Global Macroeconomic Challenges and Its Impact on Portfolio Activity in Asia

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29 January 2013
Synopsis for today

- Global macro overview
- Structural challenges ahead
- Class warfare
- What to do about our retirement woes?
- A word about the Eurozone and the US
- A word about private equity
- A few words about hedge funds
The Middle Kingdom Reigns

- China continues to contribute to global GDP growth, which is currently three times the size of the US' contribution.

- The Asia Pac region contributes almost 60 percent to global GDP growth, more than half of which contribution comes from China.

- The Conference Board predicts that by 2025, China will contribute close to 23% of the world's output - more than any other economy. It is currently at 16.4%.

Source: The Conference Board Global Economic Outlook, November 2012
However, Structural Issues Remain (China and ROA)

- Resource constraints - growing middle class and hence increasing consumption of goods, services and leisure
- Corporate Governance (or the lack thereof) – reducing relationships or cronyism-based business
- Demographics and ageing population – which brings opportunities in the retirement space (investment, financial & lifestyle products, technology, health care)
- Inflation – rising once again on a y-o-y basis:
The Gap between the Haves and Have Nots


Recommended Reading:
Income Inequality and the Limits to Capitalism: The Haves and Have-Nots
Dr Brian Fabbri, CAMRI Visiting Research Fellow
MD, FABBRI Global Economics & Former Chief US Economist (NA), BNP Paribas
Hoping for the best, preparing for the worst: risk management for retirement

• Ageing population and changing demographics in Japan, Hong Kong, Singapore and other parts of Asia. Declining “support ratios”

• As a consequence, expect compressed equity risk premiums and disappointing long-only equity returns

• An attendant issue: the development of cutting-edge financial innovations & solutions to meet investment and retirement planning needs

• Hedge funds, alternative investments, principal-protected and/or inflation-linked investment products, equity-indexed guaranteed life annuities (a.k.a. ratchet or click funds), etc.
Structuring "matching" and "return seeking" portfolios

Return-seeking (well-diversified) portfolio:
- Equities, hedge funds, portable alpha, commodities, real estate, private equity

Matching (or “hedging”) portfolio:
- Fixed income, laddered bond portfolios (including active management, high yield, EM debt)
- Interest rate and inflation total return swaps

Options

Downside Protection = Insurance

Performance + Risk Reduction = Diversification, Asset-Liability Management and Risk Management via Financial Engineering
What about *Inflation-Indexed Participating Annuities*?

"Upside Participation Portfolio, $S_T$"

Diversified portfolio of equities, private equity, hedge funds, commodities, real estate, etc., based on your individual risk tolerance profile

Future Realized Investment Value (Annual Payout)

- Investment depreciates
- Investment appreciates

Future Risky Investment Value $S_T$ ($)

- Strictly limited downside (indexed to inflation)
- No hedging
- Some participation in upside

$K = \$48K$ p.a.

$K$ = Floor

√ diversification
√ hedging (some form)
√ insurance

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Eurozone: To Save The Euro, Just Leave It!

- Despite all the signs (claims?) of green shoots appearing, and that the “worst is behind us”, the Eurozone’s prospects continue to remain dim …

- This is what the Europeans should do: Germany reintroduces the mark, the euro devalues; the rest band together to recalibrate their balance sheets

- All with the able help of funding bodies like the ECB and IMF

- Do as the Asians did circa ‘97: Can be done – recall, the AFC

- But this is not Asia: On a positive note, 99% of the Eurozone’s debt is denominated in euros, making its devaluation a non-event from the borrower’s point of view

- The ECB/IMF can then take on multiple roles - as a policy guide, a target setter as in the case of deficits, a structuring advisor across Europe, etc.

Source: Ken Griffin, Citadel
US: A Turbulent Ride

- Despite the historically low mortgage interest rates and the drop in prices that have made housing exceptionally affordable, there exist headwinds:
  1. lenders have maintained tight terms and conditions in mortgage loans, even for potential borrowers with relatively good credit
  2. about 20 percent of existing mortgage borrowers owe more on their mortgages than their homes are worth (There are still around 8 million “underwater” borrowers)
  3. overhang of vacant homes placing downward pressure on home prices and new construction

- The tailwinds: The ongoing shale gas & oil boom in the US

Private Equity is Looking Pretty

Fig. 1: All Private Equity Assets under Management, 2000 - 2011

Source: 2012 Preqin Private Equity Performance Monitor

Fig. 2: Private Equity Assets under Management by Fund Type

Source: 2012 Preqin Private Equity Performance Monitor

Fig. 4: Fund Types Sought in the Next 12 Months by Institutional Investors in Private Equity

Proportion of Active Investor Strategies

- Buyout: 63%
- Venture Capital: 49%
- Growth: 38%
- Distressed Private Equity: 31%
- Fund of Funds: 27%
- Mezzanine: 22%
- Secondaries: 22%
- Natural Resources: 9%

Fig. 7: Countries and Regions within Asia that Investors Feel Are Currently Presenting the Best Investment Opportunities

- Greater China: 58%
- India: 36%
- ASEAN: 33%
- Japan: 1%
- Other: 12%

Source: Preqin
# Asian versus American hedge funds – some summary stats

(Jan 2000 to Dec 2012 = 156 months)

