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Be Smart: Focus on Processes and Diversify

Singapore Management University

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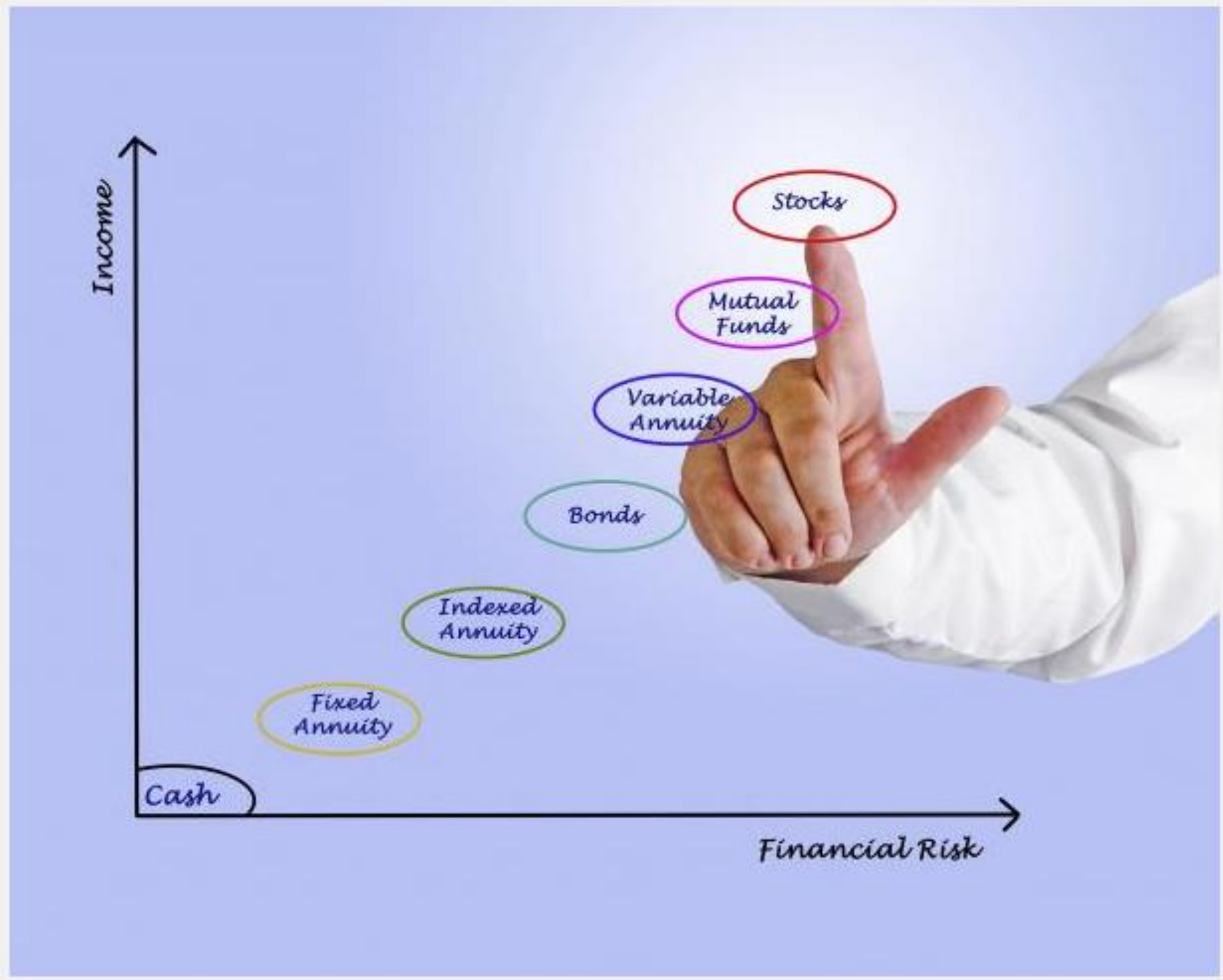

