



# Opalesque Round Table Series '09 TOKYO

# Editors' Note

Dear Reader,

Some facts and findings in this new Opalesque Japan Roundtable will surprise many financial professionals. Learn directly from Japan-based investment veterans how the financial crisis has changed investing in Japan and asset raising from Japanese institutions, and what new opportunities are arising.

## A Reality Check for visiting hedge fund managers

In their quest to raise assets, considerable numbers of overseas managers are visiting Japanese institutions each month, looking for funding and assuming that the Japanese must be ready to invest money *"merely because they have it, whereas it is not there some other places."* However, many allocators in Japan are still in shell shock: Chris Wells from White and Case, who lives and works in Tokyo since 1983, says "it will take time for allocators to realize how much they really have lost. A lot of investment staff aren't even telling their bosses how bad it is."

## Paradigm Change: Brand does not allure Japanese investors any more

However, more than has been true for a long time, the ability to compete for Japanese assets is much more equal today than before, because with the financial crisis, "the shine has come off of the big name hedge fund managers." According to Wells, "Japanese allocators, who traditionally tend to be pretty picky consumers concerned with name value, have lost this type of fixation on brands and perceived reputation. While before they may have been blinded by the light of the big famous asset managers or hedge fund names, now it matters less, all names are more equal. The questions for managers will be: how did you do last quarter? Where are you going? How good are you at communicating where you are going? Do we fully understand your strategy?"

## Japanese assets no more "sticky"

Rory Kennedy from UMJ adds that historically "you have to put more effort into getting Japanese institutional money. But in return, the consensus was that that Japanese money would therefore be 'sticky' and would stay longer in your funds. However, following poor performance across hedge fund strategies over the last two years, it seems that from now on hedge funds will have to put as much effort or more into raising Japanese money, but it will be no more loyal than any other money in the world. In fact, it may be less loyal because they usually insist on liquidity as well."

The Opalesque Japan 2009 Roundtable was sponsored by AIMA Japan and took place on April 16th at the Tokyo office of Nikko Citi. I want to thank Ed Rogers from Rogers Investment Advisors and Koichi Shijima from Nikko Citi for helping me to put the following Roundtable together:

1. Shinichiro Shiraki, Founding Member, [Monex Alternative Investments](#)
2. Chris Wells, Partner, [White & Case](#)
3. Koichi Shijima, Director, [Nikko Citi](#)
4. Rory Kennedy, COO, [United Managers Japan \(UMJ\)](#)
5. Ed Rogers, CEO, [Rogers Investment Advisors](#)
6. Yhu Kuni, Fund Manager, [Stats Investment Management](#)
7. Shin Matsui, Chief Portfolio Manager, [Nissay Asset Management](#)

This Roundtable further covers:

- The evolution of Japanese hedge fund industry - what are the new managers and strategies?
- What impact does the ailing Japanese real estate market have on the economy?
- What is the number one mistake when Western firms hire Japanese staff?

Why each investor in Asian funds should do significant due diligence on the fund's ability to manage their foreign exchange exposures.

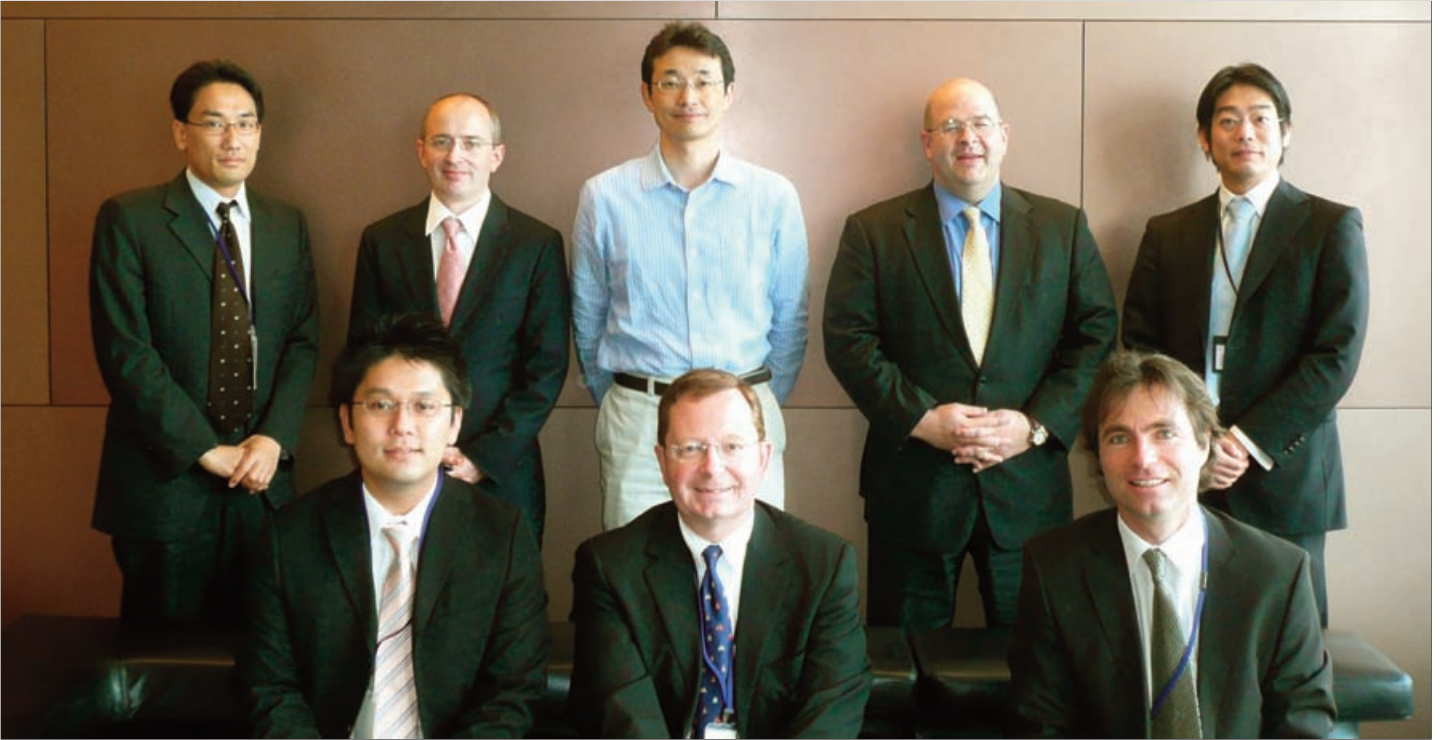
Enjoy "listening in" to the 2009 Opalesque Japan Roundtable!

Matthias Knab  
Director Opalesque Ltd.  
[Knab@opalesque.com](mailto:Knab@opalesque.com)

Cover Photo: Five-storied pagoda and cherry blossoms, Japan



# Participant Profiles



## STANDING (LEFT TO RIGHT)

Shin Matsui, Rory Kennedy, Shinichiro Shiraki, Ed Rogers, Koichi Shijima

## SITTING (LEFT TO RIGHT)

Yhu Kuni, Chris Wells, Matthias Knab

# Introduction

**Shinichiro Shiraki**  
AIMA Japan/Monex  
Alternative Investment

My name is Shinichiro Shiraki, I am involved with a couple of operations here in Japan. One is a fund of funds business which was launched in 2005 by two companies: Monex Group, a Japanese online broking company and Asuka Asset Management, a domestic hedge fund firm founded by an ex-Tudor Capital trader here in Japan. The intention of the fund of funds business is to distribute the hedge fund of funds products, which invest mainly in Asian and Japanese hedge funds, to the retail public through the online brokerage. Japanese retail investors can invest in hedge fund of funds buying small units that start at around US\$ 100 only. This is quite unique, and I don't think anywhere else you can get into a hedge fund of funds with such a small amount.

Monex Alternative Investments also launched a fund of funds that invests not only in hedge funds, but also private equity funds. This fund is also distributed over the internet to Japanese retail investors.

The Asuka Group runs a couple more operations, for example a CTA called Asuka Commodity Investments which is also very unique as the CTA invests mostly in Japanese commodity exchange markets. Therefore, the profile of this CTA is much different from others who do the typical trend following or other strategies within U.S. or European markets. The Asuka CTA follows a multi-strategy approach including trend following, arbitrage between the Japanese and other markets, and a short-term discretionary component. As I mentioned, this CTA has a very different return characteristic compared to its global peers.

Asuka is also running a pure Japanese long/short hedge fund and multi-strategies including macro, relative value, as well as market-neutral equities. In addition, Asuka set up a value-up fund. This is a kind of activist fund, but with a very friendly activist mindset and collaborative approach.

**Chris Wells**  
White & Case

I am Chris Wells, I am a partner with White & Case which is an integrated, global international law firm. I am a partner here in Tokyo and head up the Tokyo Financial Services Group. The office here has about 130 lawyers, of which roughly 25 are in my group. The Financial Services Group has five subgroups: one for investment funds, a regulatory and compliance group (which we call the Bank Advisory Group), a Capital Markets Group (which is transactional in nature for corporate issuances), a Corporate Services Group, and most recently we have started an Insolvency Finance Group, which is a developing expertise.

