# Yeo Lian Sim: Hedge funds - a mainstream alternative

Keynote address by Ms Yeo Lian Sim, Deputy Managing Director (Market Conduct) of the Monetary Authority of Singapore, at the Hedge Funds World Singapore 2002, Singapore, 19 September 2002.

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Good morning, Ladies and Gentlemen

**A decade of controversy and rapid growth**

Ten years ago this month, speculation that Europe's Exchange Rate Mechanism (ERM) would be realigned gained momentum and the British pound came under intense pressure in the foreign exchange markets. The rest, as they say, is history.

Hedge funds have come a long way since the Sterling attack. They have been linked to other instances of market turmoil, like the Mexican Peso meltdown in 1994-95 and the Asian financial crisis of 1997-98. Studies have revealed little evidence that hedge funds were mainly responsible for those episodes. But their participation is not in dispute.

Also in 1998, we saw the near collapse of Long Term Capital Management and its subsequent recapitalisation by a consortium of banks brought together with the help of the New York Fed. The incident raised questions about the risks that large and highly leveraged hedge funds pose to systemic stability.

It was to address these concerns that the Financial Stability Forum (FSF), of which Singapore is a member, set up a working group on Highly Leveraged Institutions (HLIs). In March 2000, the group issued a sobering reminder: institutions that provide leverage to HLIs must improve their counterparty risk management and hedge funds need to enhance their disclosures.

Along with these developments, or some say in spite of them, the hedge fund industry has continued to grow from strength to strength. There are now about 6,000 hedge funds worldwide, managing more than US$550 billion. In 2001, some US$140 billion of new capital was invested into hedge funds. By comparison, the entire industry was only US$20 billion in 1990[1].

While high net worth individuals remain the main source of capital, hedge funds are becoming more popular among institutional and retail investors. Funds of hedge funds and other hedge fund-linked products are increasingly being marketed to the retail market[2]. For example, ABN Amro launched the first retail fund of hedge funds in Singapore last month.

There are a number of factors behind the meteoric rise in demand for hedge funds. The unprecedented bull run in the US equity markets during the 1990s swelled investment portfolios. This led both fund managers and investors to become more keenly aware of the need for diversification. Hedge funds are seen as a natural "hedge" for controlling downside risk because they employ exotic investment strategies believed to generate returns that are uncorrelated to traditional asset classes.

More recently, the bursting of the technology and telecommunications bubbles, the wave of scandals that hit corporate America and the uncertainties in the US economy have led to a general decline in stock markets worldwide. This in turn provided fresh impetus for hedge funds as investors searched for absolute returns. As one commentator put it, "Where else are they going to put their money?"[3].

And the maths is compelling. From 1987 to 2001, the Hennessee Hedge Fund Index posted annualised returns of 18%, higher than the S&P's 13.5%.

1 Brooks, C. and H.M. Kat, 2001, "The Statistical Properties of Hedge Fund Index Returns and Their Implications for Investors". 8th Annual Hennessee Hedge Fund Manager Survey, 2002.

2 Financial Stability Forum, 11 Mar 2002, "The FSF Recommendations and Concerns Raised by Highly Leveraged Institutions: An Assessment".

3 F-Times News, 10 Sep 2002.

The growing demand for hedge fund products has wrought changes on the supply side of the market. The prospect of untold riches has spurred on many former fund managers and proprietary traders to strike out on their own and set up new hedge funds. This year’s ranking of top 100 hedge funds by Institutional Investor magazine included several funds founded by “Tiger Cubs”, former employees of Tiger Management. Investors now have a wide array of hedge funds to pick from, instead of only a few prominent ones previously.

With hedge funds entering the mainstream and becoming respectable, an increasing number of banks, insurance companies, pension funds and fund managers are investing in them. Some are also offering their own hedge fund products to meet customers’ needs, diversify their fee income and stem the outflow of talented staff.

In short, the hedge fund industry has attracted a wider following in the last decade and is expected to broaden its appeal further in the years to come.

**Hedge funds in Asia**

This trend is also evident in Asia, where hedge funds are starting to take off. According to AsiaHedge magazine, some 150 hedge funds operate in Asia, of which 30 were established in year 2000 and 20 last year. Currently estimated at around US$15 billion, hedge fund investments in Asia are expected to burgeon. Europe’s experience in this regard is encouraging, with its hedge fund industry quadrupling in size between 1999 and 2001[4].

Industry participants believe that Asia could be the next region of growth for the hedge fund industry. Several factors support this view. Asian hedge funds currently account for a tiny slice of the global hedge fund pie and a mere trickle of the total financial wealth of high net worth individuals in Asia[5]. Demand for Asian hedge funds should increase as investors in the region build up a better understanding of this new asset class.

The potential of Asian hedge funds is well-supported by fundamentals. From an investment perspective, the volatility in the Asian markets in recent years has allowed long-short and other strategic plays to outperform regional indices. The relative inefficiency of the regional markets also presents arbitrage opportunities.

From a demand standpoint, US and European investors are expected to turn to alternatives in Asia as capacity (and quality) in their home markets diminish. Further, the improving economic climate in South East Asia should help foreign fund managers and investors to refocus their attention on the region.

