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March/April,2005

A new approach to investment has crossed the horizon with companies now introducing a quantitative approach to structuring hedge funds and investment products. And, according to Alex Frew McMillan, it is about to take the industry by storm

When former college buddies Simon Nip and Lewis Chan started preparing their Hong Kong-based hedge fund last year, they figured they were the first of their kind.

Their fund, the MaunaKai Quantitative Asian Long/Short Fund, is an Asia-focused quantitative hedge fund, meaning it uses computer models, statistics and objective data to generate trading ideas rather than relying on the judgments of a sometimes-all-too-human fund manager.

"It's totally objective," Nip says. "That's what we think is different from other strategies. When we look at companies, we don't have preconceptions." But since the idea for their Hong Kong-based hedge fund first took root, there has been a flash flood of Asian quant funds pouring onto the market.

"It looks like a small trend now," Nip admits. He is managing partner of MaunaKai Capital Partners, which plans to launch its fund in April with US$50 million in assets under management.

Within three months at the end of last year, Asia-focused quant funds sprang up in Hong Kong, Singapore, Australia and London, with luminaries such as Stephen Stonefield, the former chairman of Credit Suisse First Boston in Asia, getting in on the quant-fund act.

Frank Holle, an Asian quant-fund pioneer who launched Singapore-based Quant Asset Management early last year, says the potential is almost limitless.

"Every quant model is different, and every quant model will come up with different stocks," Holle explains. "As long as they are not based on the same factors, the potential for quant funds is pretty unlimited."

Debutants grow

Though most Asian hedge funds start very small, with $10 million or so in assets under management, quant funds are exploding on the scene with much more money to manage.

MaunaKai expects to debut with $50 million. But Nip, a former investment banker with Goldman Sachs and Morgan Stanley, says it could start with as much as $100 million after a recent fund-raising trip generated a lot of interest in Europe.

"I think they'e looking for more systematic approaches," Nip said of the institutions he visited. "They would like to know what we are doing, so they like the quant approach." Because quant funds use computer models instead of human interpretation to pick stocks, they generally produce very predictable results. Their performance may not outpace the top hedge funds, but they are intended to generate steady gains with low volatility - features that appeal to large institutions with predictable future obligations such as pension installments or insurance claims to pay.

Start-ups like MaunaKai are not alone. The big fund houses are moving around the same turf. Gartmore, the London-based fund-management house, is targeting to launch its Asia-focused AlphaGen Crucis hedge fund in February with $150 million under management.

In the biggest Asian quant fund launch to date, former CSFB bigwig Stonefield started Singapore-based Precise Asset Management at the end of last year. The company plans three Asia-focused quant funds for

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launch in 2005.

Singapore is a hotbed of activity, boosted by friendly hedge-fund regulations. Also in the Lion City, two former Government of Singapore Investment Corp. (GIC) managers left the safety of their government posts to form Octagon Capital Management.

Octagon's founders, Lam Poh Min and Nelson Chia, launched the Octagon Pan Asia Fund late last year as a long/short quant fund. Lam previously worked as senior portfolio manager of the quantitative investment unit at GIC, where he helped introduce quant investing in 1996.

Elsewhere in the region, Sydney-based Highland Capital Management has kicked off its Highland Asia Opportunities Fund, a low-volatility Asian quant fund. The company principals, brothers Mat and Andrew Kaleel, say they have been surprised by the amount of interest from US and European funds of hedge funds looking to invest in Asia.

Class acceptance
Exponents suggest that more quant funds are on the way. So what explains their sudden proliferation?

Part of the possible flood stems from the emergence of hedge funds from the shadows into the limelight. These so-called "alternative investments" have gone mainstream and are no longer thought of as shady investment groups best known for almost wrecking the US economy in the Long-Term Capital Management blow-up and for allegedly destabilising Asian currencies during the financial crisis.

Hedge funds are flavour of the month in the investment world, with their total assets cresting above $1 trillion worldwide. Man Group, the largest listed hedge fund manager in the world, now has an estimated $42 billion under management alone.

But these funds can be difficult to define. The easiest way to describe hedge funds is, not surprisingly, that they hedge - often by selling short, or borrowing investments they don't own, selling them and hoping to buy them back at a lower price later. That is different from a traditional long-only investment fund, which simply buys investments and holds them, hoping the price goes up.

Hedging in theory means a hedge fund can produce returns in both
up and down markets, otherwise known as "absolute returns," while the traditional fund only gains when investment prices go up.

Contentious funds
The surge in popularity of hedge funds over the last few years has led to critics as well as fans. Keith Skeoch, CEO of Standard Life Investments, one of Britain's biggest fund-management houses, raised the hackles of the hedge fund industry in January when he said hedge funds were a trend that is rapidly coming to an end.

