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Hedge fund offerings for retail investors

Nomura Research Institute, Ltd.

Hedge fund-like investment trusts were first offered to individual investors in the second half of the 1990s, and assets under management have grown steadily ever since. Retail investors now have access to a widening array of hedge fund strategies, and the market is deepening.

Hedge fund-like investment trusts for retail investors

Until recently, only institutional investors such as pension funds and financial institutions had access to hedge funds in Japan. Institutional investors have steadily expanded their investments in these funds, driven by an extended period of historically low interest rates and a growing need for diversification. Meanwhile, a dearth of information, limited access, and large required investments have made it difficult for retail investors to purchase hedge funds.

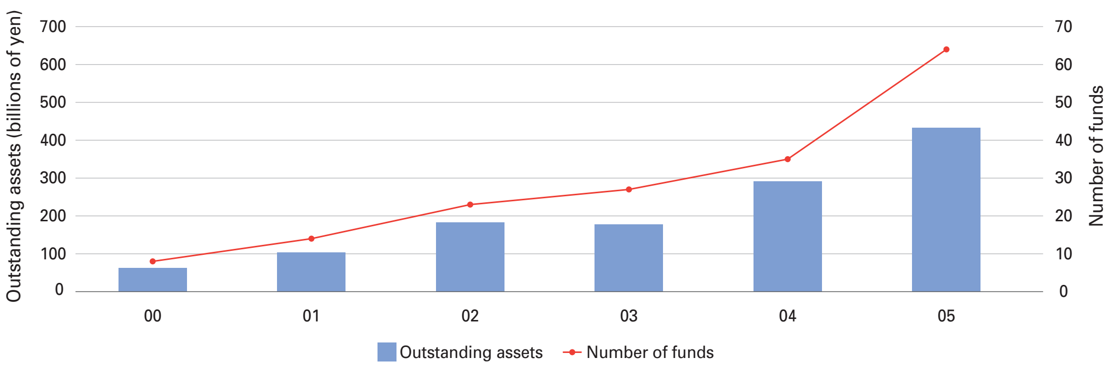
But investment trusts utilizing techniques similar to those applied by hedge funds were introduced in the second half of the 1990s, and the assets they manage have gradually grown. According to an FSA survey published in December 2005,[1)] sales of hedge funds to retail investors have increased more than tenfold over the past five years. This contrasts with five- or six-fold growth in sales to financial institutions and corporate clients over the same period.

This report surveys hedge fund investments by retail investors, who have a smaller profile than institutions but have greatly expanded their market presence over the past few years.

Growing market for hedge fund-like investment trusts

Based on data on public open-end investment trusts based in Japan and overseas and sold in Japan, we estimate that hedge fund-like investment trusts open to retail investors managed about 430 billion yen at the end of March 2006.[2)] In other words, assets have grown more than six-fold in the five years since end-March 2000, when they stood at 70 billion yen. At the end of March 2006, there were 64 such funds with outstanding assets of at least 1 billion yen, a number up eight-fold in the past five years. Hedge fund-like investment trusts for retail investors have clearly exhibited robust growth compared with all open-end investment trusts, at which assets outstanding grew just 70% during this period.

Exhibit 1. Hedge fund-like investment trusts for retail investors, FY00–05



Wider range of hedge fund strategies now available

In the past few years a wider range of strategies have become available to retail investors. At the end of FY00, when outstanding assets in all hedge fund-like investment trusts open to individual investors were still less than 100 billion yen, about 40% of the funds employed long/short strategies (Exhibit 2). However, the percentage of funds pursuing market-neutral strategies, which are designed to be unaffected by market fluctuations, increased as the stock market fell in FY01 and FY02. More recently, as stocks began to recover in FY03, market-neutral strategies gave way to global macro strategies and commodity index-linked funds. At the end of FY05, 24% of these trusts followed market-neutral strategies, 23% global macro strategies, and 19% long/short strategies, resulting in a much more balanced market (Exhibit 2). In short, the market has broadened not only in terms of outstanding assets and the number of funds available, but also in the variety of investment strategies.

Fund selection and funds of funds

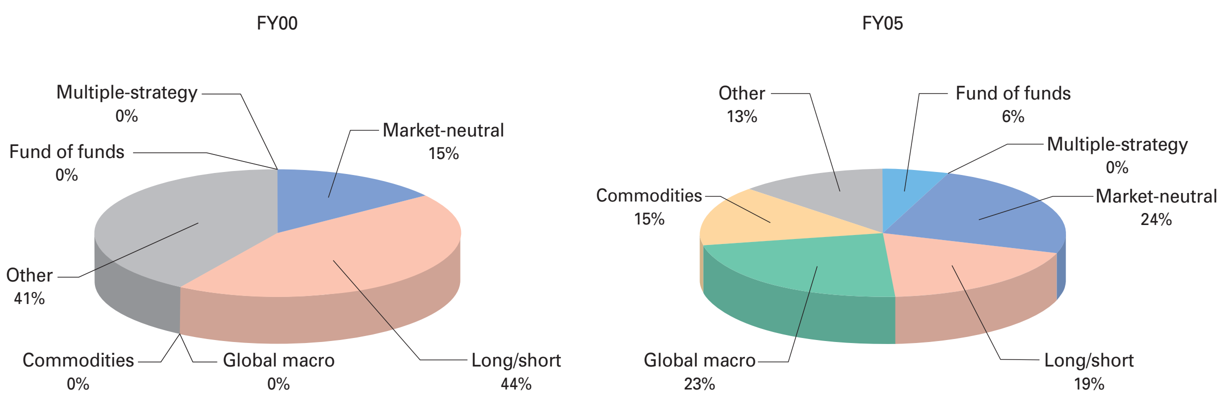
As noted above, the widening selection of hedge funds open to retail investors is a welcome development. But at the same time it has made it more difficult for individuals—who do not have the resources of institutions—to select an investment strategy, and in particular to select a specific fund.

The problem is compounded by the fact that hedge fund-like investment trusts, which typically seek absolute returns independent of market movements, tend to rely more on manager skill for their performance than ordinary investment trusts. Although the wide variety of funds available today means generalizations should be avoided, the performance of ordinary funds depends far more on overall market performance. When we estimated the fluctuations in excess returns as a percentage of fluctuations in total returns at investment trusts, we found it to be about 20% at ordinary domestic equity investment trusts compared with more than 90% at hedge funds. This result underlines the extreme reliance of hedge fund performance on manager ability.[3)]

Given the heavy impact of fund selection on performance and the growing difficulty of selecting funds, one useful option for individual investors may be to purchase funds of funds or funds linked to hedge fund indices.

Funds of funds typically offer smaller minimum investments than individual hedge funds, facilitate the diversification of investments across a number of funds, and entrust fund selection to professionals. At present, such funds are frequently used by institutional investors. But we think their product characteristics will lead to greater acceptance among retail investors going forward.

Exhibit 2. Market share of hedge fund-like investment trusts, by strategy



Note

1) *Summary of Hedge Fund Survey and Related Issues*, published by the FSA in December 2005.

2) Our estimates used qualitative judgments based on NRI (Fundmark) categories and prospectuses available on fund web sites. The estimates include funds linked to commodity indices and hedge fund indices.

3) Because Japan has relatively few hedge fund-like investment trusts, we used the Lipper TASS database to calculate the excess return of market-neutral funds relative to LIBOR over the past three years and used this figure in our calculations. For domestic equity investment trusts, we used the NRI database to calculate the excess return earned by domestic equity/general/flexible funds relative to TOPIX over the past three years.

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