Our firm has 2200 lawyers globally, and in Asia we have offices in Singapore, Hong Kong, Beijing, Shanghai, Tokyo, and a long historic relationship with a firm that broke away last year in Bangkok, so our Asia coverage is very broad.

In our investment funds group we work with hedge funds, private equity funds, real estate funds, and occasionally with a venture capital fund. These days, we specialize in infrastructure funds and real estate funds and we act as advisors to various real estate groups in Japan as well.

My office has another group that exclusively services real estate packaging and the securitization of real estate investments; this group is not part of the Financial Services Group, but is equally large. The Tokyo office has a very strong tax practice, part of which is transactional advisory, and the other part handles disputes - meaning disputes with the Japanese Government over taxes, transfer pricing, and permanent establishment cases.

I have been in Tokyo since 1983, and so have some perspective on the development of the Japanese financial services market. I have a personal interest in regulatory policy. I had that interest already when I first started practicing law in California, and I have maintained this interest throughout my career in Japan. I think that there are very few lawyers in Japan, maybe none, who have a similar interest. I do a lot of advisory work for foreign hedge funds that need advice about setting up in Japan, or compliance issues, transaction structuring, regulatory questions etc.

**Koichi Shijima**

NikkoCiti

My name is Koichi Shijima. I currently co-head the Tokyo Prime Finance Group for Citi along with my colleague Andrew Hill, who is currently based in Singapore. Citi started to grow their prime brokerage business in 2005 and I joined that year to start the capital introduction service. Prior to that we did some stock loan business, but were not a full service prime broker.

Currently, Citi's Global Prime Finance Group is headed by Nick Roe based in London, and Asia Pac (including Japan) Prime Finance Group is headed by Hannah Goodwin based in Hong Kong. We are in the fortunate position that we actually still have about 40 people on staff for our Asia Pac prime brokerage business. We have nine people here in Tokyo, and after the recent events this means that we are one of the few prime brokers with such headcount in Tokyo.

We provide full service prime brokerage here in Tokyo, which of course includes client service, capital introduction, trading, stock loan, synthetics, swaps etc.

I joined Bank of Tokyo in 1995 and moved to Morgan Stanley, Nikko Salomon and Credit Suisse, where I was involved with Japan equity program trading and sales of derivatives, listed futures and options.

**Rory Kennedy**

UMJ

My name is Rory Kennedy; I am COO of a company called United Managers Japan or UMJ. UMJ was setup nearly five years ago now as a hedge fund platform; one of the first of its kind in Japan and in Asia. It was setup by an individual called Masahiro Koshiba, who is one of the pioneers of the Japanese hedge fund industry. He was one of the founding partners of Japan Advisory Ltd where he and his partners built a \$5 million AUM fund in 2002 into a multi-billion dollar hedge fund advising the Whitney Japan funds. UMJ is his second major project.

Mr. Koshiba launched our UMJ Kotoshiro Fund in November 2008 as he believes the current conditions are excellent for delivering alpha. The Kotoshiro fund is a Japanese equities long-short fund and I am happy to say that the performance since launch in November has been on target. Year to date, the fund is up approx 2.5% (net), and more importantly, over one of the most turbulent times in the modern history of the financial markets, the fund has never been down more than 32 basis points on any given day. Despite having a diversified all-equity portfolio, the fund shows zero correlation with the Japanese indices which is extremely rare among Japanese L/S hedge funds.

The fund's aim is to deliver stable, realistic hedge fund performance genuinely uncorrelated to the market. We aim for 15-25% a year returns and I think we'll reach that in 2009.

I came to Japan around ten years ago while working for an investment bank. I was initially supposed to come here for six months but I got seduced by Japan; at a general level and at the personal level. Ten years later, I am happily married here with three kids, so I don't think I'll be going anywhere else soon...

**Ed Rogers**

AIMA Japan/Rogers  
Investment Advisors

My name is Ed Rogers. I am the CEO of Rogers Investment Advisors, which is a three-year old investment advisory company headquartered in Tokyo. Rogers IA is fully licensed and registered with the Japanese Financial Services authorities.

Rogers Investment Advisors advises the Wolver Hill Japan Fund, which is a Japanese multi-strategy fund of hedge funds. The Wolver Hill Japan Fund launched in November 2006. In 2008, net of fees, we were up +6%. Since inception in October 2006 through March 2009, the net returns are in excess of 10%. This is versus the TOPIX returning -52% and the Eurekahedge Japan Index at -15% over the same time period. The S&P 500 is down 42% over this period.

The annualized volatility of the Wolver Hill Japan Fund is less than 4.5%. Comparing with some of the major benchmarks, we find that the TOPIX volatility over the same time period is 21%, the Eurekahedge Japan Index is 6.5% and the S&P 500 has annualized volatility of over 19%.

The Rogers Investment Advisors Group and Wolver Hill have four full-time front office professionals to conduct very specialized hedge fund due diligence. We focus on four specific areas: the investment process of the hedge fund, risk management of the hedge fund, operations and the business management of the management firm. We look at the full range of legal, compliance and regulatory issues faced by hedge funds in Japan, which are very complex, as I'm sure we will get into a little bit later.

The Wolver Hill Japan Fund invests in strategies ranging from convertible bond arbitrage, statistical arbitrage, to the great variety of long/short strategies that we can find in Japan. All of the managers in the fund must have a minimum of 80% of their trades focused on the Japan space. We are providing a "pure Japan play" vehicle.

In 2008, nine of our fourteen managers had positive returns and five of those nine managers had double-digit positive returns.

Two issues get discussed everywhere these days - transparency and liquidity. In the Wolver Hill Japan Funds, we do have 100% transparency on over 85% of the funds in our portfolio, and we offer monthly redemptions.

I came to Japan in 1987 and started my financial career in a very unlikely place, at Nihon Kōkan, a Japanese steel company that merged with Kawasaki Steel almost ten years ago. This was a fascinating introduction to a really wonderful country, and I count myself very fortunate and lucky to have spent most of the last 22 years here. It is a wonderful place to live and a great place to do business.

**Yhu Kuni**  
Stats Investment Management

My name is Kuni, and I come from a company called Stats Investment Management. We are an independent investment advisory company in Japan and have recently obtained the investment management license from the Japanese FSA, so we are now a regulated DIM (discretionary investment) manager.

Right now we manage four Japanese hedge funds, and our total AUM is approximately \$70 million. The four funds are very different and are pursuing very different strategies. The largest fund, which is called the Ginga Service Sector Fund, has about \$45 million as of this month (April 2008). The strategy is Japan equity long/short with a sector focus.

The second fund is called Stats T1 Fund and is managed by another fund manager who previously worked as a quant analyst for Deutsche Bank and BNP. This fund has about \$20 million AUM.

The third fund is also a long/short fund, but a bit more long oriented, as here we look at deep value stocks. This fund is called the Ginga Golden Egg Fund.

As I mentioned, our total assets stand at about \$70 million, and as we started out with just \$10 million in 2005, we have been gaining assets on the way - slowly but surely, as it is a very difficult environment.

The Service Sector Fund has been performing very well. The fund obtained double digit returns both in 2007 and 2008 and so far in 2009 the fund is about flat. We are very focused on watching volatility, and we have successfully controlled risk with less than 10% annualized. On a risk-adjusted basis, we feel that the Service Sector Fund is one of the most successful funds in Japan, with a Sharpe ratio of over 1.5.

Right now we have five people in Japan and two people in Singapore. Since we have obtained the DIM license, we plan to integrate the two companies into one in Japan. We plan to implement the new structure probably at the beginning of June.

To add a bit to my personal background, I started my career at Deutsche Bank.

**Shin Matsui**  
Nissay Asset Management

My name is Shin Matsui from Nissay Asset Management. Nissay Asset Management is a subsidiary asset management company of Nippon Life Insurance Company. Nippon Life Insurance Company is one of the largest life insurers in Japan, with assets of about US\$ 480 billion. Nissay Asset Management manages about US\$50 billion.

Nissay Asset Management's alternative investments business provides two different funds of hedge funds in terms of given mandates, and a fundamentally driven Japanese equity market-neutral fund. I represent the fund of hedge funds business side.

One of our funds of hedge funds has a global mandate, which primarily is based on the advice of NLI International Inc., an investment subsidiary (based in New York) of Nippon Life Insurance Company. The other fund of funds has an Asia including Japan focus. Together, we have about \$ 1 billion asset under management on our FoHF business side, with the global FoHF being the larger one with about \$800m.

We had started our first FoHF business back in 2001, and the Asian-focused fund of funds was launched I believe in November 2007, which was not really an ideal time to start an Asian focused product. 2008 was obviously difficult for everybody, and our Asian fund was down 4.5%. Being down was not a good thing of course, but if you compare our return with the equity market or hedge fund index returns during the same period, we believe we have done a decent job.

We have currently 14 managers in our Asian focus fund, four of them are Japanese equity long/short funds. They have driven our FoHF performance up, which in aggregate was dragged down by the Asia ex-Japan managers, unsurprisingly. In terms of allocation, the majority of our portfolio is within the equity long/short space. We have a couple of fixed income and macro-type of managers, and just a few multi-strategy funds.

