Topic of the Month:

The Thriving Hedge Fund Industry in China

The United States, the United Kingdom and Hong Kong have been notoriously deemed as the main locations for hedge funds in the world. Yet, another star is rising. China has been experiencing a terrific increase of the number of on-shore located single hedge funds. Official data from the Asset Management Association of China (AMAC), the self-regulatory association representing the fund industry in China, speak of more than 27’000 funds at the end of 2016, an almost five-fold increase in the last two years. While we consider this number to comprise also “plain” long-only funds as well as private equity funds, our own research has highlighted the presence of 1’000-1’500 “real” hedge funds, exhibiting a very steep growth rate.

China also took “official” steps to support this sector of the asset management industry. Near Hangzhou, an investment management hub called Yuhuang Shannan was created: A city entirely dedicated to asset management, in particular to the alternative investment sector.

Most Chinese hedge funds are equity-focused, taking advantage of the liquid equity market. In fact, despite being less than one third of the US market in terms of market cap (at 7.3 trillion USD), the Chinese equity market exhibits a very high trade volume, with an equity turnover more than three times the US average.

While Global Macro has historically been the most commonly used hedge fund strategy at the rise of the industry, China might fast forward right to the current global trend in the industry: Just like in the Western world, the last 12 months have seen a sharp shift towards quantitative strategies in China.

Read more at

https://www.bloomberg.com/news/features/2017-02-14/in-china-s-greenwich-hedge-funds-rule-their-own-private-village

The Pillars for Hedge Fund Growth in China

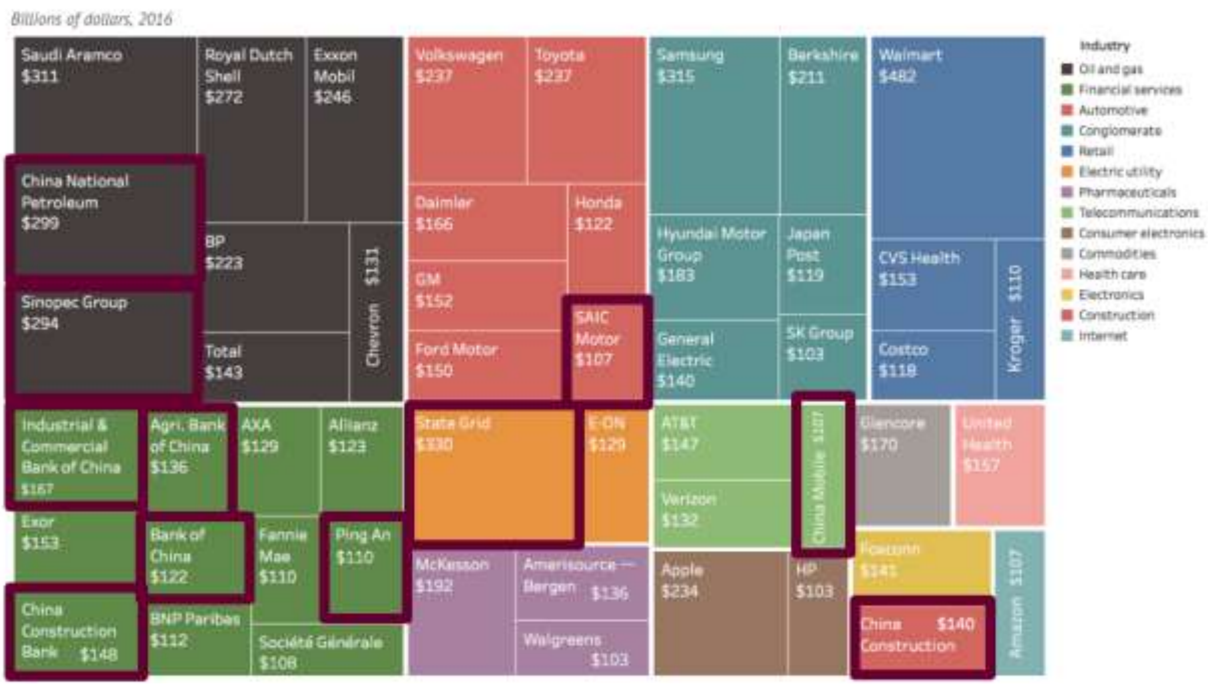
Let’s take a step back and look at which factors led to this acceleration of the Chinese hedge fund industry. Fundamental changes within the Chinese economy formed the grounds for this development.