"I think the whole hedge fund thing was a kind of fad," he told the Financial Times. "You have to remember that while the birth rate is high, the death rate is high too." His comments prompted something of a slanging match in British news-papers. Hedge fund advocates were happy to note that Skeoch is probably jealous, given what they perceived as the poor performance of Standard Life's products over the years.

Still, there's no doubt hedge funds are contentious. Their popularity has come suddenly, and Asian investors have more reason than most to beware of bubbles. But there are signs that, far from standing with one foot in the grave, the youthful Asian hedge fund industry is instead maturing out of its adolescence.

In fact, observers suggest that 2005 stands to be a watershed year for Asian hedge funds. They say the industry's rapid growth at the end of 2004 is set to continue, with the growth bringing increasing sophistication and specialisation to managers.

"I think this is like the mutual funds of the 1960s," Tom Ashworth, managing director of Hong Kong-based hedge fund specialist KE Absolute, says. "I think we are at the beginning." The reason for that optimism is that the Asian hedge fund industry
is still very small. Asian stock exchanges account for around 15 percent of the total stock market capitalisation around the world. But the Asian hedge fund community accounts for only seven percent of the global hedge fund industry, according to the hedge-fund trade group, the Alternative Investment Management Association.

That leaves plenty of room for growth. Even without any growth in the overall hedge fund "pie" the industry could easily double. New institutional money has been finding its way to Asia, and institutions
- such as pension funds, large
insurance companies and government funds - typically invest in large chunks.

That leads some industry figures to predict much faster growth. Ashworth says the Asian hedge fund industry will grow to $250 billion within the next three- to- four years, up from an estimated $70 billion now, and will cross the $100 billion mark this year.

He estimates that existing and new Asian hedge funds added $10 billion to $15 billion in assets in November and December alone. "That alone is a 20 percent growth rate for hedge funds in Asia," Ashworth said.

New launches

According to a survey by AsiaHedge, there were more than 130 new Asian funds launched during 2004 as a whole, with 69 percent of them
starting in the second half of the year. Those new Asia-focused hedge funds raised a record $3.5 billion in capital, according to an AsiaHedge survey released in February.

That growth came despite a poor year for hedge funds worldwide, with sluggish markets and low volatility making it hard for many managers to carve out a living. It was in that environment that Standard Life's Skeoch and others began sharpening their knives.

Hedge funds had a sluggish 2004. The CSFB-Tremont hedge fund index rose just 9.6 percent for the year, compared with a 15.4 leap in 2003. The 2004 gains meant hedge funds underperformed traditional equities, with the S&P 500 up almost 11 percent for the year and London's FTSE 100 up 19 percent.
But Asian hedge funds may be coming of age. Asian hedge funds used to be almost exclusively based in Europe or the US, even if the money they were investing found its way here. That was because their investors were almost always based in the same places and because London and New York, in particular, were the only cities with mature-enough investment banking and fund-management industries to spur hedge fund formation.

That is starting to change. Of the 130 new Asian hedge funds set up last year, Japan led the way with 18 new funds, followed by Hong Kong with 17, Australia launching 15, the US having 13, the UK with 12 and Singapore with nine.

The new Asian funds based in the US and the UK tend to be much larger, and those two countries topped the ranks of countries by assets raised to invest in Asia, at $1.26 billion and $1.08 billion respectively. That would seem mainly because they are home to established hedge-fund houses that have the clout to start a few large funds.

Deeper pool
The fact that more hedge funds are physically based in Asia is partly because the talent pool is getting deeper, with investment banks starting to produce graduates who are bold enough to go it alone.

But it's also a product of the Asian hedge fund industry getting larger. As the industry grows, it becomes more specialised, leading to distinct strategies such as the quantitative approach.

"When I first started researching Asian hedge funds in 1998, a common complaint was that, with no more than one or two exceptions, they were mostly go-go mutual funds with a performance fee," hedge fund analyst Peter Douglas noted in a recent report for his Singapore-based consulting company, GFIA.

Hedge funds typically charge higher fees than traditional long-only funds. Since the bulk of hedge funds in Asia were long-short equity funds, often with a long bias, critics contended they were nothing more than mutual funds that placed the occasional short position and charged double for doing so.

"While I don't think that was ever a totally fair criticism, it's true
that the universe was dominated by fundamentally driven, long-biased, directional long-short equity managers," Douglas adds.

That has started to change, as the proliferation of quant-fund strategies shows. In Asia, 60 percent of hedge funds are still long-short equity funds, but that means 40 percent should have developed specialist strategies.

Douglas says the development of specialised hedge funds is a sign of the industry's gradual maturity in Asia.

"The seed bed of the industry is moving away from refugees from long-only shops," Douglas says. "It is and more driven now by people who come out of banks or institutions and who naturally have a more
trading or model-based mentality.?

Trends changing
Five or six years ago, very few people ever left the trading desk of a large investment bank to start a hedge fund in Asia. That was really a feature of the economics of the business, according to Douglas. Starting a small hedge fund made no sense for traders who were very well rewarded by a big house.

