

Amundi Alternative Investments

Alternative Insights

Hedge funds and emerging markets: a genuinely alternative strategy?

The concept of *emerging markets* was developed by financiers in the late 1980s, highlighting hopes for higher returns from these *developing* regions. They appear to have now won their place in the universe of traditional stock market investments. What about hedge funds that invest in these new economies? This is the question that will be addressed in this latest issue, which will look into their strategies, performance, and ability – like any hedge fund investment – to provide decorrelation. Can hedge funds that invest in emerging markets be considered alternative investments?

Editorial

In terms of the current state of play in emerging markets, whilst fixed income and credit funds are active, the majority of hedge funds operating remain equity focused funds because of the breadth and depth of equity markets in these regions.

Today, managers are seeing huge opportunity on both the long and short sides, on the back of the loose monetary policies embedded in the US Dollar and the de facto global reserve currency.

Policy makers in Asia and other emerging markets are already moving to deal with inflation and hot money flows through tightening measures in interest rates in India, Australia, South Korea, bank reserve rate requirements in China, currency intervention in South Korea, and more recently capital controls in Thailand and Indonesia and, potentially, Korea. This is likely to result in market imbalances and unintended consequences in commodity markets, EM asset prices and EM currencies, offering continued investment opportunities to hedge funds who can take short as well as long positions.

Overall there are resilient areas of emerging market growth which continue to merit and reward risk taking. In Emerging Asia's case, these areas of growth are significant and also somewhat insulated from the US and Europe's malaise. For example, while most East Asian exports are ultimately re-exported to the west, 70% of Indonesia's exports to China stay in China. Thailand is performing well and India's focus on infrastructure and consumption has also helped the economy record good results.

The challenge for the long only world remains to focus on the long term secular growth areas in emerging markets and to try to best navigate around the periodic shocks emanating from these markets at different points in the cycle. In contrast, hedge fund managers, who can trade both long and short, are in the business of making money at all points in the cycle.

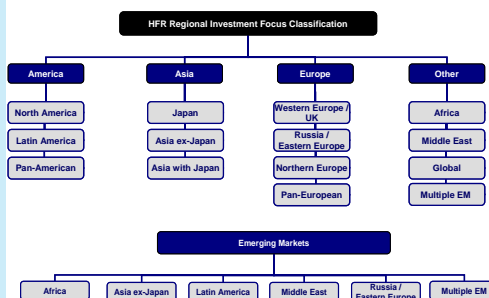
Kind regards,
Michael Rosenthal
Regional Head of Due Diligence for Asia & Europe

Did someone say "emerging hedge funds"?

At first sight, the differences between **emerging markets, hedge funds and emerging hedge funds appear to be ambiguous.**

> On the difficulty of categorising emerging hedge funds

In professional and academic literature, the nomenclature used to describe hedge fund strategies is of overriding importance as a result of the heterogeneity of the universe. A brief survey of various works reveals that emerging market hedge funds are defined as a strategy in their own right. However, a review of various suppliers of financial data on hedge funds reveals a different classification. For example, HFR (Hedge Fund Research) does not define emerging market hedge funds as a specific strategy or sub-strategy, but instead includes them within a regional classification.



Source: HFR Global Hedge Fund Industry Report (Q3 2010)

We would like to make two observations on the HFR indices, which are considered benchmarks within the alternative investment industry:

1. The geographical classification exists for emerging markets but not for other regions;
2. HFR's various studies (correlation, Sharpe ratios, performance...) systematically report on the various hedge fund strategies, to which emerging markets are added (Brazil, Mexico, Peru, Colombia, Russia, Poland, the Czech

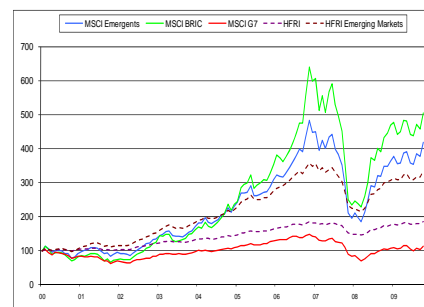
Republic, Hungary, Turkey, South Africa, China, India, Indonesia, etc.).

> Confusion between emerging markets and hedge funds

The emerging markets asset class is usually classified as belonging to risky assets for a number of reasons: limited availability of financial information, weak accounting standards, old investment rules, significant economic and political uncertainty, and strong performance but with associated high levels of financial risk. At first sight, and for these same reasons, *emerging markets* appear to be an *alternative* asset class. The article "Emerging Markets during the Crisis" (Bender, Nielsen & Subramanian), published in autumn in the Journal of Alternative Investment, confirms this initial impression. Therefore, if emerging markets are alternative investments, what about hedge funds that invest in emerging markets? Are they even more alternative?

Like hedge funds, emerging markets are characterised by high risk and limited transparency (resulting in inefficiencies and hence arbitrage opportunities). Furthermore, a comparison between emerging market equity indices (long-only) and hedge fund indices shows that the former has no reason to be jealous of the latter in terms of high performance. However, does that mean that traditional investments and alternative investments in emerging markets are alike?

Emerging market equity indices (total return)



Source: Datastream and author's calculations

These findings give rise to considerable confusion, especially since the investment universe is rapidly evolving. However, we must be careful not to fall into this trap... In the first issue of Alternative Insights, we defined hedge funds with reference to the use of leverage on the financial markets and to investments that are not benchmarked or are decorrelated. This is very different from traditional investments, even in emerging markets.