Hedge fund managers have plenty to think about today as China transitions to a consumption-driven economy, bank financing dries up, and Washington lurches along a rocky road

What makes a good hedge fund manager? Some say a good hedge fund manager must have a very high tolerance for risk and a certain degree of discipline, but Melvin Teo goes one step further, drilling down to the essence. “Many long-term successful managers are inherently process-driven, which enables them to rely on their process to consistently beat their benchmarks,” Teo tells Perspectives@SMU on the sidelines of the SMU-BNI Paribas annual hedge fund conference.

Being process-driven in this context means focusing on the business and the results, leveraging technology, process improvement methodologies and best practices; a combination of business and investment skills, he explains.

Meanwhile managers who relied more on intuition, ideas and various ad-hoc advantages “may tend to outperform in the short-term, but do not do as well in the long run”, says Teo.

In both cases, managers need an ability to appreciate the difference between skill and luck as well as a nose for sharp analysis, he says. This is particularly the case with investment in China, where strong returns, the potential for growth and development of its financial markets remain attractive to investors. In September 2013, Asian equity gains were led by China, he notes.

Changes in China

While “cautious optimism” is in order, he says consumption growth in China is “fairly robust” enabling it to transition from an investment-led to a consumption-driven economy.

Spurring investment are China’s newly established free-trade zone in Shanghai, a broader range of financial instruments, the development of a futures market for oil, and changes allowing over-the-counter trading in commodities and financial derivatives in the domestic market, says Teo. Meanwhile Hongkou (Shanghai), is planning to offer tax and rent incentives to attract hedge funds.

Teo notes there has been a gradual tightening of bank financing in China.

He believes this might provide hedge funds with a key opportunity in 2014. “If hedge funds are able to capitalise on these opportunities by providing short-term bridge financing to companies at fairly attractive rates, then that’s a definite possibility.”

As at the end of September 2013, China-focused hedge funds managed US$12.9 billion in assets, while average returns from China-focused hedge funds eclipsed those in neighboring countries, with the exception of Japan, it was reported during the conference.

Abenomics

“Equity markets remain excited about Abenomics i.e. the Japanese Prime Minister Shinzo Abe’s economic policies,” says Teo, of the policies that have proved very helpful for Japanese exporters due to the fall in the value of the yen.

“The consensus view of fund managers is that Abe-san is a politician and he obviously cares about getting re-elected. Going forward, we are sure he will be doing his best to pump prime into the economy, which will at least help it in the short term.”

However, Teo says that Abe faces two significant challenges in the long term. “The first is to try to get more women involved in the labour force, which will boost productivity—essentially boosting GDP—

while the second is to try to get Japan to accept a greater immigrant workforce. This is a very tough thing to do given the existing culture in the country."

Weathering forms and storms

Funds that successfully weather volatility and the multifaceted form that has besieged the industry do so through diversification.

"This could be through more diversification in terms of their investor pool and their investment strategies," observes Teo.

Hedge fund firms may not always operate just one fund, and they may not always obtain their capital from one source, he notes.

"And if you have long-term investors investing with you in this situation," he opines, "it's a little easier to maintain an even keel in volatile conditions. Your investors will not be so quick when it comes to pulling the trigger should you experience a few negative returns."

In the case of multi strategy firms, or a hedge fund with a couple of different products, each of which have a different strategy, diversification is still a smart move, he says.

"You may be able to diversify your performance stream, or your return profile, a little more and that should allow you to (hopefully) to weather the conditions better"

Even the uncertainty of the recent Washington shutdown can be seen as an opportunity. In fact, several hedge funds noted the U.S. government shutdown limited the release of many reports. Furthermore, as Teo points out, "Hedge funds, especially the macro hedge funds that are able to read the conditions astutely, might even be able to benefit from the possibility that the default risk for U.S. treasuries may no longer be zero."