Growth of \$100 for selected indices**



Source: Bloomberg, December 31, 1999, to December 31, 2019; returns in US dollars.

At the center of these developments is China. And for any new investor in the region, the first challenge is understanding the complexities around the largest market: Chinese equities. The launch

of Stock Connect — a two-way channel between Hong Kong and both mainland bourses — in Shanghai in 2014 and Shenzhen in 2016 has been a critical development. Indeed, these exchanges have emerged as significant and liquid financial trading hubs in their own right, with a combined market capitalization of more than US\$8 trillion and more than 3,600 constituents.

Until recently, access to the investment opportunity in China was restricted mainly to offshore markets Hong Kong and Taiwan, with the former providing the cleanest avenue to true long/short investing. The short side presents challenges, such as elevated borrowing costs (versus other jurisdictions) and variable liquidity and recall risk. However, the playing field for long and short alpha generation is attractive, particularly in Hong Kong.

The US has emerged as another offshore market in the last decade, with approximately 300 Chinese companies listed, either as American Depositary Receipts (ADRs) or directly as listed shares. This market has proved particularly fruitful for fundamental investors, as share prices can be exposed to large swings in US investor sentiment around China (resulting from top-down macro trading and retail flows). With fewer restrictions on the short side, there is scope to execute on this informational arbitrage and deliver strong alpha.

Away from the traditional single stock long/short space, one can find old-school share-class arbitrage trades. These form around Chinese companies that have dual listings in mainland China and Hong Kong exchanges. Although Stock Connect has reduced these inefficiencies, they continue to present themselves on occasion. This is partly due to the heavy presence of momentum-style retail investors in mainland Chinese markets, where volumes are already incredibly high compared to global equivalents.

Chinese mainland markets are large by almost any metric, but until now, the alpha opportunity has been limited to long-only, benchmark-relative investors. However, the scope for generating alpha through active shorting is high. Although we are in the early stages of this market development, prime brokers have been building books of A-share inventory for short-selling purposes for years. The current cost and availability of stocks for shorting, along with heightened volatility of the A-share market, may still present portfolio management challenges for investors.

Beyond equities, China's convertible bond market has grown significantly, with current total issuance outstanding of more than US\$60 billion. Unlike other equivalents, however, as the share

price declines, the conversion price can be reset lower.<sup>1</sup> China has also become increasingly attractive to FX and rates investors, aided by the opening of the country's bond markets and expansion of related derivative instruments for hedging purposes. The more extensive product suite lets macro-oriented managers apply directional and relative value strategies in markets with heightened volatility and inefficiencies.

The opening and extensive maturation of the Chinese economy presents opportunities for hedge fund investors. However, we feel that a broader Asian hedge fund allocation offers more, aided by a heterogeneous set of markets and economies that displays a mixture of economic growth levels, abundance of regulatory changes and evolving market structures.

One country that offers such opportunities is Japan. Following the election of Shinzo Abe, Japan has witnessed an upheaval in the corporate governance landscape via a slew of government-driven actions. These include an amendment of the Companies Act, forcing a change in the requirement for independent outside directors, which has been a fillip for activist managers in Japan. Furthermore, the increasing presence and acceptance of private equity firms suggests another tailwind for event-driven activity in the near to medium term as buyout battles intensify and liquidity events increase. The clearest example is the breakup of large conglomerates that helped make 2019 a record year for domestic M&A in Japan.

Emerging markets across Asia offer investors access to high-growth opportunities in countries such as India, Vietnam, Indonesia and the Philippines. The breadth of securities is relatively small, whereas liquidity, FX risk and a lack of hedging options are ongoing considerations for any investor seeking direct access. However, Pan-Asian equity strategies with wide mandates can take advantage of the pricing inefficiencies that emerge due to foreign flows into these markets.