Regarding my background, for about one year I have been managing the Asian portfolio, and prior to that I was in New York as a member of the team advising Nissay Asset Management on the global fund of funds.

**Yhu Kuni**

We run different funds in our firm, and with the following I will represent the view from the service sector fund. The service sector fund team believes that there has been a recent rally in the Japanese markets, but we fear that this is very short lived. The reason is that none of us believe that fundamentals have improved in Japanese markets, and there is no reason why we should continue buying Japanese stocks.

Right now, the earnings to price levels in Japan seem overpriced versus other markets in the world. We already know that the earnings that will be released, starting from this month onwards, will be very negative. Perhaps prices still haven't integrated some of these bad news yet, but still we feel that bottom-up research is a very good way to generate returns. This is because there are not a lot of competitors - people covering stocks - left in the market. So there are many information gaps between investors. Less competition in the markets will create extreme mispricings, which is the reason why we believe that research is a very good approach to obtain returns on an individual stock level. For the market in general, we are cautious and believe that beta exposure will not be an effective way to achieve returns going forward.

**Ed Rogers**

We agree with Kuni San's views about the market in general. Japan, and we think really all global equity markets are experiencing a bear-market rally at the moment. We believe there is a significant amount of bad news yet to come. Equities globally and here in Japan will share some retrenchment when the bad news comes.

On the other hand, we also believe that Japan remains, as the world's second largest economy, one of the most interesting and attractive places for hedge funds to do business. There are major information inefficiencies due to the downsizing of securities firms here and the lack of primary

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**On the other hand, we also believe that Japan remains, as the world's second largest economy, one of the most interesting and attractive places for hedge funds to do business. There are major information inefficiencies due to the downsizing of securities firms here and the lack of primary research being done. 20 years ago, when I came to Japan, there were probably over 500 listed companies effectively covered by sell-side analysts - maybe even 600 at the peak. Today, I would put that number in the neighborhood of 200-300 at best.**

**The quality of sell-side analysis has also deteriorated as many of the best analysts have moved to open hedge funds.**

**The growth of the hedge fund market here reflects the substantial inefficiencies in the dispersion of information in Japan and across many different types of hedge fund strategies. This includes not just research-based long/short strategies, but also statistical arbitrage, convertible bond arbitrage, event driven trading, merger arbitrage trading.**

**Many of the managers in our portfolio think that this will be their best year since 2005. Keep in mind that from 2006 to 2008 we saw significant redemptions and withdrawals of international funds from Japan, so there was not much value in stock picking when tens of billions of dollars were withdrawn every month from the Japanese market. Given that the international flow of funds out of Japan has probably come to a halt, the country may be down to a domestic market, where fundamental research and stock-picking skills will reap significant rewards.**

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We think TOPIX ends up somewhere between -10% and +5% this year; we might end up a little bit positive or we might end up significantly negative. But we think that the hedge fund space here will enjoy its best performance in four years. Our fund of funds is approximately flat for the year, and we think that it's quite possible to make somewhere between 8% and 12% given some of the positive numbers that we'll see continuing from the underlying funds.

#### Rory Kennedy

I agree with Ed and Kuni - we at UMJ also think that this is a classic bear-market rally. In addition to other developed countries where the fundamentals are only getting worse; Japan also suffers from a paralyzed political situation. With the collapse in exports that Japan has relied on for years for growth and no prospect of a domestic boom any time soon, there are no sustainable reasons for the rally now underway.

However, that being said, we are a true hedge fund so we don't care whether the markets go up or down. Frankly, I am sometimes happy when the market turns down in a month because it allows our fund -which can make money in such markets - to shine.

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One of the reasons why the hedge fund industry in Japan has suffered in comparison to Asia over last year was that there were too many beta players in the market. In a positive-market year, it can be very hard for investors to distinguish between who is delivering alpha and who is just playing the beta. In these difficult times, a true hedge fund manager can demonstrate that with the right tools, you can hedge effectively and still deliver uncorrelated returns.

#### Shinichiro Shiraki

If I look into our own fund of funds, most of the Japan managers have done a really good job for the last two years. Let me give you more details here. Last year, short-biased managers, neutral, and also the long biased made money in our fund of funds. If you look back a bit to 2005 or 2004,

then we only had the long-managers; and in 2006 or 2007, many of the long-managers probably made a loss.

The point I want to make is that the market conditions have actually trained those managers. Therefore for an investor, the situation has changed and is completely different to just a few years earlier. We are now able to diversify different sources of returns, and that is why we are quite optimistic about the Japanese hedge funds or the industry in general.

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**Also the Asuka Japanese commodity CTA that I mentioned is doing quite well. They did 14% last year and were positive in 2007. As it is focused on Japanese commodity futures, the correlation to the U.S. CTAs is just 0.1. This CTA demonstrates that Japan has deep markets even outside its equities that should be taken into consideration.**

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**Matthias Knab**

**Chris or Koichi, you have been servicing the Japanese market for many years and can add an unique perspective. Can you share some of your observations with us?**

**Chris Wells**

As others have suggested, over the last few years a lot of foreign capital has left Japan, and that capital departure appears to be coming to the end of its cycle. Apart from that, firms who set up investment advisory offices several years ago are now shutting those advisory offices down. I don't know if this is a good idea or not, however those offices were set up to look for opportunities in the Japanese market for investments, and the circumstances have clearly changed. Another observation I can share is that at the moment, there is an almost entire dearth of transactional activity in the market. There is an occasional M&A transaction or strategic investment, but virtually no significant transactional activity.

All of the securitization activity has dried up. This global financial crisis is in fact probably worse for Japan than it is for many other countries, because historically Japan is – and this is to some extent true of China now – highly dependent on debt capital. When you have any kind of disruption of debt capital flow, this has a big impact across the entire economy.

Some industries are suffering terribly, for example the auto and auto parts industry are in very serious trouble. They will probably end up being helped by the government, just as they are being helped elsewhere. But the issues here are really nothing compared to the other areas that are highly capital dependent – I am talking here about real estate in particular.

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A week ago, I was speaking with a director at a major trust bank about their views on Japanese real estate valuation. That person is a real estate appraiser, and I was sort of kidding around saying it looks like their market is down 30-45%, or something like that. He looked me in the eye and said "my estimate is that across the national economy of Japan, real estate has declined 50% in value". 50% - well, that puts virtually every REIT in Japan underwater. Maybe a few of the top REITs can argue that they have some equity left in them, but if these valuations are true, the number is very small as most are leveraged at least at the 50% level...

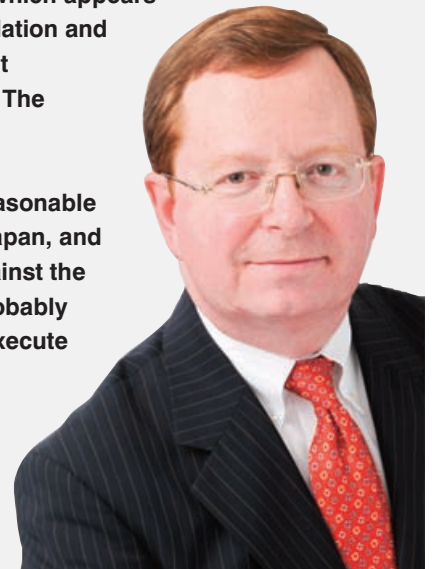
The real estate market in Japan is a very important market, both economically and psychologically.

However, we have a couple of dark clouds on the hedge fund horizon. One of them, which appears to have passed like a storm for the hedge funds that are still around, is Japan's regulation and reporting of short selling. In late October and November, some of the most significant reporting requirements in Asia were imposed on funds trading the Japanese market. The rules were extended at the end of March and they will continue through July.

These rules pick up almost everything that the recent IOSCO report suggested as reasonable measures to control short selling. But thanks to the far-sightedness of the Bank of Japan, and a number of mid and senior managers of the Bank of Japan who argued strongly against the politicians and the FSA, we did not have a total short selling ban in Japan. This is probably good news for the people around this table, as the real hedge funds will be able to execute their strategies, and market price discovery will not be impaired.

But we should never forget that politicians are the biggest obfuscators in the world, and price discovery is not a priority for them.

Chris Wells



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The real estate market in Japan is a very important market, both economically and psychologically. If you have 50% decline in real estate values across the entire country – less perhaps in Tokyo, more maybe some other places – that is going to have an ongoing impact. We will see what is going to happen during the rest of this year. People tell me that if the real economy continues to decline, then rent rolls will decline, then the cash flows to service REIT debt – which is the only

thing supporting the debt advanced to the REITS and to the private funds – will start to decline.

Unless there is a recovery by the fourth quarter in the real economy, it will be inevitable that cash flow servicing to the debt on highly leverage REITs will fail and foreclosures will follow, even if you assume that the FSA and the Bank of Japan don't insist on mark to market valuation of REIT portfolios, because if they insist on mark to market before the next fiscal period, which is September 30, there would be huge impairment losses amongst the major Japanese banks.