## Eurekahedge North American Hedge Fund Indices

<table>
<thead>
<tr>
<th>Eurekahedge North American Hedge Fund Indices</th>
<th>HF Index</th>
<th>Arbitrage</th>
<th>Fixed Income</th>
<th>Long-Short Equities</th>
<th>Macro</th>
<th>Multi Strategy</th>
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<tbody>
<tr>
<td>No. of months of negative returns</td>
<td>46</td>
<td>23</td>
<td>26</td>
<td>54</td>
<td>55</td>
<td>43</td>
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<tr>
<td>% of negative returns</td>
<td>29.5</td>
<td>14.7</td>
<td>16.7</td>
<td>34.6</td>
<td>35.3</td>
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<tr>
<td>Sharpe ratio</td>
<td>1.72</td>
<td>2.16</td>
<td>2.53</td>
<td>1.09</td>
<td>1.50</td>
<td>1.67</td>
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<td>No. of 3 month consecutive negative return periods</td>
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<td>4</td>
<td>5</td>
<td>11</td>
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<tr>
<td>No. of 6 month consecutive negative return periods</td>
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<td>0</td>
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<tr>
<td>Number of funds</td>
<td>625</td>
<td>33</td>
<td>43</td>
<td>253</td>
<td>8</td>
<td>27</td>
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## Eurekahedge Asian Hedge Fund Indices

<table>
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<th>Macro</th>
<th>Multi Strategy</th>
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</thead>
<tbody>
<tr>
<td>No. of months of negative returns</td>
<td>54</td>
<td>46</td>
<td>49</td>
<td>58</td>
<td>60</td>
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<tr>
<td>% of negative returns</td>
<td>34.6</td>
<td>29.5</td>
<td>31.4</td>
<td>37.2</td>
<td>39.0</td>
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<td>Sharpe ratio</td>
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<td>0.65</td>
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<td>No. of 3 month consecutive negative return periods</td>
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<td>No. of 6 month consecutive negative return periods</td>
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<td>Number of funds</td>
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<td>8</td>
<td>20</td>
<td>244</td>
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Data as of 18 January, 2013

Source: Eurekahedge, CAMRI
Factor analysis: Hedge fund risk exposures have decreased post-GFC

Based on Historical Returns From Jan ‘00 to Sep ‘08 (Pre-GFC) and Oct ‘08 to Dec ’12 (Post-GFC)

Source: Eurekahedge, CAMRI
Rolling β’s (S&P500) indicate strategies may not be entirely “market neutral”...
Asian hedge funds AUM below pre-GFC levels

Number of Asian hedge funds deaths per month and total AUM of Asian hedge funds (Jan ‘02 – Dec ‘12)

Number of fund deaths

Total AUM, US$b

Source: Eurekahedge, CAMRI
Almost 1 in 2 Asian hedge funds pass away...

Survival rate of Asian hedge funds by strategy
(Jan 2000 to Sep 2012)

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Survival rate</th>
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</thead>
<tbody>
<tr>
<td>Value</td>
<td>95.6%</td>
</tr>
<tr>
<td>Relative Value</td>
<td>56.1%</td>
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<tr>
<td>Others</td>
<td>42.9%</td>
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<tr>
<td>Multi-Strategy</td>
<td>57.3%</td>
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<tr>
<td>Macro</td>
<td>52.3%</td>
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<tr>
<td>Long Short Equities</td>
<td>50.1%</td>
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<tr>
<td>Fixed income</td>
<td>64.9%</td>
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<tr>
<td>Event driven</td>
<td>47.8%</td>
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<tr>
<td>Dual approach</td>
<td>61.8%</td>
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<tr>
<td>Distressed debt</td>
<td>44.1%</td>
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<tr>
<td>CTA/Managed Futures</td>
<td>59.3%</td>
</tr>
<tr>
<td>Bottom-up</td>
<td>78.3%</td>
</tr>
<tr>
<td>Arbitrage</td>
<td>59.4%</td>
</tr>
</tbody>
</table>

Average survival rate across strategies: 56.5%

Source: Eurekahedge, CAMRI
Flows have shifted out of Asian long-short equities into alternatives strategies

Strategic mandates to Asian hedge fund strategies by percentage of AUM

- Large drop in long-short equity funds
  - Reflects maturation of Asian hedge fund industry?
  - Availability of more instruments on Asian exchanges enabling alternative strategies?
- Investors allocating to newer and less crowded strategies
- Strong performance of CTA/Managed Futures and Macro Funds during GFC bolstered flows into these strategies

Source: Eurekahedge
Top performing strategy in 2011 was CTA/Managed Futures

Event driven also performed well in 2011

- High volume of Asian corporate activities, particularly IPOs in North Asia
- Large volumes of M&A within Asia

Source: Eurekahedge
Loss Profile across lock-up periods (America versus Asia)

Loss distribution of individual hedge funds by lock-up periods
(Jan ’95 – Oct ‘12)

North America

Asia

Maximum 12 month drawdown

1st percentile
5th percentile
10th percentile
25th percentile
50th percentile

1 year or less
More than 1 year
None
Unknown

Source: Eurekahedge, CAMRI
Loss Profile by leverage (America versus Asia)

Loss distribution of individual hedge funds by leverage
(Jan ’95 – Oct ‘12)

North America

Asia

Source: Eurekahedge, CAMRI
Private capital flows to emerging economies

Source: The Institute for International Finance's January 2013 report on Capital Flows to Developing Countries
Summary

- Higher growth prospects in emerging markets and developing Asia

- Wealthier nations will continue to see lower yields / returns, fiscal challenges, easy money

- Other structural issues remain: demographics, ageing population, inflation, rich/poor divide

- What happens in China and the US on the political and economic fronts will continue to dominate the trajectory the world takes

- Nevertheless, incredible opportunities abound for alternative investment strategies such as hedge funds and private equity in developing Asia

- Asset owners and asset managers’ strategic interests have to align (with a renewed focus on the long-term), fees have to moderate