(1) Internationalization of Chinese Markets:

Chinese markets have opened up to Western investors through the Stock-Connect Programs: The Shanghai-Hong Kong Stock Connect was launched in 2014. In 2016, the Shenzhen-Hong Kong Stock Connect was added. Currently, plans for the first Bond

Connect Program are materializing as the launch of this scheme is penciled in for the end of 2017. The recent inclusion of China's A-Shares into the MSCI Emerging Markets index represents a further boost to this development. Moreover, more and more Chinese companies have become dominant players in the world's economy. Chinese institutions acquired trophy assets such as companies and real estate across the US and Europe, but due to tighter restrictions, this development is currently (and therefore artificially) muted. Take a look at the graph below, which presents the world's 50 largest companies by revenue. 11 Chinese companies (highlighted in red) are among the world's largest 50 companies by revenue. The biggest concentration is within the financial services sector.

Chart 1: 50 Largest Companies by Revenue



Source: Fortune & Visual Capitalist

(2) Talents

More and more Chinese, who were educated and raised abroad, take the opportunity to return to China and contribute to the growth of the economy. The asset management industry particularly benefits from this know-how transfer. Many of these "overseas returnees" are very skilled in quantitative strategies ("Rise of Quants").

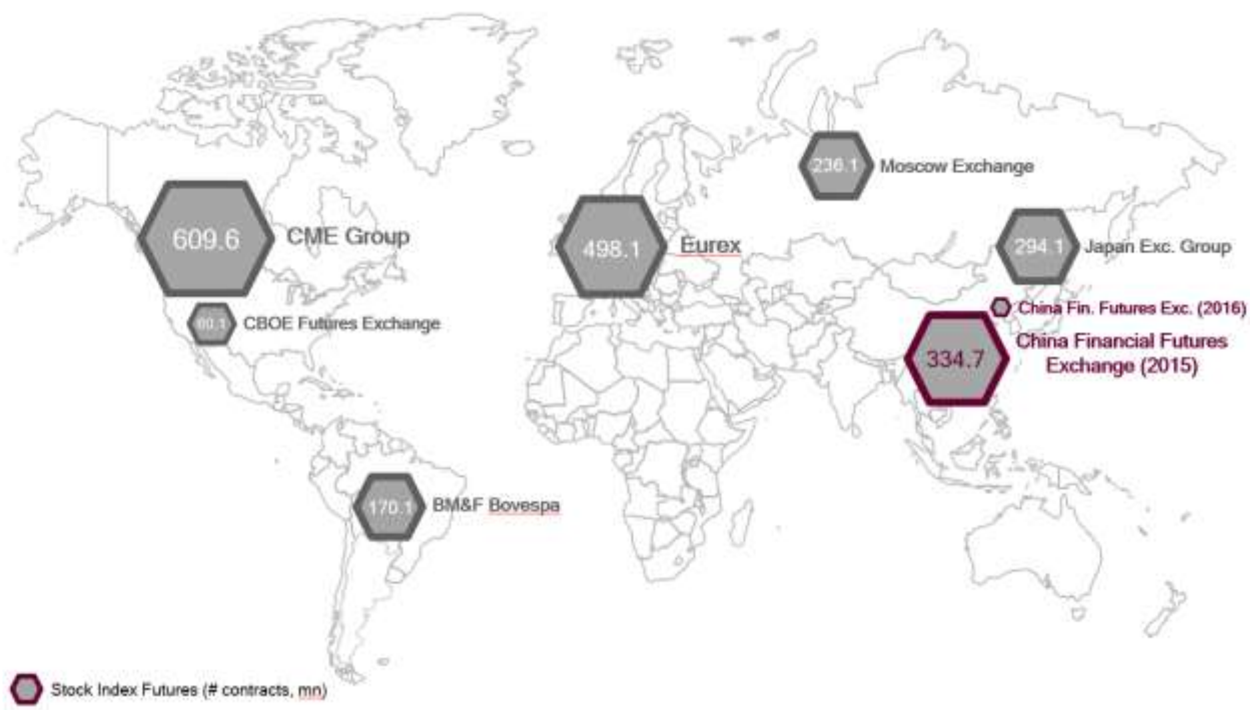
Read more at

http://www.chinadaily.com.cn/china/2017-03/01/content_28388252.htm

(3) Financial Tools

The spectrum of derivatives and financial instruments for hedging has significantly increased: Credit default swaps were launched in November 2016; ETFs on A-Shares were introduced in January of this year. Stock index futures had enjoyed enormous growth until new trading rules hampered their use. Restrictions have now been softened.