The banks are challenged. I believe that one bank is going to show a loss this quarter. A couple of other banks are still saying that they are making money, and true, they do benefit from very large positive spread on new loans advanced, which means they have a nice cash flow. It is a wonderful business if you happen to have money. When you talk to the Bank of Japan and others, this is what they point to: "we have healthy banks, we are not America, we don't have to have the government subsidize us, our banks were careful, etc."

The problem is the other shoe hasn't dropped yet regarding failing bank loans, there may be another 12 months ahead of us before that happens fully. Luckily for people in the hedge fund space, they are watching the macro factors as they aim to make money in bad and good markets.

Who do we see entering the markets at this time? We see a couple of firms coming in to do arbitrage strategies. The short-term NPL market is picking up again, just like in 2002, with people buying short-term assets from issuers like banks and other credit companies. There is also some, although fairly subdued, activity in the M&A space, which I guess will probably pick up in the remainder of the year.

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But we should never forget that politicians are the biggest obfuscators in the world, and price discovery is not a priority for them, and neither is it for many sectors of the government, including the Ministry of Transportation and others who are very worried about the public perception of Japanese issuers. So further short selling regulation remains a possibility

With no securitization going on and only modest capital market activity, the real question for the Japanese economy is: where will debt be coming from going forward? There are some good signs there. The Development Bank of Japan, which had been marginalized for almost a decade, is now back in action. It is receiving funds and improving its programs to support the Japanese industry. I believe we will see government-led activity following the stimulus program that has just been passed, but again, the next 12-18 months will be tough for Japan's macro economy.

## **Koichi Shijima**

There is one aspect which can have a positive effect on the markets. If you look at the long-only funds, I believe they are mostly underweight Japan equities, I don't think that they are over-weighted; some may be neutral, but we will see what happens when people reposition their weighting.

2005 was a booming year for the Japanese hedge fund market. So actually already from 2006 onwards, the Japanese hedge fund managers had to cope with market turbulences, which hit hedge fund managers in other regions only in 2008. You can say that the managers outside of Japan are



starting to face similar problems that Japan faced from 2006 onwards. Therefore, it can be argued that Japan, or the Japan hedge fund managers who survived up until this point, are actually ahead of other markets and are therefore in a relatively good position.

When I speak with various investors, the cash is not moving yet, but they are starting to show more interest in Japan than before. Japanese strategies are heavily focused on equities - listed securities - whereas many hedge fund managers in other parts went into the illiquid space and side pockets when the market got crowded. Japan managers didn't have to do that. This also includes the fund of funds level - a Japan fund of funds can easily provide liquidity and also transparency with the listed securities.

An important development regarding new Japanese managers is that while previously a lot of the emerging hedge fund managers came from the long-only space, whereas now you have talent

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**An important development regarding new Japanese managers is that while previously a lot of the emerging hedge fund managers came from the long-only space, whereas now you have talent coming also from other sectors. This includes for example talented traders from the prop desk of an investment bank who move into hedge funds, which adds another different color. In the past, these people did not join hedge funds, but now they are out there.**

**Therefore, the diversification of Japan-focused hedge fund strategies will continue. We will see more derivatives and volatility type trading strategies, as some very interesting people with experience in those kinds of markets are coming out with or within hedge funds.**

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Therefore, the diversification of Japan-focused hedge fund strategies will continue. We will see more derivatives and volatility type trading strategies, as some very interesting people with experience in those kinds of markets are coming out with or within hedge funds. There is of course the challenge to get seeding or funding, as there isn't a lot of capital flowing at the moment.

Looking at some global data points, the total AUM of Japan-centric hedge funds is only about 2% to 3% of the whole hedge fund market, and if you add Asia including Japan, the number may be somewhere around 5%. I would think with the continued influx of top people into our space, at some point the AUM of Japan strategies can grow versus the global market.

## Ed Rogers

Shijima-san raised a great point here. Looking back at 2001 and 2005 when I worked in prime services at Deutsche Bank, I interviewed more than 100 Japan startup managers. By and large they were one-trick ponies with long-only analyst or portfolio management backgrounds.

What we're seeing right now is completely different. We are in discussions with five different hedge fund startups. Each one is formed by two or three principals with a Managing Director level background, and they have five to ten million dollars of their own money to startup with, whereas normally people here used to start with somewhere between one and five million dollars, and that was their entire net worth.

So, not only do we see a much greater diversity in the types of hedge fund strategies offered in the Japan investment realm for hedge funds, but we are seeing far more credible start-up businesses.

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**So, not only do we see a much greater diversity in the types of hedge fund strategies offered in the Japan investment realm for hedge funds, but we are seeing far more credible start-up businesses. They are far fewer in number, but their business experience, their ability to manage a fund, trading background etc. is much more developed. I cannot stress enough how important that is, and I believe this is very good news for investors.**

**Approximately 50 Japan specific hedge funds have gone out of business in the last 18 months. These funds were almost all in long/short and probably in the bottom quartile when it comes to performance. We think those funds will be replaced with ten to fifteen managers that will be much better at producing absolute returns.**

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## Shin Matsui

If you took a look on a portfolio of any typical Japan hedge fund back in 2005, everybody was long-biased, in particular small cap. Long small caps and short TOPIX, that was in essence what most people were doing.

So when Manager A was up, you had a good chance that managers B, C, D and E were up too, as there seems to have been little differentiation in terms of the stock picking effect. No matter how many managers you refer to, everybody was up. And when Manager A was down, you had a good chance of almost everybody was down as well at the same time, when you really needed a diversification benefit. The risk here was of course that as an investor, you thought you created a diversified portfolio by spreading your bets across let's say five managers, however it did not work

as you hoped as they were all correlated by investing in the same manner. But particularly from last year onwards, we could observe a much higher dispersion among the managers' returns. From an allocator perspective, the benefit of putting money across several managers in order to get diversification seems to have started to work. On the other hand, if you

**Starting out particularly from last year onwards, we could observe a much higher dispersion among the managers' returns. From an allocator perspective, the benefit of putting money across several managers in order to get diversification seems to have started to work. On the other hand, if you compare the situation in Asian ex-Japan with Japanese equity long short funds, the former seems to be more or less in the same situation as the Japanese were back in 2006. As it is likely the case that most hedge fund investors are now less keen on taking beta risk of Asian equity markets through their hedge fund holdings, Japanese managers' return profile may have a good chance to look appealing to them from now on.**

**In my personal view though, one of the biggest challenges for Japanese hedge fund managers when trying to attract foreign investors money going forward is probably the language barrier. Few of them can be regarded to be excellent when it comes to presentation skills, particularly when compared with US based managers, for example...**

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In my personal view though, one of the biggest challenges for Japanese hedge fund managers when trying to attract foreign investors money going forward is probably the language barrier. Few of them can be regarded to be excellent when it comes to presentation skills, particularly when compared with US based managers, for example...

As a matter of fact, in 2008 - for the first time since 2005 - Japan-based Japanese equity long/short managers on average have probably outperformed Japan-focused funds which are managed outside Japan. After having suffered a depressing environment for such a long time, the surviving Japanese managers (based in Japan) seem to have been well trained in terms of better portfolio management and how to deal with a bear market, and now also having a local footprint clearly played in their favor last year. So assuming they develop better presentation skills, there should be a good chance that they can attract attention from a wider audience, taking advantage of their recent track records.

### **Rory Kennedy**

In my firm we ha've helped some Japanese managers to start up and I completely agree with the language barrier that Shin mentions, let me elaborate a bit on that. If you go to Hong Kong, Singapore, Beijing, or to Shanghai, you will meet many Asian managers and the one thing they will have in common is that they will be fluent in English, and typically will have been educated in the U.S. or U.K.

In Japan, a typical prospective hedge fund manager would be someone in his mid 40s and therefore, the time he (and its nearly always a he) became an investment professional, was when Japan was still experiencing its boom period. At that time, young Japanese financial professionals didn't go overseas to learn English in the U.S. because they didn't need to, as Japan was large enough for a rewarding career.

So when some foreign investors come to Japan to meet with the managers here, sometimes there seems to be a perception that "if every other manager in Asia speaks English well and this Japanese doesn't, perhaps this manager may be less smart than the others?" Obviously,

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So when some foreign investors come to Japan to meet with the managers here, sometimes there seems to be a perception that "if every other manager in Asia speaks English well and this Japanese doesn't, perhaps this manager may be less smart than the others?" Obviously, performance results count and not all Japanese managers may be confronted with such a perception, but I think communication levels have been a major barrier for many Japanese managers.

I think language will continue to be a barrier in Japan, so my advice to prospective Japanese managers is that they need to improve their English if they want to attract outside money from outside of Japan.

Research has shown that while the AUM of Asian-focused hedge funds tends to be higher if the managers have been based in centers of hedge funds allocators - like the U.K. or the U.S., the performance of the locally based managers tends to be higher. So in other words, those who are closest to the investors tend to get more assets but the performance of the managers who are nearer their markets where they are investing tends to be higher.

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Also adding to Shin's other point about the location of the manager: research has shown that while the AUM of Asian-focused hedge funds tends to be higher if the managers have been based in centers of hedge funds allocators - like the U.K. or the U.S., the performance of the locally based managers tends to be higher. So in other words, those who are closest to the investors tend to get more assets but the performance of the managers who are nearer their markets where they are investing tends to be higher.