Within India, recent regulatory developments are promising if not yet tested across a full market cycle. The country's newly legislated Insolvency and Bankruptcy Code is seen as a positive step, providing an essential pillar for current and future distressed credit and equity restructuring opportunities, notwithstanding the limited onshore restructuring skills and dedicated capital currently available. On the equity side, shorting has improved markedly, although managers must continue to implement through single stock equity futures.

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<sup>1</sup> Many Chinese convertible bond issues have a reset mechanism whereby the issuer resets the conversion price down if the share price falls. This effectively resets the equity optionality lower and keeps the bond's conversion value close to par.

Many of today's prominent firms hold relatively short histories compared to US and European peers, which, in itself, supports a diverse collection of investment approaches. But it can be a barrier for some investors. We have also found a wide array of offerings in terms of liquidity, fees, return and volatility profiles as well as traditional versus niche strategies.

The industry is institutionalizing, which is most visible in terms of business management and expands to other considerations, such as ownership structures, compensation and retention plans. The guidance of overseas investors is partly responsible; our perception from manager meetings is that the majority of inflows are coming from outside Asia. With a challenging outlook for traditional asset classes, we may see interest from international investors continue to grow.

Hong Kong and Singapore have proved to be the most attractive jurisdictions for operating hedge funds, although Japan and Australia are small yet active markets with mature regulatory environments. These changes have laid the foundation for global and regional banks to consider Asia-Pacific as a primary source of growth, with capital introduction and prime brokerage services proving highly competitive.

This base of operational support has prompted an increase in the quality and quantity of hedge fund COOs. Reflecting the industry's short life in the region, experienced operations staff have been difficult to source. At the same time, the difference in operating environments, cultures and language has made transferring from the US or Europe a daunting task. There has been a noticeable improvement here, with high-caliber COOs joining several new, high-profile hedge fund launches. However, due diligence is still crucial, as smaller managers typically struggle to compete for this talent, held back by limits around compensation and resource support.

Chinese financial market reforms add to the already-attractive playing field for unconstrained hedge fund managers in Asia. The opportunity set benefits experienced, on-the-ground specialists, since progress across the spectrum of jurisdictions is not always linear, predictable or in step. As these markets evolve and expand, the opportunity to capitalize on inefficiencies appears ripe relative to the rest of the world and well-suited to active management.

After several years of market development, hedge funds can now access a toolkit to support genuine, uncorrelated alpha generation. Furthermore, the talent pool of experienced investors now also includes large numbers of younger professionals that typically have a combination of local cultural awareness, language skills and Western investment experience. Teams have become more diverse

and well-rounded in terms of talent. As a result, the foundations appear strong for Asia-focused strategies to enhance the risk-adjusted return potential of hedge fund portfolios.

Shifting rules and regulations, along with diverse languages, cultures and business practices, enable the opportunity but may also challenge global allocators. We believe locally sourced, best-in-class managers can navigate these markets, bringing natural diversification to a typical hedge fund portfolio, and can do so with levels of alpha that are difficult to achieve in more mature Western markets.

## About the author



### **Adrian Worth**

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Adrian leads the Asia hedge fund research effort from Mercer's Hong Kong office. He joined Mercer in April 2017. Prior to joining Mercer, Adrian accumulated close to 9 years' experience in the hedge fund industry while based in London. This included nearly 4 years at Man Group where he worked as a senior investment analyst in the firm's performance reporting team. In 2010, he moved to Cambridge Associates where he led the firm's European hedge fund research effort for close to 5 years. Adrian was responsible for sourcing, selecting and monitoring of best-in-class hedge funds in the region. He built strong relationships with funds across a variety of styles, strategies and geographies. In mid-2015, Adrian embarked on a gap year before joining Cassia Investments, a small Hong Kong-based private equity fund, in October 2016. There, he conducted company and sector research with a focus on businesses geared toward the Asian consumer.

Adrian has a Master degree in Finance & Management from Keele University (UK) and is a CFA and CAIA charterholder.

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