A Finnish investor’s perspective on Asian hedge funds

Helsinki (HedgeNordic) – Most investors would agree that hedge funds should be viewed as an extreme degree of active management, an unrestricted way to manage money, not as an asset class of its own. The fund manager’s skill dictates returns, instead of an arbitrary benchmark. Hence an investor does not want exposure to the average return of hedge funds as a group, but to the best decile of the managers. Even assuming that the lion’s share of alpha could be explained and captured by smart beta; i.e. styles and risk premia, it still takes skill to harvest them.

How does one begin to look for the most skilled managers? Is it enough to get access to a database and find out the past winners, optimize a portfolio based on past correlations and hope for the past to repeat itself? Unfortunately persistency of hedge fund returns is not high, and strategy performance alone varies drastically over years. In the humble opinion of the writers, finding the best skill and future performance is a combination of science and art. The minimum level is knowing the research target well in quantitative terms to know what behavior to expect, but that tells you nothing of the managers’ likelihood of succeeding in the future. The differentiating work starts by understanding what makes the managers tick, to be able to evaluate their probability of success and the factors affecting that. So, you want a handful of really great managers who deliver uncorrelated returns, but you cannot find them based on past performance alone, and have to put in some cumbersome footwork to get to know the targets well. There is however one way to improve your chances of finding winners; look in places where you have a disproportionately larger concentration of them. Asia represent one such anomaly. Asian hedge funds have over performed their global peers strongly for 4 straight years.

Why is this? The obvious answer is the inefficiency of the Asian markets offering an environment with plenty of mispricings that can be utilized. In Asia retail investors represent ~80% of the market volume, whereas in the US over 90% of market participants are professional investors. Another explanation would be the lesser dilution by more institutional funds, as in Asia funds have a high turnover reflecting the urgency to succeed, or close shop and do something else. Time really does turn into money in Asia – and if not, the opportunity cost is high.

You can read the full article on pages 18-21 in the HedgeNordic Special Report on Finland

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