Hedge funds look set to play a larger role in Asia.

**The role of hedge funds in Singapore**

In Singapore, hedge funds form part of the expanding menu of products offered by the asset management industry. This industry grew rapidly over the last ten years: assets under management increased eightfold from just over S$35 billion in 1992 to more than S$300 billion last year. For the reasons mentioned earlier, asset managers and investors alike are finding a place in their overall strategies for alternative investments including hedge funds, commodities and real estate. (Of course, judging by concerns about Singaporeans over-investing in property, one wonders whether real estate can indeed count as an alternative investment here.)

That aside, hedge funds can contribute to the development of Singapore as an international financial centre in a number of ways. First, as evidenced in other major financial centres, hedge funds can attract a mix of supporting professionals such as fund administrators, prime brokers and product specialists skilled at structuring new instruments. Other positive spinoffs include fund of hedge funds managers and consultants, who can add value to investors in the areas of hedge fund selection and allocation among different fund strategies.

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[4] Merrill Lynch/Cap Gemini Ernst & Young World Wealth Report, 2002.

[5] An estimated 1.7 million high net worth individuals (defined as individuals with more than US$1 million in financial asset wealth) in Asia hold in aggregate US$5.1 trillion of financial assets. (Merrill Lynch/Cap Gemini Ernst & Young World Wealth Report, 2002).

Second, hedge funds can lead to more wide-spread use of innovative financial instruments and the development of cutting-edge technical and investment skills. Unit trusts typically go long-only on listed equities, bonds and cash. In comparison, hedge funds, with their broad investment mandates, can employ a selection of designer instruments and creative investment strategies and face little (if any) restrictions on what they can hold.

Third, hedge funds can add to the liquidity and efficiency of our capital markets. The contrarian instincts of hedge fund managers provide liquidity and help curtail unsustainable asset bubbles. By seeking out arbitrage opportunities, hedge funds also improve the information flow and, consequently, the efficiency of the market. Further, specialist hedge funds that invest in unlisted stocks and unrated bonds facilitate fundraising by small, relatively unknown companies.

### Singapore's regulatory approach

Singapore's approach to regulating hedge funds is risk-focused and differentiated, balancing the potential benefits with the risks that hedge funds could pose to the financial system.

Hedge fund managers are regulated like any other fund manager that manages third-party funds in Singapore. Small or boutique fund managers, that manage funds for accredited investors[6], are subject to less stringent licensing requirements because investor protection concerns are less acute. Smaller firms, with fewer than 30 qualified investors[7], are exempted from licensing. Hedge fund managers should find such operating structures conducive, as they are typically small outfits managing funds for a limited number of institutions and high net worth individuals.

MAS applies the same risk-focused and differentiated approach to the marketing of hedge funds. MAS does not regulate offers of collective investment schemes and hedge funds to professional and institutional investors in the financial sector as these investors are adequately skilled to evaluate for themselves the investment characteristics of hedge funds. Similarly, financial institutions can offer hedge funds to sophisticated investors on the strength of an offering memo.

MAS' regulatory oversight of the marketing of hedge funds is focused on retail investors. Retail investors may not be familiar with the differences between a hedge fund and a typical collective investment scheme. In particular, key aspects such as legal structure, investment objectives, trading strategies and fees may not be fully appreciated. Unlike unit trusts where a growth fund usually invests in stocks and an income fund in bonds, there is no simple correlation between investment style and asset exposure for hedge funds. Hedge funds also tend to be leveraged and can trade in derivatives, whereas traditional funds have limited scope for borrowing and dealing in derivatives.

Further, retail investors may be lulled into thinking that hedge funds are low risk investments based on studies showing hedge fund returns to be less volatile than mutual fund returns. Such statistics must be carefully considered especially since hedge fund returns are anything but normally distributed. Indeed, they are negatively skewed and exhibit high kurtosis. A fat-tail event, such as the Russian default in 1998, was enough to scuttle any profits Long Term Capital Management might have projected with its elaborate models.

Retail investors may not realise that hedge funds also display other characteristics that make them riskier than traditional funds. For one thing, hedge funds have an average life span of 3.5 years, with one-third of newly-established funds folding before those three years are up primarily due to poor performance[8]. Further, hedge funds are usually subject to a lock-up period and, after that, fixed redemption windows, unlike unit trusts which are typically redeemable every trading day.

This is not a preamble to a blanket prohibition on the marketing of retail hedge funds. Retail hedge funds will continue to be permitted under a comprehensive regulatory framework. MAS' approach is to balance investor needs and investor protection on three pillars – enhanced disclosure, enabling regulation and enlightened investors.

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6 "Accredited investor" refers to an individual with net personal assets exceeding S$2 million or a corporation with total net assets of more than S$10 million.

7 "Qualified investor" means an individual with net personal assets exceeding S$5 million, a corporation with total net assets of more than S$10 million, a collective investment scheme that is marketed only to accredited investors, or a collective investment scheme that is not marketed in Singapore.

8 Brooks, C. and H.M. Kat, 2001, "The Statistical Properties of Hedge Fund Index Returns and Their Implications for Investors".