Chart 2: Volume Stock Index Futures Trading in 2016



Source: Ayaltis. Data from the World Federation of Exchanges.

Hedge Fund Trading Opportunities: Performance Dispersion Example

Performance dispersion within stock indices is an interesting key feature for several hedge funds strategies overall. Historically, China always presented wider spreads. While the US spread was around 10%, with no major swings, the spread on Chinese stocks sometimes shot up to 50%. However, it has to be noted that since April 2016, the spread on Chinese stocks has strongly contracted and is now similar to that of the US. Moreover, it is important to consider the fact that restrictions on trading (mainly on short selling) create important challenges for Long/Short strategies (as a matter of completeness, it must be highlighted that these short restrictions are also valid for certain moments in Europe and in the US).

The chart below illustrates the dispersion of Chinese equities versus US equities, from April 2012 to April 2017. The top line represents the best monthly return while the bottom shows the worst monthly return. The wider the spread, the more opportunities there are for equity strategies (e.g. long/short and market neutral) to capture alpha.

The Chinese equities are represented by the CSI 300 and the US equities are represented by the S&P 500. To have a comparable set, we focused on 300 stocks each. We excluded the 10% outliers on each side.

Chart 3: Dispersion of the Chinese Stock Market

Source: Ayaltis Research

Reality Check of Chinese Hedge Funds: Interview with Dr. Hao Shao

Dr. Hao Shao, Senior Investment Research at Ayaltis just returned from a research trip in China. He dedicated some time to explore the Chinese market on the ground.

Dr. Shao, you just returned from a trip to China. Could you share with us what struck you the most with regards to the Chinese asset management industry?

The rapid pace of growth in the asset management industry is very fascinating. In the past, Chinese investors favored investments in companies, and a lot of wealth was accumulated. With the rising concerns on growth and a high level of over-capacity, these types of investments have continuously lost attractiveness. Real estate is also not an option, as Chinese are only allowed to take a mortgage to buy the home in which they live. Moreover, real estate purchases for the purpose of subletting have to be fully funded. So indirectly, the slowing Chinese economy pushed the asset management industry. Another factor to keep in mind is the impact of capital controls. With so much liquidity stuck in China, regulators feel the need to support the growing asset management industry to accommodate the money flows within China.

How would you describe the Chinese hedge fund space? In what way does it differ from the US hedge fund space?

The hedge fund industry is still in its infancy in China. It has taken off rapidly, but there remain substantial differences: On the one hand shorting is a challenge. Futures are your best option, but even here managers face restrictions. Within the commodity space taking a short position is much easier and therefore this space offers better trading opportunities.

By law Chinese hedge funds are obliged to post weekly NAVs, which is obviously a big plus for investors. In general, the level of transparency is a lot higher with Chinese hedge funds than with what we normally see in the US.

One particularity of the Chinese hedge fund space is that they offer share classes with different return profiles: There a share classes with a first loss tranche and share classes with principal protections. In the case of a first loss tranche, which is usually held by the hedge fund manager himself, it assumes the primary losses which occur. Only after a pre-defined level of loss, investors are affected. As a form of compensation, the first loss tranche is likely to stronger participate in above-average returns. Principal protection programs ensure that investors may not lose any of their initial investors. Structures like these are highly unusual among US hedge funds.

Is the fund of hedge fund concept familiar to the Chinese investors?

Fund of funds are a rather new concept to Chinese investors. Retail investors are a dominating force and, from a trading perspective, a key feature of the Chinese market. However, regulators struggle with their impact as they significantly re-enforce trends. Therefore, regulators actually welcome and support the concept of fund of funds structures in order to channel retail investor demand into more sophisticated investment structures. Direct investments into single hedge funds are very difficult, due to high initial investment requirements and the complexity of strategies adopted by hedge funds. This also led Chinese investors to acknowledge the values of fund of hedge funds.

While the hedge fund space itself has taken off rapidly, the next step, the fund of hedge funds segment, is still emerging. There also seems to be a lack of talent and know-how. As a fund of hedge fund expert, you need to be familiar with all segments of the markets and possess extensive expertise in comprehending all hedge fund strategies. Moreover, the portfolio management concept is pivotal in successfully managing a product.

What should a savvy hedge fund manager be paying the most attention to while investing in China? What set of opportunities could be particularly attractive?