Perhaps one of the big changes in the hedge fund industry will be that the name of the manager and how much AUM he may have amassed will become less important relative to the track record of that manager and that can only benefit the specialist and boutique managers close to their markets.

### Ed Rogers

We have a thesis that actually supports and sums up a lot of what has been said: Japan's biggest problem is that it is the second largest economy in the world. As the second largest economy, the vast majority of investment professionals active here, who for example work at Nomura, Daiwa or any other domestic firm, never had to learn English.

They had deep and rich investment careers, managing tens of billions of dollars - all domestic



money, all with domestic Japanese clients, and no one ever had to speak a word of English. In almost every other country in the world investment professionals have had to learn English to participate in the global economy and run multi-billion dollar investment or trading vehicles.

We don't think that will change so quickly. Japan will be one of the largest, if not the second largest economy in the world, for some time to come. The internally driven market dynamics will continue to allow career development that does not include learning English. This creates an ongoing advantage for local intermediaries like us - fund of funds that are bilingual and able to access managers in Japanese. If you're an investor and want to access all Japanese hedge funds, then you have to have Japanese language abilities. History clearly shows that very few foreigners will take the time needed to acquire that skill.

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#### Rory Kennedy

But for the Japanese hedge fund manager, the reason why they still need to learn English is to get off the ground from their initial capital stage. Even in order to get to 30, 40, 50 million dollars AUM, they need to rely on foreign investors, because typically the Japanese institutional investors won't invest without a significant track record and a certain size of assets under management. In order to get to the point where they can even get Japanese institutional money, they have to attract foreign money first which frequently won't speak Japanese.

#### Yhu Kuni

Just to defend the poor who don't speak any English... language doesn't necessarily correlate to performance. I think performance should be a more important test when investors choose investments. Not to say that language isn't important, but many funds that have great marketers, who speak great English, still do not collect assets. In the end, it is performance that speaks more than words.

Ed is right that traditionally Japan has been a very easy environment where Japanese long-only managers have historically collected assets just from Japanese institutions. Now the world has changed. We need to raise assets from foreigners, so in many cases a language barrier for Japanese managers exists.

#### Chris Wells

This language issue also has another aspect. I have seen many foreign managers, from large groups, come to Japan and hire people who spoke good English as opposed to hiring primarily on the skill set required for the particular position. As time passed, there have been a lot of disappointments in that regard. I think the underlying issue here is actually a weakness of the recruiting process, and a lack of willingness to actually understand the Japanese market and try to sincerely integrate and interface with the Japanese market.

I always give compliance officers, or even visiting business people that come here, the advice that when they visit the FSA, or for any relevant meeting, to hire a translator. You want to

communicate, if you want to talk to a decision maker with influence, it is very unlikely for these people to speak English. This holds true virtually across the board.

Maybe the 30 major allocators have a capability of English, beyond that - none, and there are issues even among those 30. So it is much cheaper and easier for you to hire a translator for two hours and actually have your message clearly formulated.

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**As I said before, some Japanese that are hired to staff foreign offices are hired primarily for their English speaking skills. They are not necessarily persuasive or influential and may be viewed as mavericks in their own society in part because they went somewhere else to learn English. Foreign firms need to focus first on expertise rather than mere communication skills.**

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But going forward, I think this is changing. There is a new generation of younger Japanese that were also in part brought up within foreign investment banks and similar environments. The situation will change and improve to some extent over the next decade or two. In general, Japan is a much more international place than it was 20 years ago. And finally, the desire and importance of speaking English is much better understood by young Japanese through the magic of the internet.

#### **Koichi Shijima**

I am not sure that here at this table we will have a definite consensus regarding the English skills, so allow me to come back to finance for a moment. We know that a lot of Japanese financial institutions, pension funds and so on have a lot of cash. The Japan FSA said in their "Hedge Fund Survey Results (2006)" about \$80 billion of Japanese assets would be in hedge funds, but I would guess that this number really was more like \$150 billion at the peak, when hedge fund assets were at around \$1.9 trillion. This is still less than 10% of the whole hedge fund AUM. So if you are a hedge fund and you want to raise assets, would it be a good plan to target only this less than 10% universe, or would you be going after the \$1.9 trillion? From that perspective, language does sometimes become an issue if you want to raise or get access to more pools of cash.

#### **Chris Wells**

At the moment, a number of overseas managers are visiting Japanese institutions, looking for funding and think that the Japanese must be ready to invest money merely because they have it, whereas it is not there some other places.

I think it is time for a big reality check for these people traveling here. From what I know and what I have heard, the allocators here are very much in shell shock. It takes time to get over the terrible losses they have suffered over the past year, especially in Japan as a consensus-based society. It takes time for allocators to realize how much they really have lost. A lot of investment staff aren't even telling their bosses how bad it is - so the losses are going to take a while to flow through - and they certainly don't want to tell their ultimate investors or shareholders about how much was lost.

But for the reasons we discussed at the beginning, it remains a compelling story for Japanese capital to go out of Japan. Where will it go? Well, it will go into fixed income which is where Japanese investors always prefer to put it, it might go into infrastructure, but inevitably, investors who diversify abroad will put some money into the hedge fund space.

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**More than has been true for a long time, the ability to compete for that money is much more equal today than before, because with the recent events, the shine has come off of the big name hedge fund managers. I believe that Japanese allocators, who traditionally tend to be pretty picky consumers concerned with name value, have lost this type of fixation on brands and perceived reputation. While before they may have been blinded by the light of the big famous asset managers or hedge fund names, now it matters less, all names are more equal. The question for managers will be, how did you do last quarter? Where are you going? How good are you at communicating where you are going? Do we fully understand your strategy?**

**I have been told that some of the big allocators in Japan are starting completely from ground zero in this space. Every single fund investment is undergoing a review, evaluation and benchmarking in a way that wasn't done previously.**

**Chris Wells**



Now, those managers receiving these funds can be foreign or Japanese, they can be famous firms or they can be unknowns. More than has been true for a long time, the ability to compete for that money is much more equal today than before, because with the recent events, the shine has come off of the big name hedge fund managers. I believe that Japanese allocators, who traditionally tend to be pretty picky consumers concerned with name value, have lost this type of fixation on brands and perceived reputation. While before they may have been blinded by the light of the big famous asset managers or hedge fund names, now it matters less, all names are more equal. The question for managers will be, how did you do last quarter? Where are you going? How good are you at communicating where you are going? Do we fully understand your strategy?

I have been told that some of the big allocators in Japan are starting completely from ground zero in this space. Every single fund investment is undergoing a review, evaluation and benchmarking in a way that wasn't done previously. The last eight or nine years were a market of sellers, in other words, the allocators were sold products, but now it seems they understand the need to act more like investors. More than in the past the big allocators will be thoughtful about how they allocate their resources, they will be less prone to brand value and more focused on performance, capital conservation, volatility and other risk-related data.

**Matthias Knab**

**Let's look at funding and asset flows for a moment. We have here two new funds that were able to get going in this tough environment and secured funding. You are even growing your assets - can you share with us who is investing, where is the money coming from?**

Regarding their Japan exposure, some have told me they are in a situation where they are ready to invest once the dust has settled and can see who is still standing. It looks like the industry is now at a point where redemptions have globally slowed down, almost to a trickle, because most of the money which needed to come out has come out, and we are down to just professional investors left in the game. It will be those investors who made profits over the last few years who will be the first back into Japan.

A lot of the attention goes to the bigger managers but what typically happens when the manager gets to a large size, say \$500+ million, they often start to expand and take on new managers under the same brand name. But those people are not the same guy you invested with in the first place.

I think allocators should be happy when a fund tells them "I only want to raise \$500 million or a billion dollars, I don't intend to become \$5 billion dollar firm, and that way I will concentrate on your investment and not on just growing my business".

I agree with the other observation that offering liquidity is absolutely critical at the moment. There is no room for debate on liquidity any more. The hedge fund industry in Japan was already fairly liquid, and has become even more so. Monthly is now the standard.

Rory Kennedy



#### Rory Kennedy

Since our Kotoshiro fund launched about five months ago, we have been fortunate to have trebled its assets to over \$30 million. The money at this time is coming from allocators who are rather close to our own home base, i.e. Asian-based fund of funds and family offices. We have seen attention coming particularly from the more nimble fund of funds who took profits in Japan in late 2005 and then moved into ex-Japan Asia in 2006 from where they then correctly redeemed in 2007 & 2008 and are now holding a large percentage in cash.

Regarding their Japan exposure, some have told me they are in a situation where they are ready to invest once the dust has settled and can see who is still standing. It looks like the industry is now at a point where redemptions have globally slowed down, almost to a trickle, because most of the money which needed to come out has come out, and we are down to just professional investors left in the game. It will be those investors who made profits over the last few years who will be the first back into Japan.

