It's a lot of money, largely sourced from European and US institutional investors, especially pension funds keen to get some exposure to Asia.

Certainly, the investment banks that act as these funds' prime brokers have become increasingly addicted to such activity; during 2006, hedge funds comprised 22% of brokerage commissions paid on Asian cash equity trades, up from 5% in 2004, according to Greenwich Associates. The funds also accounted for 30% of total credit derivatives trading during 2006 as well, and many participated in the pre-equity financing efforts alongside banks that have led to some highly lucrative profits being booked.

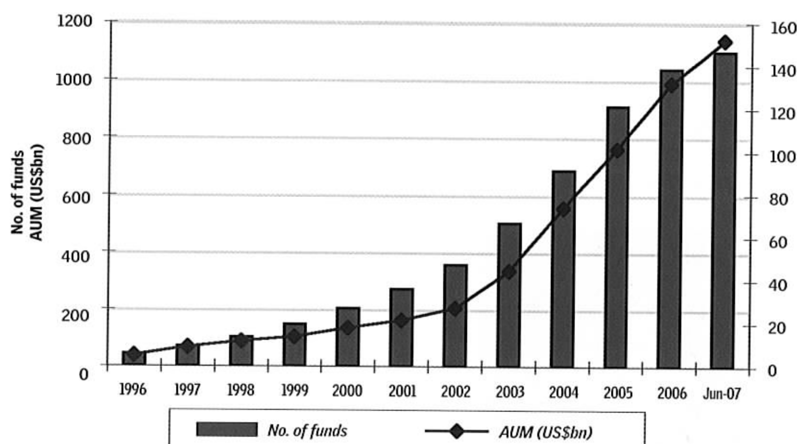
The performance of Asia-focused funds stands up to scrutiny, too. Over a three-year period to July, Asian hedge funds recorded a mean annualised return of 10.62%, slightly lower than Latin American funds with 10.63%, but much better than European and North American hedge fund returns, with 7.42% and 7.1% respectively.

And the best Asian funds surpassed them all: the top 25% recorded an average annualised return of 15.04% compared with 12.98% for next best in Latin America.

Within such a positive environment, a few regionally created firms do stand out. Well-regarded companies include the US$1.2 billion Tree Line, which was set up in July 2006 by Zaheer Sitabkhan and Katherine Tan, the former managers of the Asian Plus Fund at Lloyd George Management. Others generally thought to be top-grade hedge funds based out of Asia include Ward Ferry; Asian Debt Management (ADM), Citadel, DKR Oasis, and Highbridge Capital Management, which was started by JPMorgan.

Then there is the Hong Kong-based PMA Capital Management, run by Farhat Malik, which had become the largest investment manager in the region outside Japan even before it was bought by Tokyo-based SPARX Asset Management to make it

HISTORY OF HEDGE FUNDS INVESTING INTO ASIA



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OCTAGON CAPITAL MANAGEMENT, SINGAPORE

LAM POH MIN, PORTFOLIO MANAGER
STRATEGY: QUANTITATIVE LONG-SHORT EQUITY DIRECTIONAL
ASSETS UNDER MANAGEMENT: US$350 MILLION

Octagon Capital's flagship US$326 million Pan Asia Fund is a prime example of the merits of quantitative investment – as well as being the largest boutique company of its kind in Singapore.

Founded in April 2004, the fund started with US$500,000, including US$300,000 of the partners' own money, but grew as "news of the fund's strategy and performance spread", says founding partner and majority owner Lam Poh Min. Its investors have largely been European and Asian institutions, but for the past year it has been closed to new subscribers.

While the style is long/short, the quant model makes it a different beast to most Asian hedge funds. Instead of fundamental analysis or gut feelings about stocks, the fund takes long and short positions across Asia including Japan as a result of technical indicators. In Lam's words, it takes a "systematic and quantitative approach to investing", although there is a qualitative overlay, particularly in terms of market timing and risk management. As such it attracts investors keen to participate in the Asian story "who have an interest in diversifying against the typical fundamental and value-based manager within the Asian equity long/short space", says Lam, who unusually combines modesty with the smooth demeanour of an investment banker.

Lam and co-founder Nelson Chia developed the basics of the model while working at the Government of Singapore Investment Corp. "It has been stress-tested through experience," smiles Lam, who had been a senior portfolio manager in GIC's quantitative investment unit.

The specifics of the model are complicated. It scans about 2,000 stocks on a daily basis and ranks them according to a proprietary momentum measure that considers factors such as account strength and quality of trend, long and short-term price trends, relative trends and sector trends.

The goal is to go "long on the up-trend and short on the down-trend," says Lam. To keep itself nimble, stock liquidity is vital – daily turnover is the first vetting procedure – while the fund had no problems selling even in August's depressed and volatile markets. It is "not designed to be market neutral but opportunistically directional". Right now that means that it is "defensively positioned all across Asia".

Net of 1% management and 20% performance fees, the fund has returned 80.47% since inception, an annualised return of 23.17% with volatility of 9.47%. It has returned 18.27% [year to end-July] and won the Best Local Hedge Fund (Singapore) at the Asian Masters of Hedge Awards 2007. "The tactical use of shorts has contributed meaningfully to the high risk-adjusted return," adds Lam.

But times have been tougher of late. "Markets are suffering from a severe dislocation," he notes from his unpretentious offices on a turbulent morning for the markets in August. "The fund has been reducing its gross exposure and has just 70% gross leverage. It is net long 30%, so is 70% cash."

Like many funds, it has had to sell [falling] long positions and buy back [rising] short positions, leaving it slightly down in August as a result. "The biggest challenge is to survive the fat tails [extreme market volatility]," Lam concludes.