I see two main risks in China. The biggest danger, which is the same all around the globe, is the risk to be facing a fraud. However, as pointed out earlier, transparency in China is greater than in the West. Hedge funds have less bargaining power with investors, and therefore are willing to disclose more information. As mentioned before, they have to calculate the NAV every week. Furthermore, they allow full access to the own trade records, through their prime broker. The downside is that the track record of most funds is not very long, since in the Chinese asset management industry customized products for a single investor have been the norm. Therefore, there are a lot of funds in the space, which were often liquidated due to the investor's wish and new ones were opened.

The second risk is a sudden change in regulation. The regulator might step in and force market participants to just quit trading certain instruments. In such a case, you must cash out and wait. Such measures would be highly unusual for the Western world, but should be taken into consideration in China. However, where there are inefficiencies, opportunities emerge. Moreover, one has to keep in mind that Chinese regulators have a strong interest in stabilizing financial markets, to secure their ability to support the real economy.

As pointed out earlier on, retail investors are a strong force (representing around 85% of the market volume, against a mere 15% in the Western markets). They are a headache to regulators, but in terms of trading opportunities this feature offers interesting aspects. Basic trend following strategies could greatly take advantage of this herd behavior to extract alpha, exploiting a less crowded trading space.

Thoughts and News:

Hedge Funds in Q2

Hedge Funds have registered other 3 months of back-to-back positive performance in Q2 2017.

Chart 4: HFRI Indices Overview

Apr-17	HFRX Macro -0.07%	HFRX Relative Value 0.20%	HFRX Global 0.42%	HFRX Event-Driven 0.70%	HFRX Equity Hedge 0.72%
May-17	HFRX Equity Hedge -0.57%	HFRX Global 0.24%	HFRX Relative Value 0.27%	HFRX Macro 0.49%	HFRX Event-Driven 0.93%
Jun-17	HFRX Macro -0.41%	HFRX Event-Driven -0.03%	HFRX Relative Value 0.21%	HFRX Global 0.21%	HFRX Equity Hedge 0.86%

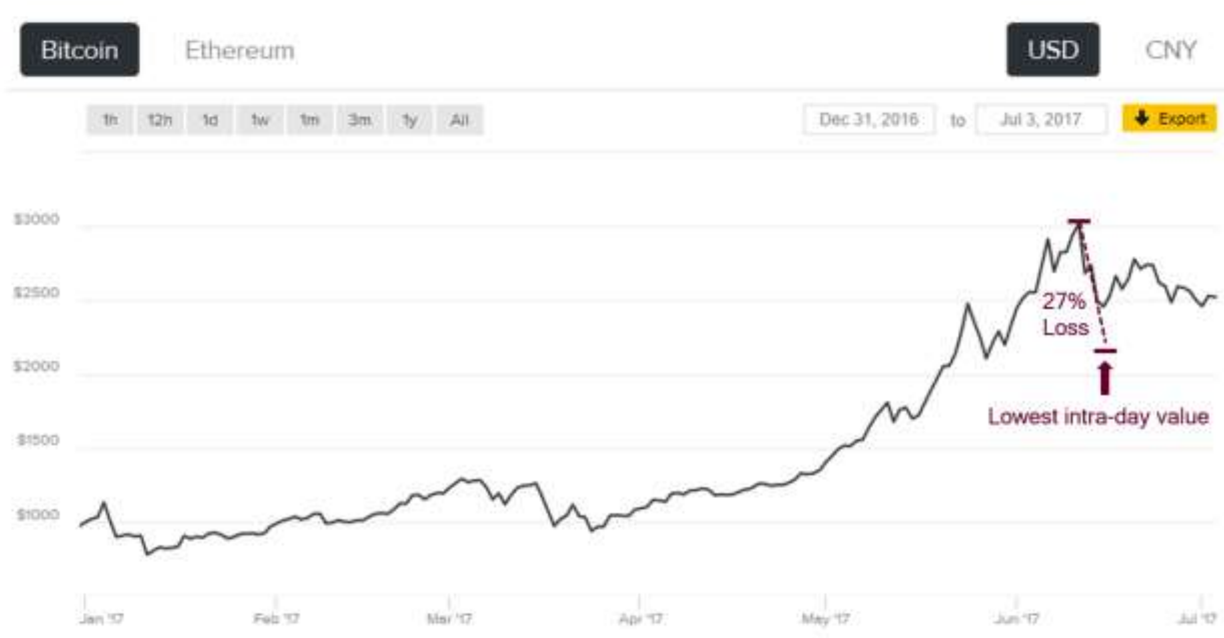
Source: Ayaltis Proprietary Database

Equity Hedge strategies were the best performing ones in April and June, but struggled in May. Macro strategies posted negative numbers in both April and June. Relative value strategies exhibited the most constant performances, with three positive months in a row.

