

CAPITAL MARKETS & COMMODITIES

Hedge funds heed call of the wild in EMs

Emerging market funds are springing up and those willing to be geographically diverse are reaping the benefits, writes Joanna Chung

Hedge funds are piling into emerging markets. In the past year alone, they have more than tripled their trading in emerging market bonds and now account for 45 per cent of annual volumes, according to research conducted by Greenwich Associates, the consultancy.

The dramatic rise in hedge funds' activity "reflects their increasing geographic diversification as they seek out market inefficiencies and arbitrage opportunities", according to Greenwich's Woody Canaday.

Patrick Holt, the head of Deutsche Bank's emerging market and credit hedge funds sales in Europe, agrees: "Hedge funds provide a significant amount of liquidity to the market."

As well as diversifying geographically, the funds are also broadening their investments into new financial instruments.

"The involvement of hedge funds has grown significantly in all sectors of the asset class," Mr Holt says. "It used to be that they were just in external debt and the currency market, but now they are expressing their views in the emerging markets through corporate debt, credit derivatives and local market products."

Lou Gerken of Gerken Capital, an alternative asset manager based in San Francisco with about \$1.5bn



Lou Gerken points to opportunities in the 'Bric' economies

under management and advice mandates for various funds, is one of the latest to venture into the space.

He believes the hedge fund community has missed a trick in not placing more emphasis on individual markets. The biggest opportunities lie in the fast-growing "Bric" economies of Brazil, Russia, India and China, Mr Gerken says.

"Hedge funds or funds of hedge funds tend to invest in emerging markets as a whole," he says. "But these markets do not move together and you are better off investing in dedicated regional or country-specific funds."

By early next year, he plans to launch a Latin America fund, a greater Russia fund and a Middle East fund. These will add to last

year's launch of the greater China and the India funds, which currently have assets under management of about \$25m each.

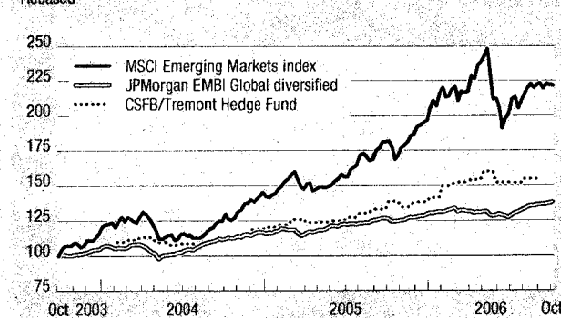
Emerging market funds are springing up all the time. Richard Segal, chief strategist at Argonaftis Capital Management, a hedge fund with \$800m under management, says: "There are hundreds devoted to emerging markets."

But these are not the only ones playing the game. "There is also increasing interest from forex funds, credit funds and [interest] rate funds that are looking further afield from the core G7 markets," says Mr Holt of Deutsche.

Mr Segal says many funds whose core business is not emerging markets are "crossing over" into the

Total return indices

Released



Source: Thomson Datastream

area, either with existing staff or by hiring new niche teams. "It can cause volatility to jump, because many of the crossover funds are quite large and they want to invest more money than the smaller EM markets can handle."

All this activity, however, comes at a time when some hedge funds are finding it harder to generate returns from emerging markets. In the year to date, hedge funds have done better than both the broader equity and bond markets, according to John Cleary, who has recently launched Focus Capital, an emerging market specialist fund of funds.

Emerging market equities were up 9.43 per cent in the year up to August, as measured by the MSCI EM Free index.

Meanwhile emerging market bonds, as measured by JPMorgan's EMBI Global Diversified index, were 5.21 per cent higher. Emerging market-focused hedge funds were up 10.92 per cent, according to CSFB/Tremont Hedge Fund Index.

But Mr Cleary says hedge funds are producing only marginal returns relative to the amount of trading they do. "Hedge funds are not performing well enough for us to invest in them right now. Theoretically, they should be sharply outperforming the markets but they are not."

Other analysts point out that the fortunes of all emerging market investors could fluctuate with the health of the commodities markets, which are the drivers of growth in many

emerging economies. There are also concerns among investors that hedge fund activity exacerbated the widespread sell-off in emerging markets this year and may be a destabilising factor the future.

John Pollen, head of emerging market equities at Pioneer Investments, says that all investors who are new to a particular product have the potential to "run for the hills at the first sign of trouble".

But he adds: "I think it is a good thing that hedge funds are getting involved because they are perceived to be a sophisticated group of investors... They are definitely not tourists but investors who are willing to live in emerging markets for the longer term."

In fixed income, Mr Holt of Deutsche says that to generate the returns they want, hedge funds are likely to look for riskier credits than they have in the past. "This is due to the improved credit quality of emerging market sovereigns in the past two or three years."

Hedge funds dealing with a tough 2006 may not get any relief next year. "The returns this year have been nothing like the previous three years. It is perceived that the environment will be more challenging into the year-end and next year," says Mr Holt.