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Hedge fund investments at leading Japanese financial institutions

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In October 2006 AIMA-Japan conducted a study of hedge fund investments at leading Japanese financial institutions, following a similar survey in 2005. The survey revealed that institutions tended to concentrate their investments in funds of funds, use separate accounts, and monitor risk at individual securities on a monthly basis.

Survey objectives and respondent profile

In 2005 AIMA[1)]-Japan, with the help of NRI, first surveyed 30 leading Japanese financial institutions to ascertain their investments in hedge funds. The survey focuses on departments tasked exclusively with selecting hedge fund investments and seeks to profile the behavior of leading-edge hedge fund investors.

Eighteen (60%) of the 30 institutions responded to the survey. Respondents were divided fairly evenly among banks, life insurers, nonlife insurers, trading firms, and asset management firms. All were major hedge fund investors, with more than half reporting at least 100 billion yen invested. In aggregate, the 18 companies had placed more than 2 trillion yen in hedge funds, accounting for a significant percentage of total investment in such funds by Japanese financial institutions.

More than half the firms began investing in hedge funds before 2000 and have more than five years of experience in the field. About 70% of the institutions had at least four employees working exclusively on hedge fund investments. In the rest of this article we examine the findings of the 2006 survey in light of the results of related surveys.[2)]

Investments center on funds of funds

The survey findings revealed three key points. First, even at these large institutions, investments continue to center on funds of funds. Only two of the 18 respondents said they invested exclusively in single hedge funds,[3)] with the remaining 16 concentrating their investments in funds of funds. [4)] The same trend was in evidence at regional banks and pension funds. In addition, more than half the respondents said funds of funds accounted for 60% or more of total hedge fund investments.

With a majority of hedge fund managers still based in Europe and the US, investors in Japan find it extremely difficult to select single funds. As a result, even large financial institutions have taken the position that selection of such funds is best left to experts.

Most institutions use separate accounts

The second notable point is that a majority of institutions use separate accounts.[5)] Eleven of the 18 institutions, or about 60%, used separate accounts. The figure rises to 70% at institutions with at least 100 billion yen invested.

Separate accounts offer investors two advantages. One is the ability to tailor investment strategies, risk, and disclosure to their specific needs. Another is that the isolation of invested funds eliminates the possibility of unexpected hits to performance caused by the actions of other investors. The second point is particularly important for risk management by both investors and managers, because an investor’s approach to investments—and particularly the investment horizon—impacts on the performance of all asset managers and not just hedge funds.

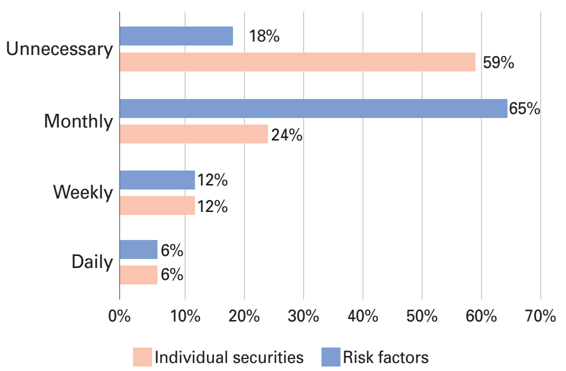
When a manager invests in an illiquid asset class and experiences a patch of poor performance, for example, impatient investors may withdraw their funds early on, forcing an unexpected sell-off of assets. This not only increases trading costs but can also adversely impact on performance by eliminating the chance to profit from an eventual turnaround. In the case of jointly managed accounts, an investor may want to sit through such a downturn but face a hit to performance because of redemptions by other parties. Hedge funds in particular are more likely to invest in illiquid assets, so investor behavior is more important than for ordinary managers.

The fact that many financial institutions choose to use separate accounts suggests that they are fully aware of the risk of investment performance being influenced by other investors' actions.

Managing risk at the individual securities level

The third point is the advances made in risk monitoring. A number of the institutions surveyed are now managing risk at the level of individual securities (see Exhibit).

Exhibit. Frequency and level of risk monitoring



Along with the new BIS capital regulations, the FSA has announced plans to conduct a review of fund credit risk weightings based on their grasp of individual investments. This review, which will start in the year ending March 2007, has sparked a growing interest in risk monitoring at financial institutions. Although some 60% of the respondents said they saw no need to monitor individual securities, the remaining 40% (seven institutions) said they were already monitoring risk at individual securities on a monthly basis. And nearly 20% said they are doing so on at least a weekly basis. Most institutions monitor risk by conducting monthly reviews of risk factors rather than individual securities,[6] but it was surprising to see just how many institutions are trying to manage risk at the fund level.

Keys to enhanced risk management

When portfolios are built around funds of funds, the lack of transparency tends to complicate risk management. But the leading financial institutions are clearly making efforts to deal with this through the use of separate accounts and efforts to understand risk at individual securities. Realistically, however, such measures would be difficult to adopt for investors unable to allocate sufficient resources, whether in terms of amounts invested or the number of staff that can be assigned to risk management. Services such as managed accounts, which enable investors without adequate risk-monitoring infrastructure to monitor and manage risk at individual securities, could be helpful in this respect. The emergence of a variety of hedge fund-related services will help to remove obstacles to investment and contribute to the future development of the hedge fund industry, in our view.

Note

1) Alternative Investment Management Association. A global, not-for-profit association formed in London in 1990 for the alternative investments community, which includes hedge funds and managed futures. Members include some 900 asset managers, service providers, and other companies in the alternative investments field. AIMA seeks to promote the healthy development of the industry through a variety of activities, including policy proposals. As of end-November 2006 the association had 47 member firms in Japan.

2) Numerous surveys of hedge fund investments by Japanese financial institutions have been conducted, including studies by the Daiwa Institute of Research and the FSA and one by the Pension Fund Association that focuses on pension funds.

3) Hedge funds that invest directly in individual securities.

4) This trend was also evident in the 2005 survey.

5) Separate accounts are managed for specific clients instead of pooling funds from several investors. As a practical matter, managers will often decline requests to establish a separate account for investments of less than 10 billion yen because of efficiency issues. Once the amount exceeds 10 billion yen, the investor has greater bargaining power and is usually allowed to establish a separate account.

6) Many firms manage risk based on fund sensitivity to common risk factors such as interest rates and share prices.

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