Chinese hedge funds enter second generation with greater flexibility

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Despite a difficult year, hedge fund managers in China are heartened by the ongoing renminbi liberalisation and new measures to lower the barrier to entry

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Chinese hedge funds have come a long way from their early days. Managers are now more diverse, follow a greater variety of strategies, and are more likely to hedge. Moreover, China's gradual liberalisation of the renminbi promises to open up opportunities for Chinese hedge funds, managers and investors alike.

Though Chinese hedge fund managers still mainly follow an equities long/short strategy, not all funds are long-biased now-adays. The first generation of Chinese hedge fund managers typically came from a unit trust or mutual fund background. But starting from around 2008, managers were more likely to have spent time at a hedge fund before starting their own business. "The second generation is more flexible and adaptable to market opportunities," says Julius Wang, head of Samena Asia Managers.

"Many of the start-ups who launched last year are actually running market-neutral exposures, both as a function of the opportunity set, and their desire to produce a 'hedge fund-like' return profile, making them more palatable to institutional investors," says Joanne Dai, head of China prime finance sales at Deutsche Bank.

Flexibility and an ability to hedge have become particularly important in the current rollercoaster market. Thankfully, China-focused hedge funds now have a larger toolbox to help them hedge, which improves their chances. Market watchers say hedge funds have been shorting Hong Kong and Taiwan stocks using ADRs and 2823 A Share ETFs. Some have also been shorting European and US companies that have a vested China interest.

Even homegrown Chinese hedge funds, known as private funds, have been using a number of ways to mitigate market risk by raising cash, stock index futures and shorting of single stocks, although it is extremely expensive, at 9% annualised cost.

Despite the greater variety and the bigger toolbox, Chinese funds have been facing an extremely difficult year. There has been a bit of a shake-up in the sector, with some weaker performers closing shop. Average performance of China funds has been lacklustre this year, with most underperforming the benchmark indices, year-to-date. The AsiaHedge Chinese Long/Short Equity Index is down 1.18% in the year to date, and was down 17.75% in 2011.

“Very few of them actually have the edge and deliver consistent returns,” says Mark Hibbs, managing director at Gen2Partners in Hong Kong. “I would be surprised if many managers are up double digits this year,” adds Samena’s Wang.

Top performers

Indeed, most funds are not up this year. Most Chinese long/short hedge fund managers have been flat, but there have been a few standout performances – one being Greenwoods Asset Management in Hong Kong, whose flagship Golden China Fund was up 4.5% in June and was up 8.7% year to date as of 30 June. Greenwoods, a value investor with a focus on fundamental research, has been seeing opportunity in China’s locally listed A shares, which are trading at higher valuations than H shares.

Another strong performer, Trivest’s China fund, was up around 8% in the first half of the year, having made money by maintaining a tight net exposure, with both long and short books being profitable.

There is also Zeal Asset Management, which focuses on company fundamentals and the availability of good long or short names. The firm has been more cautious lately, but avoids taking a bearish or bullish view, favouring a bottom-up approach. Another new kid on the block is Sean Ma’s Snow Lake Capital (HK). The fund, which is closed to new investors, invests entirely outside the Chinese domestic market in more established markets such as Hong Kong or the US, allowing itself to take both long and short positions more easily. Most of Snow Lake’s performance is understood to have come from the short side.

There have also been smaller funds that have generated double-digit returns, but their exposures were high so it is always questionable as to whether or not their performance will be sustainable, says Brenda Tse, managing director and head of greater China at Permal Investment Management.

The tough market conditions give rise to some concerns, even when funds are doing well. “Liquidity has become an increasing concern and will continue to be so in the near future, particularly on the short side,” adds Tse.

Funds eye renminbi liberalisation and QFII

The breadth and depth of Chinese hedge funds is expected to further increase as Chinese regulators continue their renminbi liberalisation plans. Managers hope that with looser regulations, they will have more access to the Chinese market, as well as to Chinese investors.

The China Securities Regulatory Commission in June 2012 proposed measures to ease regulation on QFII, lowering the barrier to entry. Fund management institutions would need only two years of experience and $500 million under management, instead of five years of experience and $5 billion, to use QFII. In April 2012, the CSRC enlarged the QFII quota from $30 billion to $80 billion.

One issue with the QFII quota system has been that the quota is not available for foreign hedge fund managers, no matter how big and reputable the manager. “Hedge funds are not recognised as a structure in China, though [regulators] are starting to address the structural issues,” says Wang.

The CSRC has traditionally been more focused on traditional asset managers. Foreign hedge funds have been blocked from direct access to China’s A-share market, though managers can still access it indirectly by using the QFII quota provided by brokers. Hedge funds also cannot use the QFII quota to short – a significant shortcoming.