There has been a lot of talk in the industry about how global assets have shrunk from \$1.9 trillion down to \$1 trillion or whatever the current size is. Frankly, for new funds such as ours, that doesn't matter, as the institutional investors who are putting several billion dollars into hedge funds are most likely not investing into emerging funds anyway. You have to get to institutional size, and as Chris has pointed out, brand name doesn't guarantee performance. In fact, that's clearly the case now - it has been shown in hedge fund industry research but often ignored: that AUM size has been inversely related to performance.

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## Yhu Kuni

There is definitely a survivorship benefit right now. There used to be about 120 hedge funds in Japan, and now the number has shrunk to about 60, or maybe less. However, the funds that are still surviving in this market are all making money. Funds that have survived this crash are in a very favorable situation.

Most investors are probably underweight Japan. If they raise their allocation, the new investments will go to funds that have survived, that are making money, and where the investor believes they will still continue to make money in the future. So for asset raising we think we are actually in a very good market right now.

## Shin Matsui

The Japanese equity long/short managers in particular have been providing good liquidity terms to investors. The reason for this is when you want to target Japanese pension funds, regional banks or other institutions, monthly liquidity is pretty much the required norm, and quarterly is the minimum that needs to be offered. Let's say you would ask for a one-year lockup, probably very few pension funds are prepared to accept that in the Japanese context.

**The Japanese equity long/short managers in particular have been providing good liquidity terms to investors. The reason for this is when you want to target Japanese pension funds, regional banks or other institutions, monthly liquidity is pretty much the required norm, and quarterly is the minimum that needs to be offered. I would ask for a one-year lockup, probably very few pension funds are prepared to accept that in the Japanese context.**

**This is different from U.S. pension funds or an endowments situation for example, as according to my understanding they are more prepared to accept longer lock ups. Apart from a small number of managers who got stuck with small or micro caps investments, I have heard of very few Japanese hedge fund managers last year who suspended redemptions, raised the gates or imposed any other sort of restrictions to investors, making a contrast to what has happened in the rest of the world.**

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**I think it has been well known that you have to put more effort into getting Japanese institutional money. But in return, the consensus was that that Japanese money would therefore be "sticky" and would stay longer in your funds.**

**However, I think its very important for people who want to come to Japan in the hopes of raising money to realize a substantial change in this respect. Following poor performance across hedge fund strategies over the last two years, it seems that from now on, you will have to put as much effort or more into raising Japanese money, but it will be no more loyal than any other money in the world. In fact, it may be less loyal because they usually insist on liquidity as well.**

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**In my 22 years in Asia, and particularly in Japan, when you see all the foreigners finally give up and throw in the towel, that's absolutely the bottom of the market. I see that everybody around this table is laughing, because we have all seen it: in 1993, 1994 - when everybody was convinced that Japan was going to fall into the Pacific Ocean and disappear, we saw it in 2001, 2002 with SARS. Each time this has marked the market bottom, and in retrospect was one of the best entry points into Japan and into Asia.**

Ed Rogers



## Ed Rogers

Chris mentioned before that investment advisors and foreign shops, including funds of funds, are closing down their regional presence in Asia. This is noticeable not only in Japan, but throughout Asia. Over the last two years, about 40 foreign firms opened shops in greater Asia, so including Hong Kong and Singapore, and some of them ran quite large shops. About half of them have or will close down over the next six months.

But in my 22 years in Asia, and particularly in Japan, when you see all the foreigners finally give up and throw in the towel, that's absolutely the bottom of the market. I see that everybody around this table is laughing, because we have all seen it: in 1993, 1994 - when everybody was convinced that Japan was going to fall into the Pacific Ocean and disappear, we saw it in 2001, 2002 with SARS. Each time this has marked the market bottom, and in retrospect was one of the best entry points into Japan and into Asia.

## Matthias Knab

**What are the hedging tools available in Japan? How does the infrastructure, the development of hedging tools and derivatives look like?**

## Koichi Shijima

Japan is a very liquid market. The top 200, 300 names in TOPIX for example are liquid in the cash market, and listed index futures are very liquid. You can say that so far, Japan has failed to capture liquidity in listed equity single name options market. However, there is a lot of liquidity on the OTC for these options.

**In Asia, there is no other market that comes even close to Japan in liquidity and depth. Just compare the Nikkei 225 with the Hang Seng 30 stocks; you have maybe ten liquid stocks in Singapore, and maybe 20 in Australia. On top of that, Japan has the largest corporate bond market in Asia and boasts the largest government bond market by multiple factors when compared to other Asian markets.**

**Hong Kong, Singapore, Australia, Taiwan, Korea - no other regional equity market turns over more than \$5 or \$6 billion a day, whereas Japan, even after four years of extreme draw-downs, turns over \$20-25 billion a day in notional value in the equities. There are still over 250 companies here with convertible bond issuance. You couldn't get more than 20 in any other market in Asia.**

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**Ed Rogers**

In Asia, there is no other market that comes even close to Japan in liquidity and depth. Just compare the Nikkei 225 with the Hang Seng 30 stocks; you have maybe ten liquid stocks in Singapore, and maybe 20 in Australia. On top of that, Japan has the largest corporate bond market in Asia and boasts the largest government bond market by multiple factors when compared to other Asian markets.

Hong Kong, Singapore, Australia, Taiwan, Korea - no other regional equity market turns over more than \$5 or \$6 billion a day, whereas Japan, even after four years of extreme draw-downs, turns over \$20-25 billion a day in notional value in the equities. There are still over 250 companies here with convertible bond issuance. You couldn't get more than 20 in any other market in Asia.

Some of the other markets may have their own particular strengths like the single stock options in India or the derivatives market in Korea, but if an investor is looking for a place to put multiple billions of dollars into an Asian market with liquidity and depth of product offering, then Japan should be the number one choice.

**Shinichiro Shiraki**

I happen to have some numbers: Japan has almost triple or four times the daily trading volume for 30 core stocks compared to Korea or Hong Kong. That is very attractive to long/short managers. There may not be deep secondary markets for debt, but generally for fixed income, the JGB is very deep as well.

**Chris Wells**

A short comment here on the exchange landscape - there are lots of exchanges in Japan, not just one. The Osaka Stock Exchange is the futures and options market, and one can argue that they struggle along because they are a second market which theoretically is located in a different city, although most of their operations are in Tokyo.

I think that the single stock option market did not develop in Japan in part because American investment banks have little interest in developing a transparent and low cost options exchange market when at the same time they were trading very large numbers of OTC derivative contracts. They knew they could never own the options market, but they had a real monopoly on exotic derivative strategies and so-called "basket trading".

Japan is also the deepest Asian market for stock lending. The accessibility, inventory, and safety of the transfers in the domestic market for Japanese issuers is very high. The market displays a high concentration of few, well-capitalized institutions, with good technology and increasingly centralized and automated systems for moving those volumes.

Sometimes you can hear some criticism regarding the Tokyo Stock Exchange and its ability to handle large volumes or some legacy issues. I believe those are being addressed.

People who come to Japan from elsewhere in Asia have almost nothing but compliments for the Japanese trading environment. The technology is here, there is healthy competition amongst prime brokers, people get very good financing terms, and the markets have a robust infrastructure and strong service mentality. Regarding compliance, monitoring and accountability, Japan has possibly the best developed and toughest infrastructure globally. It is a great place to come to do business.

**Shin Matsui**

There is also no doubt that the borrowing costs for Japanese stocks are much cheaper than any other Asian market. While single stock options may not be available, the inventory of stocks for shorting is much more abundant than anywhere else in Asia.

**Matthias Knab**

**We have some funds here at this Roundtable who are up for 2008 and also for 2009. Could you tell us how you achieved that?**

**Yhu Kuni**

We have been generating returns for the last three years, half from the short side and half from long. This shows that the availability of the shorts is not an issue in Japan and the lending fees

have been cut quite dramatically, it is very easy to obtain shorts at very cheap prices right now.

### Rory Kennedy

Shorting and hedging is very straightforward in Japan, certainly from the long-short perspective. The depth of the stock loan market and the professionalism of the prime brokers and trading desks involved is extremely high.

We have also benefited in that over the last couple of years, some global players did not really try to set up the full prime brokerage business here but rather concentrated just on stock lending, which they are able to offer therefore at rock bottom rates, because they are international banks. There is a very healthy competition here.

### Ed Rogers

I can speak very directly to this, because we get full transparency from all of our underlying managers as to what their GC (general collateral) borrowing rates are. For the five years that I spent at Deutsche Bank, I had an insider's view on competitive GC rates throughout Asia.

In a place like Korea or India, you would easily pay 1%, 2%, or 3% for what you would consider an easy to borrow/GC name: a liquid, deeply traded stock. In Japan, the tier one customers might pay as low as 15 or 20 basis points for the easiest to borrow names. Even a small hedge fund is not going to get charged more than 40 or 45 basis points; so Japan is a very cheap, easy, liquid market for stock borrows.

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**This is important not only for the long/shorts managers. As I noted earlier, five of our fourteen managers had double-digit positive returns in 2008. This included a statistical arbitrage fund and a convertible bond arbitrage fund. To run these strategies successfully, you have to be able to borrow shares.**

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### Chris Wells

Many clients tell me that Japan is the only place in Asia where you can run certain strategies. There really are no other markets that have the same depth of liquidity and access to financing. Having said that, if you look at the second section TSE stocks or over-the-counter issuers, it may not be that different than in other places in Asia. While there are also illiquid issues, it is important to realize that in absolute numbers, there are many more liquid issues here than elsewhere in the region.

