

## *Emerging markets hedge fund investing*

For this month's Tapestry SPOTLIGHT, we focus on Emerging Market hedge fund strategies.

Given the current state of the developed markets and consideration by market participants looking for varied points of economic stability around global markets, we felt it was a timely discussion for reflection.

As is evident from a variety of sources, it is generally accepted that EM GDP growth is likely to outpace that of developed countries, and therein emerging equities could out-perform developed equity markets.

However, when considering a HF investment into the EM space, we believe the emerging market call is essentially a 'macro call' that is driven by an investor's tolerance of liquidity, shorter and longer term volatility parameters as well as longer term return expectations.

Once a macro weight has been arrived at with respect to portfolio construction, a HF investor into the EM space has many ways to implement their investment. As we have been made aware on numerous occasions with investing in the EM, illiquidity proffers a heightened return premium but comes with a commensurate risk. It has been our experience that at times of stress in the markets, correlations seem to go to one and this has been typified by various emerging market crises both in Asia and Latin America.

Hence, if an investor values liquidity then it is our suggestion to focus on the liquid strategies proffered by EM Equity L/S managers coupled with a select number of Macro and Arbitrage managers.

### **What are the primary HF strategy options available for investment?**

On the whole, the EM space is dominated by equity based hedge fund managers. They are the majority both in terms of number of managers and assets managed.

#### ***Equity Long/Short***

- In the Equity L/S arena, managers are generally bottom up or top down, thematic or a combination thereof.
- Typically L/S managers are long biased since many emerging markets do not have developed capital markets proffering instruments required to efficiently hedge positions although many managers will try and take advantage of ETFs, derivatives markets or customized OTC solutions
- It is possible to lower portfolio volatility by using Equity L/S managers with a managed net and regional/sector exposure.
- Targeted manager based approach to a particular sector that is the "bread and butter" of a specific region and best "played" through focused fund, e.g. Natural Resources for Russia, or technology for India

There are a variety of types of EM L/S hedge fund strategies to choose from. They typically vary around:

- Focused Country Funds, typically BRIC regions: Brazil, Russia, India, China as well as focused funds on smaller geographies
- Regional Funds are typically Eastern Europe, various Asian and Latin America, Middle East & North Africa (MENA) focused vehicles. More recently we have seen the emergence of some Africa focused managers
- Long Only, Long Biased, Sector Focused, Diversified, Managed Net

- Investing via a developed fund with carve out of emerging market that is consistent with the wider developed mandate
- There are a variety of managers seeking lower volatility while capturing the potential for larger returns through wider discrepancies in anticipated relative company valuations e.g. domestic versus international listings, etc

### **Trading**

- In the Trading space most managers generally take a discretionary approach to investing across equity, fixed income and currency markets. Typically managers are trading views on anticipated central bank action or strength of local markets and liquidity flows
- There are not many systematic traders in the EM space since most futures contracts are traded on exchanges in the developed markets
- In some cases futures contracts on domestic exchanges are not approved for foreign investment.
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### **Arbitrage**

- In terms of arbitrage strategies, EM managers can essentially be broken down into relative value traders and event driven managers
- The majority of relative value managers are looking for opportunities on an either inter or intra capital structure basis. The majority of such traders use convertible bonds as their preferred instrument since the corporate debt markets are not as developed nor as liquid and local corporates like to issue them to benefit from debt tax treatment
- In terms of convertible bonds, we have seen an increase in the number of private convertibles being offered to the markets. These instruments can provide for outsized returns but they come at the cost of liquidity and in some cases are un-hedgeable
- Other examples of common relative value arbitrage are share class, capital structure and cash/futures arbitrage to mention a few
- Most event driven managers focus on the other hand focus on deal flow. Their skill pertains to an expertise within the dealer community or anticipation of outright needs of equity/debt financings on behalf of local corporates

### **What are some of the challenges of investing in Emerging Markets?:**

- In our experience there is tendency for performance within emerging markets to correlate quite heavily in times of liquidity pressures and market stresses cause pockets of excessive volatility with longer periods of recovery
- We find, there are more instances of government intervention as it relates to restricting trading without notice even in the face of a lack of concern for a working market environment. Govt intervention is also prevalent in the FX markets and in some instances LatAM debt markets
- Style of leadership or government may in some countries be counterintuitive to a broad acceptance of the principles of international capitalism
- Foreign investor flows may play a heavy role regionally resulting in dramatic moves and drops in trading volume
- Not all markets provide access to cost effective hedging
- Potential vulnerability to political and economic instability
- Immature corporate governance framework and opportunities for financial irregularities are often heightened

**What are some of the mechanical considerations?**

- An ability to short directly or in a structured way to affect a hedged approach or strategy
- View on taking currency exposure – is it hedged or not in the strategy? What exposure are you taking in addition to the stock or theme selection?
- Cost associated with trading within developing regions. Is the net return still attractive?
- Underlying buyers within the market of focus: foreign flows, domestically driven, combination thereof. This greatly effects the liquidity of the underlying market
- Ability by PM/team to have “on the street” or in the “neighborhood intelligence”, is there a connection between the manager trading the approach and the regional focus?
- Operational and legal infrastructure to meet the demands of trading in a particular region
- Regulatory issues
- Domestic counterparties strength

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