China hedge funds less risky than thought

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

by LIVENTE KHOOD

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 return investment strategies. “They have alphas, what we call skills that allow them to extract returns, encourage risk-taking in the market and protect on downturn through stockpiling capability, re-coasting 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, said Melvin To, associate professor of finance at SMU, who conducted the study.

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

Hence, it is believed that Greater Chinese hedge funds cannot easily offload positions and in the process, load up on market risks, Dr To said.

It is also director of BNP Paribas Hedge Fund Centre at the university.

The study obtained data from the merged Eurekahedge and Asia Hedge data base, with happy data ending in December 2006. Its analysis focused on Greater China equity long/short hedge funds, since there were insufficient data on other hedge funds and Greater China funds are typically equity long/short funds.

The results show 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.

“The beta, or degree of volatility in relation to that of the market, is also found to be 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 To said.

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

“We argue that the reason why they have been able to avoid stock dilution 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 To 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 To 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 To cited persisting concerns on operational risks, fraud, management skills and risk management associated with hedge funds.

In addition, the wide disparity between the best and worst performing hedge funds only serves to give the right fund manager to journey through the long-term growth potential of China, he added.

“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.”