Accountability is another strength. There are quite vast areas of Asia where you are never really sure what it means when you get a trade...People may say that the Japanese legal infrastructure is not transparent, but a lot of people do depend on it as it is, and it serves them well. Contracts are honored, people know what their obligations are, and the government stands behind people honoring those are obligations. In fact, in some ways, it is more predictable than New York these days.



We have not mentioned Forex here. You can get virtually any Forex strategy overlay that you want in the Tokyo market. There are three or four major dealers across all major currencies in this market. You have Yen, Euro, Dollar, and many other currencies in huge volumes against the Yen. There are liquid markets for Yen across all major Asia regional currencies, because Japanese companies have access to those currencies. Japanese FOREX is another very sophisticated market, maybe only in Hong Kong can you get an equivalent level of products and service.

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**Chris Wells**



**Ed Rogers**

I was in foreign exchange trading for eight years - that was my first job after working at NKK. Chris raises a very important point when you consider Japan relative to other countries in Asia like India, China or non-delivery forward market such as Korea and Taiwan. An essential fact which many foreign investors seem to miss is that there is almost always a foreign exchange component to trading or investing in a hedge fund in Asia. Yet we see almost no significant due diligence on the underlying hedge fund's ability to manage their foreign exchange exposures.

At my firm, we read about maybe 300 or 250 investor letters a month now - not just Japan but Pan-Asia - and we have never once read a newsletter where a hedge fund sticks up its hand and says "oops, we made a foreign exchange hedging error, and that cost you 5% last month." But I can guarantee you that this happens at least once a quarter.

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**That said, the liquidity of Yen foreign exchange, swaps and futures contracts is unparalleled in Asia. The ability of the Japanese hedge fund managers to cheaply and efficiently hedge foreign exchange risk is far higher than any other currency regime in Asia.**

**In any other markets - for example India, where some hedge funds had an enormous run in 2007-2008 - when you look at the attribution analysis you can find cases where 40%-50% of returns were just currency movement.**

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In any other markets - for example India, where some hedge funds had an enormous run in 2007-2008 - when you look at the attribution analysis you can find cases where 40%-50% of returns were just currency movement. Most Indian hedge funds were purposefully unhedged in their currency exposure so while you thought you were investing in an equity hedge fund really you were investing in a one way currency bet. Do you want to pay for that as an investor?

### Rory Kennedy

Right, this is something that should be disclosed more and should perhaps become a greater part of the AIMA due diligence template document. There are some simple questions on hedging in that document but not enough. When people think of currency hedging, they may relate to it at the share class level, but often not on the portfolio level itself. Hedging is very

**Another hedging tool which has not been mentioned so far is the use of synthetic exposure. Synthetic portfolio exposure via OTC derivatives is very common in Japan. All major prime brokers offer extensive synthetic exposure for trading strategies such as stat arb, sector swaps and portfolio swaps.**

**In other places like India, portfolio derivatives may be used to simply get access to the market but here in Japan it serves as an entire, massive hedging tool. Even if short selling rules become tighter in Japan, you would still be able to manage some sort of hedging using synthetic exposure through the prime brokers who “own” the portfolios but give the manager the return (either positive or negative) on the instrument created.**

Rory Kennedy



important for us at the portfolio as well the investor level. We keep a very tight daily view on it.

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### Matthias Knab

**Sometimes I come across hedge fund managers who left Japan to trade and live in Singapore, and some of them quote regulatory and taxation issues can be quite burdensome in Japan. Any comments on that?**

### Chris Wells

The Japanese government has had a program for the last two years, with a lot of positive effort and intent by the head of the FSA and others, trying to attract some of those managers back.

Many of those managers went to Singapore or Hong Kong, but their hearts are still in Tokyo, meaning it is still the best trading jurisdiction for them. They are not trading Singapore from Singapore. They might do a little India and they might do a little China, but they are trading Japan from Singapore and they are trading Japan from Hong Kong.

They have their order execution and management function for regulatory reasons and tax reasons in Singapore or Hong Kong, and Singapore and Hong Kong have done a good job of making it easy for them to be there and attracting them. But most or many of them are still trading the Japanese market; its the one they know, the one they love, the one they have confidence in. If they could be back in Japan with the same tax and regulatory merits, they would be back here in a second. We have seen only a very few Japanese nationals who manage funds migrate abroad, relative to the people that manage equities in the Japanese space. We have seen many more foreigners move there. There are some individual tax reasons for that, which are fair enough. Japan is a very high tax environment, but I believe that the closer you are to the flame (the Tokyo market), the warmer you will be, or put another way, the hotter you will be.

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Chris Wells



On the other hand, you are also more likely to get burnt, and that is the other part that you ask about, the Japanese regulatory policy. I believe that FSA, especially the Examination Division of the FSA these days is way more sophisticated than it was five years ago, and way more sophisticated than it was in 1998 during the first inspections.

I also believe that management, particularly foreign management of hedge funds or regulated intermediaries here, especially the foreign individuals, are more knowledgeable about regulatory matters, and this is true of their Japanese counterparts too. There is more compliance work and much more access to training programs than in prior years. Today, people in Tokyo know what the rules are. That doesn't mean that they don't occasionally go over the line, but summing up, the market is much better regulated and more knowledgeable about where the line is than was the case at the time of the Big Bang in 1997.

The Examination Division has been criticized, but it has taken that criticism on board - not happily perhaps, but right from the top-down. Starting with the Commissioner, there has been a significant effort to improve things, to take on the criticism, and to try make sure the examiners are more fair and less confrontational than they were previously. There has been a great commitment to better understand the industry.

Also, the industry has been less contemptuous of regulators in their interactions than at a certain time in the past. Intermediaries are more willing to educate regulators and inspectors, explaining to inspectors why some things might look a certain way, but that they are not really the evil things the inspectors may be thinking.

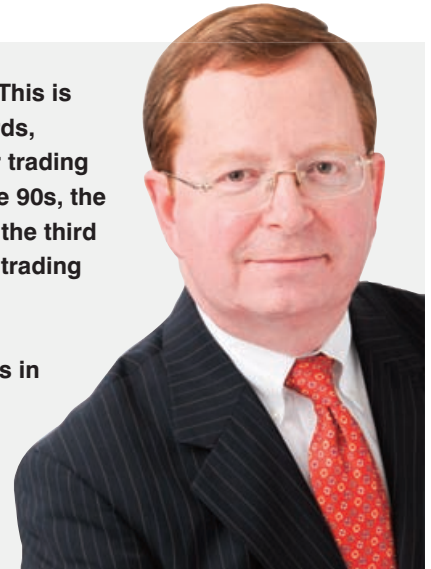
There are still areas of concern. Perhaps the hottest one currently is insider trading. This is what I call the third wave of Japanese regulatory attention: basic compliance standards, market manipulation, insider trading. In a sophisticated environment, you see insider trading enforcement

emerge after you clean up the basic issues. There was a wave in the late 90s, the first wave of financial inspection, there was a wave in 2002 to 2004, and now there is the third wave which deals with a much more sophisticated and harder to prove set of market trading abuses.

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**This in fact means that Japan is a very good environment. It is much safer than it was in 2002. If managers want to avoid Japan because they are afraid of obeying the law, those who obey the law will be happy here, and I think investors will be happy as well.**

**Chris Wells**



This in fact means that Japan is a very good environment. It is much safer than it was in 2002. If managers want to avoid Japan because they are afraid of obeying the law, those who obey the law will be happy here, and I think investors will be happy as well. When you have happy managers, happy investors - and of course this never happens - add to that a happy regulator, then people will do a good business. So if you look at this closely, I think Japan actually is leading from a position of strength. Other jurisdictions that are more casual about regulation may have more volumes, but in the longer run they may not have the best franchise.

Having said that, these other jurisdictions are clearly giving Japan a run for its money, and the lack of transparency and English language and other things in Japan is clearly holding it back vis-à-vis Hong Kong, Singapore, and potentially Shanghai. But the game is not up, Japan is still a good place to be, and I think that will continue for a while. I don't think the race will be over for another decade.

**Matthias Knab**

**What is the progress of these campaigns to make Tokyo the "London of Asia"?**

**Chris Wells**

I am a great admirer of Commissioner Sato. I think he is a visionary regulator, as good as anybody that the U.S. or UK has produced in the last two decades. Unfortunately, I just think he might have gotten on the wrong train with the plan to make Japan a financial center that he has pressed ahead with over the past 24 months. He went to London and he thought London was a great example for Japan for the future, but unfortunately, his vision and plans hit a wall in the financial crisis. It is fine to make the financial services sector a leading sector within Japan, but if you look at London now and what it's likely future is, I wonder whether that is where Japan wants to go. There have been lots of jobs lost in London and there is no immediate likelihood that those will be recovered. If Japan had been going that way over the last decade, there would be a lot more people out of work here now.