"Starting a business that manages $20 million for three years is probably OK if it gives you financial independence, Douglas notes. or a prop trader, if you're making $1 million or $3 million a year trading a big book for a big bank, it doesn't make sense. But Asian hedge funds no longer start with $5 million and remain under $20 million for their whole
existence. Like Precise Asset Management in Singapore, they are targeting $250 million or more at launch and looking to expand on that.

"Since the business has hit critical mass, the economics have changed dramatically," Douglas says. You can launch at $20 million and be at
$100 million within six months, or they'll launch with $100 million. It's a much more profitable business, and that's encouraging the prop guy or strategist to come out."And, with institutions much more keen on regular, dependable returns than shooting for the moon, quantitative strategies are appealing.

"It the investment-management process, there is no interference from a human being at all," Holle with QAM

in Singapore explains. The company has just $30 million under management in two funds but has yet to start marketing extensively.

Holle and his colleagues rebalance their hedge funds once a month and leave it at that. "Our models are all dynamic so the weightings, the factor weightings, change every month,"he says. "The trades are all computer generated, so that's the real difference. Institutions prefer the consistency of these models. They put money into your fund, and they know that three or four years later the guy won't have left and the approach is the same.

New opportunities
"It's systematic,"Lewis Chan, head of research at MaunaKai Capital, explains. "It doesn't rely on superstars."Chan, a former assistant professor of finance at the Hong Kong University of Science and Technology, points out that traditional hedge fund managers cannot find opportunities as fast as a quant fund.

With the current explosion of capital on the market, at some point the traditional hedge fund will run into constraints, in that the manager doesn't have time to analyse the whole market,"he says. "You can get around this problem with a quant approach."As a result, some hedge-fund
analysts suggest the market will become more and more distinct, with stock-picking managers in one corner and quant hedge fund managers in the other. "You can see that there are indeed people thinking about these kind of strategies, and it's coming now,"Chan says.

Read the small print
A slew of new products are vying for investor interest in the financial world, each claiming to have that unique" feature that makes it stand out from the crowd.

While most are six of one and half a dozen of the other, there are some that do offer individual features that could and would be attractive to certain brackets of investors. But, like every investment, read the small print carefully.

A new "quity Guarantee Fund" from ABN AMRO, for example, offers a 100 percent capital guarantee with an investment period of only three years and 11 months, with the icing on the cake being a "potential additional bonus"of up to 55 percent at maturity. Seems too good to be true until the small print is examined. Then it becomes clear that shareholders will only receive that bonus level "in the improbable event that every monthly movement of the stock basket level is stable or upward over the investment period of three years and 11 months". So much for the pay dirt.

Despite the hype, ABN's product does seem a safe investment since it is structured around a basket of solid, profit-earning Hong Kong stocks while also building in a safeguard mechanism, although it wouldn't take a Marc Faber-type to fill the basket with Cheung Kong Holdings, HSBC, Hutchison Whampoa, Sun Hung Kai, Swire Pacific, PetroChina and the like. The safeguard mechanism also guarantees a five percent return at the end of the first year.

Pieter de Marez Oyens, head of ABN's Product Management, Asia Pacific, played up the new product at a recent launch. "The key sales point is that it is very short, just three years and 11 months, after which investors can get access, and the triple safeguard gives investors confidence in the product," he said.

Guaranteed high pitch
The perhaps overuse of the words "guarantee" and "fixed return" seems to be a predominant feature in new product launches (that are coming thick and fast in Hong Kong) along with the almost mandatory "100 percent capital guaranteed at maturity". Investors are being
bombarded with this type of verbiage, aimed solely at adding some reassuring substance to the new product's hype.

All of this was again highlighted with the launch of KBC Asset Management's "Lock the Highs" capital guaranteed fund, which, according to its advance publicity, was born due to the global equity market being "moderately positive". The fund is based on a basket of 10 global corporations in four main sectors: finance, technology and telecom, consumer and energy, with investors getting a total of 10
percent guaranteed coupons over an investment period of five years.

Rex Lo, vice president of Structured Products at KBC, said: "We see the outlook of the global equity market is moderately positive. Uncertainties looming in the market six months ago have alleviated. Oil price, for example, has started to come down and the US is expected to slow down the pace of rate hikes. We have selected 10 global leading stocks from our four high-growth potential sectors. The accumulated return on the basket comprising these 10 stocks has grown over 2000 percent since 1992. Given the low deposit interest rate offered by banks, we believe guaranteed funds can provide investors with an investment choice which delivers reasonable return at minimum risk.?The final point is indeed valid, although it may be worth monitoring how oil prices, for example, are wavering and what is exactly happening in the tech stock sector. And remember, as most advertisements for these products usually say: "Investments can go down as well as up."

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