“The current restriction does not make sense and is not effective,” says Joseph Zeng, managing director and head of Greenwoods Asset Management’s Hong Kong office. Zeng pointed out that the restriction only ends up helping brokers make higher commissions from hedge fund clients by providing the QFII quota. “Chinese regulators should consider granting QFII quota to big and reputable hedge fund management houses,” he continues.

Having a QFII quota will allow offshore firms to buy and sell positions frequently, without getting “crushed” by transaction costs, says Paul Heffner, CEO of Gen2Partners in Hong Kong. The other difficulty has been selling funds and not being able to get the QFII quota back, forcing managers to hold on to stocks longer than they would like, he adds.

Hong Kong-based Gen2Partners manages two funds of funds – one Japan-focused and another Pan Asian fund. The Pan Asia fund typically invests in about 12 to 16 managers. Currently only one is China equities-focused. The firm also gives foreign investors access to mainland Chinese fund managers by running a managed account platform.

“Getting exposure to A-shares has been a hurdle for managers. There’s limited access, and it is expensive. So the recent changes in policy open a huge window for groups like ours,” Heffner says.

In a rare move for an alternative asset manager, Gen2Partners is applying for a QFII quota. The firm still sees lots of appeal to the Chinese domestic equities market with blue-chip names trading at “reasonable” valuations.

“We could hold for the next two-three years and those would be stellar outperformers for the next cycle,” he says.

Meanwhile, it will be a major accomplishment to successfully apply for a QFII quota. Heffner recognises the hurdles: “I think one of the things that we need to establish is that we’re not going to be borrowing this or lending it out. We’ve got principal interest and institutions that are long-term investors. We’re taking a long-term horizon,” he says.

Regulatory easing: Shanghai’s QDLP programme

Chinese regulators are not ignoring hedge funds anymore, though. The Government has been continuing its efforts to establish a hedge fund industry in the country, just as it has successfully worked to establish a homegrown private equity industry.

In March, the Shanghai government reportedly approved the qualified domestic limited partners (QDLP) programme, which will allow overseas hedge funds to raise capital in the city and invest in foreign capital markets. Details are unclear as the programme is still under wraps and officially in a consultation period, but industry watchers say that it is an encouraging step in the right direction.

The programme is an expansion of earlier efforts by Shanghai to court foreign private equity firms under the qualified foreign limited partners programme, which allowed foreign investment into local private equity funds.

Under QDLP, foreign-funded asset managers are expected to be able to raise capital locally, convert the capital to foreign currencies then invest in overseas capital markets. As of the end of 2011, 14 firms have reportedly received QFLP status – though most are expected to be private equity rather than hedge funds.

Still, industry insiders say it is too early to see how much impact the programme may have. They also fear it may be more symbolic than substantive, at least for now.

Firms on the approved list have not yet been able to open up a bank account in order to make any transactions. Also, the quota is still quite small and requirements from hedge funds in terms of commitment to opening an office or hiring staff are quite large, insiders say.

Nonetheless, the move is encouraging. Chinese investors have a dearth of investment options for their savings. This explains the country’s high savings rate and massive speculation on property and stocks. Efforts to introduce hedge funds or establish hedge funds in the country is a step in the right direction, market watchers say, by giving investors more options to invest their money overseas in properly managed products.

Growing a domestic hedge fund industry

China’s domestic hedge funds, or “private fund” industry is indeed growing. The industry took off in 2009 and at last count there were 300 to 400 such funds, says Wesley Hu, chief investment officer at Gen2Partners. Notably, many are now nearing three-year track records – the minimum needed for foreign institutional investors to invest.

The nascent industry is still occupied by mostly long-only managers, given the dearth of shorting instruments, but "it is a mixed bag", says Hu, noting that "it's personality- and style-driven. Traditionally, hedge fund strategy entails different ways of using leverage, your long and short, your instruments. There's no such differentiation in China: everyone is long-only. There are only finer differentiations in their trading style such as turnover, the stocks they pick, small or medium companies, or different sectors."

Chinese investors are becoming increasingly interested in hedge fund-like products. Some of China's traditional asset managers have responded by rolling out private funds of their own. Foreign managers have noticed the trend, but will need to wait longer until they are able to raise capital from Chinese investors. As it stands now, fundraising in mainland China is largely non-existent. Lawyers point out that bringing on Chinese investors will come with questions regarding regulations, tax and repatriation that may require a separate feeder fund and added costs.

"It's still very early days. There are still regulatory and legal issues as well as limited Rmb convertibility. There are very strong structural impediments to having real hedge funds. Until those issues are resolved, you won't see what I call a real hedge fund operating in China," says Samena's Wang.

http://www.hedgefundintelligence.com/Article/3062574/AsiaHedge-Industry-Analysis/Chinese-hedge-funds-enter-second-generation-with-greater-flexibility.html