Publication: The Business Times, p 3
Date: 18 July 2007
Headline: China hedge funds less risky than thought

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They are not more volatile than US funds and deliver alpha returns: study

By LYNETTE KHOO

[SINGAPORE] Hedge funds linked with Greater China are not as risky as might be thought, says a study commissioned by Fullerton Fund Management.

Using a robust statistical approach, the study found that Greater China hedge funds have market exposures very similar to those of US hedge funds, and some of them have been able to deliver significant positive alpha or risk-adjusted returns.

"The results are encouraging because it is not true that most funds are blindly following the market," said Shirin Ismail, director of Fullerton Fund Management and head of absolute returns investment strategies. "They have alpha, what we call skills that allow them to extract returns, uncover inefficiencies in the market and protect on downturn through stocktaking capability, micro-timing or trading capability."

The study was conducted by the Singapore Management University (SMU), on hedge funds investing in Emerging Asia – comprising Greater China and India. It sought to test the notion that these hedge funds are simply closet indexers, which "hug their respective indices" and thus load up market risks with their high market exposure.

Such concerns have stemmed from a perceived lack of options to short-sell in these markets, a common technique used by hedge funds to take profit of a declining security price, said Melvyn Teo, associate professor of finance at SMU, who conducted the study.

For instance, in China, short-selling of securities is illegal and foreign investment in A-shares are constrained by quotas under the Qualified Foreign Institutional Investor scheme (QFII).

Hence, it is believed that Greater Chinese hedge funds consist mostly of long-only investments and in the process, load up on market risks, Dr Teo said. He is also director of BNP Paribas Hedge Fund Centre at the university.

The study obtained data from the merged Eurekahedge and Asiahedge database with return data ending in December 2006. Its analysis focused on Greater China equity long/short hedge funds, since there were insufficient data on Indian hedge funds and Greater China funds are typically equity long/short funds.

The results show that there is little correlation between risks associated with Greater China hedge funds and market risks and these hedge funds actually provide good hedges during market downturns. This means that for most part, these hedge funds have been able to keep their market exposures low.

Their beta, or degree of volatility in relation to that of the market, is also found to similar to that of US hedge funds for the period 2004-06. This shows that Greater Chinese hedge funds are not more risky than US hedge funds when market risks are concerned, Dr Teo said.

The study also found that Greater Chinese hedge funds do generate alpha or positive risk-adjusted returns, which suggests that genuine asset selection skills do exist among managers investing in these funds.

"We argue that the reason why they have been able to avoid closet indexation despite the difficulty of short-selling in the domestic Chinese market is because they have been able to short foreign listed Chinese stocks such as Hong Kong," Dr Teo said.

"In contrast, Indian funds suffer from the lack of an external market for shorts and have not been able to maintain as low a market exposure," Dr Teo said at the release of the study findings.

He recommended the use of Greater Chinese hedge funds as an alternative to take advantage of the growth of the Chinese market without being overly exposed to market risks. But such investments are not meant for the faint-hearted, as Dr Teo cited persisting concerns of operational risks, fraud, managerial skills, and risk management associated with hedge funds.

In addition, the wide disparity between the best and worst performing hedge funds also warrants due diligence in getting the right fund manager to journey through the long-term growth potential of China, Ms Ismail said.

"You need to understand, do your homework, because the dispersion is very great," she added. "You may get three-digit returns but in return for large draw-downs of 10-20 per cent for certain periods."

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