To enhance disclosure in prospectuses for offers of investments (including hedge funds), Part XIII of the SFA which came into effect in July this year introduced new prospectus checklists, prospectus registration procedures and advertising regulations. A prospectus must contain all material information that a reasonable investor would require to make an informed investment decision, such as the investment objective and specific investment risks of a fund, the fees and charges, and the track record of the fund manager.

For the market to exercise discipline on prospectus disclosure, prospectuses that are lodged with MAS are posted on the MAS web-site for public comment for a minimum two weeks. We view this as an advance in speed and efficiency. As a safeguard, MAS may refuse to register a prospectus if it does not satisfy the disclosure requirements or if its registration is not in the public interest. If a prospectus is found to be misleading or deficient after it has been registered, MAS can serve a stop order on the prospectus to prevent further issuance or sale of securities to the public.

Following a public consultation in August, MAS will issue comprehensive retail hedge fund guidelines by year-end that will include, among other things, a requirement for some specific information to be disclosed in both prospectuses as well as marketing materials. In particular, the material differences between the hedge fund offered and traditional funds. Also the fees and charges. For funds of hedge funds, the method of achieving diversification must be disclosed.

Turning to the second pillar – enabling and flexible regulation, the new guidelines aim to align our hedge fund regulations with international best practice, so that well-managed hedge funds from established markets can be offered in Singapore.

A key development is to distinguish between single hedge funds, funds of hedge funds and capital protected hedge funds. Recognising that features such as diversification and capital protection would reduce the risk of investing in a hedge fund, MAS will introduce a lower minimum initial subscription of S$20,000 for funds of hedge funds. No minimum subscription will be required for capital protected and capital guaranteed hedge funds. Single hedge funds may continue to be offered to retail investors with a minimum initial subscription of S$100,000.

To maintain professional standards, retail hedge funds must have at least two executives who each have a minimum of five years' experience in managing hedge funds. In addition, managers should have at least three of those five years of experience managing funds of hedge funds if they offer this product.

Redemptions of retail hedge funds need only be made once every quarter. This is an accepted international practice. Managers who want to provide for more frequent redemptions are free to do so. Redemption procedures should be prominently disclosed.

To facilitate the entry of foreign funds of hedge funds, there will be a flexible diversification rule. The rule will require any fund of hedge funds to be diversified either across 15 hedge fund managers or by having not more than 8% of its assets allocated to a single hedge fund manager.

This would enable foreign funds of hedge funds to benefit from an earlier liberalisation introduced by the SFA in July this year, which allowed all recognised foreign funds (including hedge funds) to be offered directly to Singapore investors instead of only through feeder funds previously. For a foreign fund to be recognised by MAS, the foreign offeror needs only to register a foreign company in Singapore and appoint a representative to act as a liaison for investors. The fund and its manager should be from a jurisdiction with acceptable regulatory standards.

While providing for direct offers of foreign funds into Singapore, the alternative feeder fund structure is still available. A Singapore fund of hedge funds can therefore feed into a foreign fund of hedge funds. Such alliances could benefit from the Singapore manager's access to local investors as well as the foreign manager's working relationships with other hedge fund managers. Structures that involve a foreign fund of hedge funds feeding into other funds of hedge funds will also be allowed with good reason and disclosure of all relevant fees and charges.

Work has also begun on the third pillar – enlightened investors – which is an essential element of a disclosure-based regulatory regime. The Financial Advisers Act (FAA), which will become operational on 1 October, will create a class of financial advisers who can advise and inform investors on a whole range of investment products. These financial advisers would be able to promote public awareness of more sophisticated products such as hedge funds.

As part of the regulatory regime under the FAA, a new code of conduct will be issued shortly to provide guidance on the standards of conduct expected of all persons who provide financial advice (including exempt financial advisers like banks and insurance companies). The standards will cover specific responsibilities with regard to hedge fund products such as explaining product features and risks, as well as making investment recommendations to clients. The new regulatory framework under the FAA is expected to raise the quality of advice on investment products and, along with that, investor sophistication.

Within MAS, a new division has been set up to provide an overview of investor education efforts across the financial sector. In other financial centres, having a strong community of well-informed retail investors has helped in developing the sophistication of the financial markets. This is what we would like to see happening in Singapore. MAS will work closely with the industry to identify gaps and study ways of enhancing investor education in Singapore.

The industry itself also has a major role to play. Given the untapped potential in the market, there is much to be gained, whether at the individual firm or industry level, by being more active in educating investors about the nature of hedge funds, their contribution to an overall wealth management strategy, and the merits of different products. Only by winning and maintaining the trust of investors can the hedge fund industry seize the unique opportunities that are opening up in Singapore and the region.

For its part, MAS will maintain its calibrated approach towards the regulation of hedge funds and hedge fund managers. MAS will also continue to build on the three pillars of enhanced disclosure, enabling and flexible regulation and enlightened investors to establish sound regulatory standards for the industry and foster market development. In each of these areas, we will need to work closely with industry players like yourselves. I consider this conference to be a useful step in promoting such co-operation.

Thank you.