However, a lot of progress has been made, and interestingly, the Japanese Government has not given up on their vision for Japan as a global financial center. While other jurisdictions might have dumped such a plan overboard quickly in view of the financial crisis, that is not the case here and we still see on the FSA website commitment to the plan to make Japan a major financial center within Asia and globally. Personally, I am not terribly optimistic about that, but it's nice that they're still committed.



## Ed Rogers

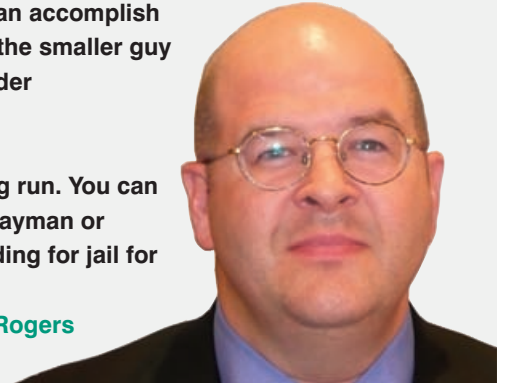
First I would like to point out that the regulatory environment in Japan is actually highly developed in favor of hedge funds right now. When it comes to strategy, I believe the Japanese regulators have taken the long view on this project. Japan does not really care about these one or two years of dislocation. (As a side note, at Rogers Investment Advisors we think five years from now we will see more than twice as many assets in the hedge funds globally than we had at the peak in 2007. It will be a \$4 or \$5 trillion industry, if not even bigger.)

**First I would like to point out that the regulatory environment in Japan is actually highly developed in favor of hedge funds right now. When it comes to strategy, I believe the Japanese regulators have taken the long view on this project. Japan does not really care about these one or two years of dislocation.**

**The Japanese are thinking - as they always do – about long term competitiveness. They want to be the financial hedge fund capital of Asia and they have set up a structure that can accomplish that. Under the FIEL, the only thing that's missing is to give a little bit of aid to the smaller guy - the investment advisor who has only \$100, \$200 or \$300 million in assets under management.**

**The current regulatory regime is still pretty flexible and put in place for the long run. You can live and manage funds in Japan, and still use offshore fund structures in the Cayman or other tax friendly jurisdictions, and you don't have to feel that you may be heading for jail for that or that you would be doing something illegal.**

Ed Rogers



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The FIEL regulations are written for the multi-billion firms, not for the start-up firms - they had forgotten that the billion dollar guys usually start as startup guys. Not everybody starts out like Eric Mindich with \$3.5 billion; in fact, nobody does anymore.

The current regulatory regime is still pretty flexible and put in place for the long run. You can live and manage funds in Japan, and still use offshore fund structures in the Cayman or other tax friendly jurisdictions, and you don't have to feel that you may be heading for jail for that or that you would be doing something illegal.

Japan has set up a very clear road how, over the next 5-10 years, they will be structured to be the financial services capital of Asia. We believe that Singapore, Hong Kong and Shanghai will all be remain important region financial centers, but the depth of opportunities in Japan, and sound regulatory and political environment, will facilitate Tokyo as the premier financial center in Asia. As I explained before, the missing link is a structure within the FIEL to facilitate start-up managers.

If an intermediary step to the DIM license would be available, my guess is that 40 or 50 managers would be back in Japan next week, and those are not just foreigners by the way. We have also seen some good 15 to 20 Japanese managers who moved offshore on the back of these regulations as well.

## Shinichiro Shiraki

Our firm is one of the few fully registered DIM (discretionary investment manager) who also run a hedge fund. Our firm and our products are registered here, we are based in Tokyo, we do not have any trading office outside the country, and therefore we have to pay the full tax here in Japan, it is a high tax.

We see this as the cost we have to pay to be a reliable financial company here in Japan. About once every one or two years the FSA inspectors come and for their visit, this part of being an

independent Japanese fund management company.

You have to have in mind that the politicians and regulators also aim to build Japan as an attractive and reliable investment destination for the foreign investor in order to attract foreign cash. I believe this is a good focus, and we agree it is a good idea to make Japan a leading and reliable financial platform in Asia.

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**Shinichiro Shiraki**



### **Rory Kennedy**

We can be considered an emerging manager. We have the advisor office in Tokyo and the hedge fund investment management office in Singapore, which is very common for Japanese hedge funds.

So typically, people have set-up in Hong Kong and Singapore, because they felt there is a regulatory "light" regime, rather than Japan, which is seen to be the big bad wolf of the region, with a very big stick and not very much carrot... However, you can already see that across Asia this regulatory spread is becoming narrower.

Singapore has already come in for inspections to every single hedge fund based there; they demand more documentation and that they may walk in at anytime, and I am sure Hong Kong will do the same. As everyone knows across the world, the trend is towards increased regulation, not less. And to the extent that this spread narrows, Japan will become less unattractive. I would not say attractive from a regulatory point of view, but less unattractive in the beauty parade of where people are going to set-up. It will be interesting to see what is going to happen in future.

**Many people have set-up in Hong Kong and Singapore, because they felt there is a regulatory "light" regime, rather than Japan, which is seen to be the big bad wolf of the region holding a very big stick and not much carrot... However, post- Madoff, you can already see that across Asia this regulatory arbitrage is becoming narrower.**

**For example, Singapore is currently planning to inspect every single hedge fund in Singapore and I expect Hong Kong will do something similar. As everyone here is well aware, the global trend is towards more regulation not less. And to the extent that this "spread" narrows, Japan will become a little less unattractive in the beauty parade of where people are going to set-up.**

**Rory Kennedy**



### **Chris Wells**

I would like to comment on the perception about the view that Japan's FSA has about its own success. In the international context, I think they feel and express the view, not by tooting their own horn, but modestly they do politely say that they got it right. For example you hear the view *"we didn't have a Madoff here, we have reliable trustees, administrators, and custodians, our system with investment advisors and discretionary managers is tougher, and given what happened in the financial crisis our carefulness was the right thing (compared to elsewhere). We didn't have*

*most of the huge problems experienced elsewhere, and the result is that our banks are still solvent. Because of that we haven't had to nationalize (or semi-nationalize) them. We tried to be balanced, we did require a disclosure regime for offshore managers that had Japanese money in them under Article 63, and we think we fine tuned it right. We are in control and know where we are going—other jurisdictions have a bankrupt regulatory policy and no direction for the future.”*

*“We got right what the SEC didn't “get” at all, and as a result we have a real systemic sense of where our market is, which other regulators don't. Other regulators didn't know (and still don't know) anything about which investors were in their markets, whereas we knew, through Article 63 and other regulation, how much systemic exposure there was here throughout the crises.”*

We used to get a lot of criticism about how conservative we were, but not any more.

Of course as a regulator, the FSA may also feel that they need more transparency and reporting - regulators always love to have more - but these various regulations were put in place in a very deliberative and careful manner, and they got a lot of it right.

Whether that will last or not, I don't know, but Japanese regulators feel very proud of the regulatory progress they have made.

## Ed Rogers

As a fund of funds that has made investments in Hong Kong, Singapore, London, and Australia headquartered managers trading into Japan, we have actually had to look at each and every regulatory regime. I think across the board in Asia, regulators have actually done a very good job in the hedge fund space, frankly they lead the global regulatory environment. This is a very clear and easy comparison to make.

The level of problems that you see in many cases is directly related to the level of disclosures and frankly, to the abilities and smartness of the regulators in understanding what they are looking at. When I was at Deutsche Bank and was managing the swaps book for four years, I would have regular visits from the regulatory authorities in Japan. There has been a clear progression of knowledge on the part of the regulators and as Chris said, a much less hostile attitude over time has developed.

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**The Australians probably do one of the best jobs of any regulators in the world. The government literally does background checks before they give you a license to run a fund management company. Hong Kong's licensing regime for asset management companies is similarly quite strict.**

**Singapore may have been referred to as "regulation light", but the Singaporeans actually have a very good idea what is going on and why they want the finance sector. The real issues are back in the United States as far as it lacks regulatory procedures. It is often confusing to me and a little bit discomfoting when I tell U.S. based investors that I run an Asia focused fund of funds and they still claim that "Asia is Wild West", while the U.S. regulators failed to catch Bernie Madoff, allowed Enron and Worldcom to happen, and presided over a fairly dramatic banking collapse...**

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The fact of the matter is, if you compare the regulations in Asia and Europe against the U.S. - maybe this is because of the smaller size of the markets, because of the fact that the hedge fund industry developed much later - there is a lot more application of best practices throughout Asia, and we all benefit from that as investors.

**The expertise regarding hedge funds on the side of the regulators also makes a difference. It has become clear that this was missing at the SEC in America. There were too many SEC people with a legal background and not enough from a financial background. In Japan, there has always been a respect towards the regulator because they do carry a big stick. Over the last six to eight months, the regulators here have done intensive inspections of many local hedge funds - often to learn more about the industry. Hedge funds in Japan are very much aware that they need to abide by the rules and that there are very severe penalties for breaking those rules. In this current environment, it should be reassuring for foreign investors reading this to know that Japan has always had a strict compliance environment and does not need to play catch-up with other jurisdictions around the world.**

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