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**Key capabilities required of prime brokers in Asia**

With their assets under management showing signs of recovery, Asian hedge funds prefer to use full-service prime brokers that offer research and back-office capabilities and access to IPOs and Chinese stocks. The Asian prime broking market has consequently become an oligopoly dominated by major investment banks.

### Asian hedge fund market's rising profile

Non-Japan Asian hedge funds' assets under management<sup>1)</sup> (AUM) fell sharply from their December 2007 peak of \$152.4 billion in response to the 2008 financial crisis. Since 2009, however, their AUM has been gradually recovering, rising to \$119.2 billion as of July 2011.

One driver of this resurgence in Asian hedge funds' AUM is growth in alternative investments by US and European institutional investors. According to one survey, 60% of major US pension funds have assets invested in hedge funds as of 2010<sup>2)</sup>. This wave of hedge fund investing by US and European institutional investors is now spreading to Asia.

CalPERS<sup>3)</sup>, a pioneering institutional investor, has been investing in Asian hedge funds since 2005. Recently, however, even small and mid-sized US pension funds have started to follow suit. For example, the Arizona Public Safety Personnel Retirement System (AUM: \$7 billion) invested \$50 million in a Hong Kong-based hedge fund<sup>4)</sup> in August 2011. Another example is the New Jersey State Investment Council (AUM: \$75 billion), which recently increased its alternative investment allocation from 19% to 26%. It is conducting due diligence in the aim of allocating assets to hedge funds focused on China and India in particular.

Meanwhile, major European and US hedge funds also have started to build up a presence in Asia. In 2007, D.E. Shaw & Co. became the first major Western hedge fund to open an office in Hong Kong. By 2010, a number of other major hedge funds, including Davidson Kempner Capital Management, Moore Capital Management, and GLG Partners, had established a presence in Asia by opening local offices and hiring local staff.

### Key capabilities include research, access to IPOs and Chinese stocks and back-office processing

Among Asian hedge funds, those that employ equity-centric investment strategies (e.g., long-short funds, event-driven funds) accounts for over 60% of Asian hedge fund AUM. In contrast to North American hedge funds, which tend to favor equity investment strategies that involve ultra-short holding periods, many Asian hedge funds hold equity positions for 3–4 months on average. What do such Asian hedge funds look for in a prime broker<sup>5)</sup> (securities brokerage, investment bank) that provides services such as order execution?

According to an NRI survey, the main criteria by which Asian hedge funds select prime brokers are (1) research capabilities, (2) access to IPOs, (3) access to Chinese stocks, and (4) back-office capabilities.

In terms of research capabilities, European and US hedge funds tend to place more priority on short-term trading strategies than on fundamentals. In the Asian market, which offers better growth prospects, hedge funds want research that helps them select stocks. Recently in strong demand from hedge funds is research on not only developed Asian countries/regions such as Hong Kong and Singapore but also emerging countries such as India and Indonesia.

Back-office capabilities are another prime broker selection criterion peculiar to Asia, where market infrastructure is not yet fully developed. In Asia, SSI<sup>6)</sup> codes differ from one market to the next and executed trades sometimes fail to settle properly due to SSI input errors by executing brokers. Additionally, accurate, up-to-date information on corporate actions (e.g., dividends, capital transfers) is not always readily available in emerging countries. Circulation of erroneous information can sometimes impede asset

management operations. Prime brokers that reliably perform functions such as trade reconciliation, settlement reconciliation, and issuance of settlement instructions are consequently highly preferred by hedge funds.

### Market is dominated by four full-service prime brokers

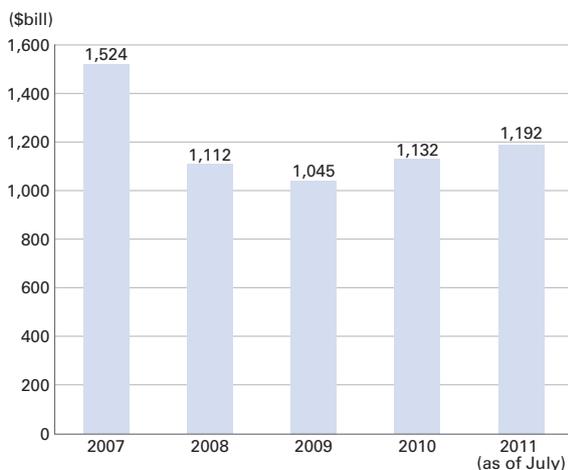
In North America, where hedge funds are generally distinguished by large-scale AUM, frequent trading, and relatively high leverage, many prime brokers are boutique firms that differentiate themselves by specializing in what they do best. Some specialize as executing brokers, while others profit by earning interest revenues from stock lending.

In Asia, hedge funds prefer to use full-service prime brokers that meet their aforementioned needs with services ranging from trade execution to middle- and back-office support. Only the major prime brokers are capable of providing such comprehensive services. In fact, UBS, Goldman Sachs, Morgan Stanley, and Deutsche Bank collectively command a 73% share of the Asian prime broking market (in North America, their aggregate market share is 55%)<sup>7</sup>.

Previously, UBS, Goldman Sachs, and Morgan Stanley controlled some 70% of the Asian prime broking market, but Deutsche Bank has joined their ranks since 2010. Following the financial crisis, many hedge funds have started to use multiple prime brokers instead of entrusting their assets to the custody of just one. Deutsche Bank succeeded in gaining market share by winning mandates as hedge funds' second or third prime broker. Goldman Sachs, which built a customer base by capitalizing on its early-entrant advantage, has shifted to a strategy of limiting new prime brokerage clients to funds with AUM of at least \$100 million. UBS and Morgan Stanley, by contrast, are pursuing new clients even among small funds.

The shift toward using multiple prime brokers appears to have nearly run its course. The Asian prime broking market looks likely to remain an oligopoly dominated by the aforementioned four major investment banks for a while longer.

Exhibit. Asian hedge funds' year-end AUM



Source: Eurekahedge



#### Note

- 1) AUM of funds located in non-Japan Asia and funds that invest in non-Japan Asia (source: Eurekahedge).
- 2) US Government Accountability Office, "Defined Benefit Pension Plans: Plans Face Challenges When Investing in Hedge Funds and Private Equity," July 2010.
- 3) California Public Employees' Retirement System.
- 4) Namely, the Pacific Alliance Group's Special Situations Fund.
- 5) Prime brokers provide a range of services to hedge funds, including securities custody and trade settlement.
- 6) Standard Settlement Instructions transmitted between trade counterparties.
- 7) Market share data are current as of December 2010 (source: Eurekahedge).

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