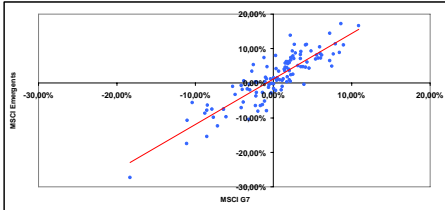
In search of decorrelation

One specific characteristic of hedge funds brings clarity to this confusion: do emerging markets enable significant decorrelation?

> An attractive inter-dependency...

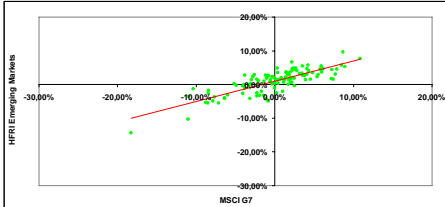
The inter-dependency between returns shown below will finally enable us to distinguish the emerging markets asset class from hedge funds.

Scatter plot: MSCI Emerging Markets vs. G7



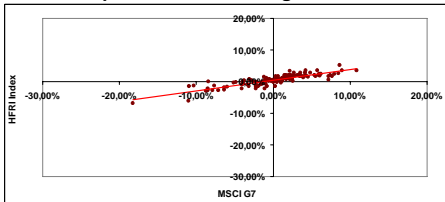
Source: Datastream and author's calculations

Scatter plot: HFRI Emerging Markets vs. G7



Source: Datastream and author's calculations

Scatter plot: HFRI Fund Weighted HF vs. G7



Source: Datastream and author's calculations

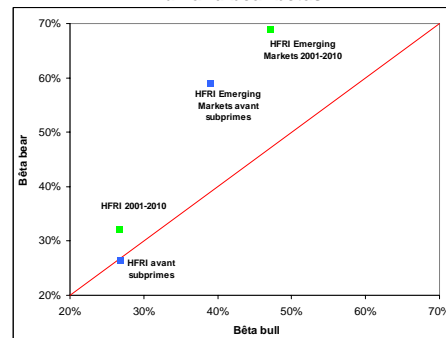
Indeed, emerging market equities are far from alternative investments in terms of decorrelation. Conversely, the HFRI *Emerging Markets* index smoothes out the associates' shocks, although it is positively correlated to G7 equities. However, this decorrelation loses some of its lustre when the HFRI Emerging Markets index is compared with the HFRI Global index (HFRI Fund Weighted Hedge Fund).

> ... Though with directional betas in bear markets

We will explore this point in greater depth by way of an analysis of betas in both falling (bear) and rising (bull) markets. Given that the hedge fund universe has proven itself to be more resilient to the technological bubble than the subprime bubble, we have calculated betas for the periods 2001-2010 and 2001-2007 (July).

Decorrelation appears to be weak overall, and especially so in bear markets. Hedge funds positioned in emerging markets thus appear to be relatively directional. This runs against the traditional characteristics of hedge funds, as may be observed in the HFR Global Index and its low beta.

Bull and bear betas



Source: Datastream and author's calculations

The explanation undoubtedly lies in one of the fundamental characteristics of emerging financial markets: they are relatively shallow and illiquid. This means that there are few, if any, leverage opportunities (e.g. via short-selling). This makes decorrelation all the more difficult to achieve.

If, as some predict, a bubble in emerging equity markets is in the process of forming, there is every likelihood that a good proportion of emerging market hedge funds would be impacted.

Pierre Clauss (Ensaï)

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One step further...

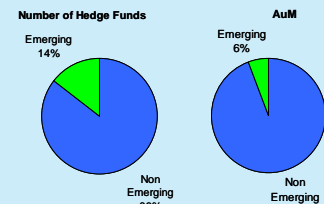
A comparison between the various emerging market regions reveals significant disparities within this asset class for hedge funds.

Descriptive statistics

An initial analysis shows that the supply of emerging market hedge funds is relatively low; this is even more glaringly true of assets under management. Secondly, the market is dominated by Asian funds - more true in terms of the number of funds than in

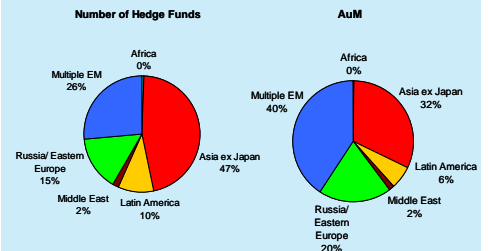
terms of assets under management. Africa and the Middle East are little represented.

Proportion of hedge funds represented by EM



Source: HFR Global Hedge Fund Industry Report (Q3 2010)

Number of funds and assets by EM region



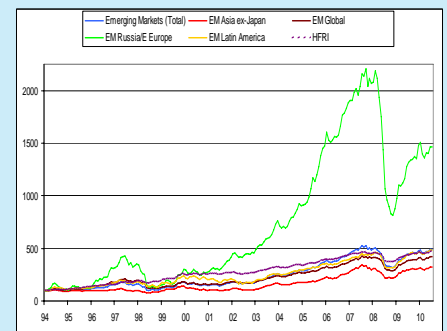
Source: HFR Global Hedge Fund Industry Report (Q3 2010)

Performance

The HFR indices reveal relatively differentiated performance. Two groups emerge:

1. Asia excluding Japan and Latin America, with performance comparable to that of the global hedge fund universe;
2. Russia and Eastern Europe, with significantly stronger performance (and significantly higher risk).

Emerging market indices over time



Source: Datastream and author's calculations

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NEXT EDITION: Popular misconceptions about speculation

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