Hedge Funds & Cryptocurrencies

Bitcoin and cryptocurrencies are the hype of the moment. Yet, hedge funds still prefer to stay away from them. Strict investment guidelines are one of the most common reasons. While performance has been sky-high, there are huge volatility and security concerns. In fact, Bitcoin has been up 145.09% year-to-date (as of June 26th, 2017), but as this very article was being written, Bitcoin had slumped to 2'207 USD after having topped the quotation of 3'000 USD, representing a loss of 27% in a range of only three days. The Eurekahedge Crypto-Currency Fund Index, tracking the most traded cryptocurrencies, exhibits an annualized volatility of around 52%, at much higher levels than the average hedge fund.

Chart 5: Bitcoin Share Price Development



Source: Coindesk

Read more at http://www.cnbc.com/2017/05/30/bitcoin-price-hedge-funds-not-investing.html

Activist Looking at Europe

Activist hedge funds enjoyed a good year in 2016 and while assets in this segment has fallen (due to bad performance in 2015), their activity has not. Europe and Switzerland have so far been selectively exposed to activists in the past. However, recently Nestle has become a target. Daniel Loeb's Third Point acquired a 1.3% stake in the company, asking the management to sell Nestle's holding in French cosmetics producer L'Oréal and sell non-core product divisions to increase the company's profit margin. Nestle reacted and offered a share buyback. Their shares are up 14% year-to-date and 2% since Mr. Loeb announced the investment.

We expect more European companies to be targeted from activist investors in the next months.

Read on at

https://www.ft.com/content/723b4a78-59e8-11e7-b553-e2df1b0c3220?mhq5j=e1

http://www.valuewalk.com/2017/06/fund-activist/

Wall Street or Hedge Fund?

For a long time, we have read and noticed that the big banks are cutting down on their trading activity. Have they gone a step too far? Or are US banks already anticipating a softening of prop trading rules? At least it seems like trading talents do consider jobs with banks again.

Read more at

https://www.bloomberg.com/news/articles/2017-06-29/traders-who-left-banks-for-hedge-funds-now-heading-back-to-banks

Amazon – More than Online Shopping

Amazon has gone local with its acquisition of Whole Foods. A very interesting step, indeed. However, are you aware that Amazon derives most of its revenues from its cloud computing business rather than from its online retail business? Amazons AWS is currently the market leader in cloud computing. Netflix, AirBnB and the CIA are among its clients. AWS plans to launch its Hong Kong debut later this year. Its closest competitor is Microsoft Azure.

Source: Gartner

Read on at

http://www.bbc.com/news/technology-40367626

Digging Deeper:

Hedge Fund Titans: A Lot on Their Plate

We learned from Uber CEO Kalanick a few weeks ago that a temporary leave with no designated replacement in place is not such a good idea. Investors did not agree with this idea and Travis Kalanick had to step down from his position as CEO for good. Succession issues are also a hot topic within a number of long standing, prestigious hedge fund companies. Even with the best intentions, it is anything but easy: Millennium founder, Izzy Englander (68), was challenged when he learned that his designated successor resigned to implement his own ideas. Also, George Soros's right-hand man left the investment team to pursue a career with another investment company. Bridgewater's Ray Dalio faced a similar problem when his newly appointed co-CEO (former senior Apple executive) decided after just ten months to part ways. The "cultural" fit did not work out. Other hedge fund titans have not addressed the subject at all: For Louis Bacon (60), founder of Moore Capital, succession planning is not a priority as plans relating to this subject have not been shared with investors.

Read more about this topic at

https://www.bloomberg.com/news/articles/2017-03-03/hedge-fund-titans-face-what-comes-next-as-they-pass-certain-age

Another theme hedge fund titans share is their increased move to the quant space (if they are not in the quant space from the beginning). Citadel hired Bridgewater's head of fixed income trading to further develop their portfolio tools to also account for the ever increasing need to analyse big data. Paul Tudor Jones takes a more indirect approach as he provides seed money for artificial intelligence start-ups.

Read more at

http://news.efinancialcareers.com/us-en/286209/tom-zychinski-citadel

https://www.bloomberg.com/news/articles/2017-05-22/tudor-s-jones-said-to-back-ai-hedge-funds-cargometrics-numerai

We are looking forward to your feedback. Please feel free to share your ideas with us and continue the dialogue.

Your Ayaltis Investor Relations Team

Email: ir@ayaltis.com
Phone: +41 43 502 37 60