Implications of Hedge Funds on Indian Capital Market

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Abstract

In spite of tall claims that Hedge Funds have been demystified, the fact remains a big segment of the investment community is not aware of the risk return permutations that this asset class has to offer. Hedge fund is not a new terminology for those tracking Indian Capital market at least for the last 10 years. The interesting part has been the increased acceptance (even by the regulator) of their presence, in spite of the fact they are not permitted to *invest* in Indian markets. The impact which these funds can have on the financial stability could be substantial – but like any other coin it has positives and negatives. The Monetary Policy of 2007-08 gave a never-before opportunity to Hedge Funds- Access to the Indian HNI's and Institutional investor's share of Portfolio Pie. The paper investigates the impact of Hedge Funds on emerging Indian financial markets as well as the possible implications of marketing of hedge funds in India. The paper is an attempt to tread down the lightly traveled path named Hedge Funds.

Investment is about asset classes. As an investor grows in size and experience his appetite for newer risk-return matrix increases. Then the need for an asset class which is not related to the equity and bond markets emerges. Hedge Funds form an important asset class under the alternative investments category. Its significance is escalated considering the other options in the alternative investment class- Venture Capital, Private Equity, Real Estate or Commodities. Most of these are constrained by the illiquidity or long term horizon during which they invest.

The participants in a capital market can be classified into the *buy* side (who buy the services offered in a capital market) and the *sell* side (who provide the services). The paper looks at the implications of the Hedge Funds on both the *buy* side and *sell* side as well as on the financial market itself. The rest of the paper is organized in the following manner- Section I provides an introduction to Hedge Funds as an asset class, Section II provides the role India has to play in the Hedge Fund story, Section III highlights the implications on the financial market and its participants and Section IV concludes the paper.

Section I

Necessity is the mother of Invention- Hedge funds developed due to the need of high-end investors to generate absolute positive returns not co-related to the market returns. Thus it served an important purpose of portfolio diversification and assured returns during adverse market conditions.

A Hedge Fund can be defined as a privately-held, privately-managed investment fund. They are unregulated pools of money managed by an investment advisor, the hedge fund manager, who has a great deal of flexibility and is motivated by performance based fees. In particular, hedge fund managers typically have the right to have short positions, to borrow, and to make extensive use of derivatives (from plain vanilla options to exotic instruments). In contrast to other pooled investment vehicles, hedge funds use extensive short selling, leverage and derivatives. Though financial institutions and banks also use these operations, the key difference key difference is that hedge funds do not have any restrictions on the type of instruments or strategies they can use owing to their unregulated or lightly regulated nature.

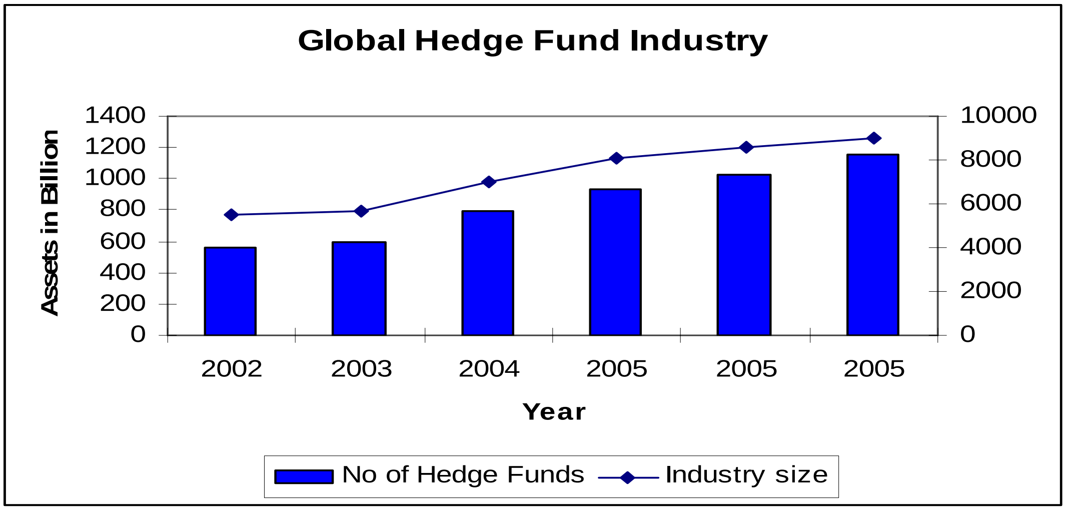
The term Hedge Funds itself is debatable. As a result one could find terms like ‘Sophisticated Alternative Investment Vehicles’ by European Parliament and ‘Highly Leveraged Institutions’ by The Basel Committee on Banking Supervision (BCBS).

The following are the major characteristics of Hedge Funds:

- The hedge funds are Private limited corporations or partnership thus limiting the regulation.
- Around 70% of these are domiciled in locations like Cayman Islands, Luxemburg, Bahamas etc to avail the benefits of minimum regulatory intervention and favourable tax treatment, while the Hedge Fund managers operate in International Financial Centres.
- The manager’s fees (which could be as high as 20%) are closely co-related to the performance of the fund.
- The investors in Hedge Funds are High Networth Individuals (HNIs), Pension Funds, Endowment Funds etc. There exist minimum investments caps which limit retail investors from entering into these funds and ceiling on number of investors.

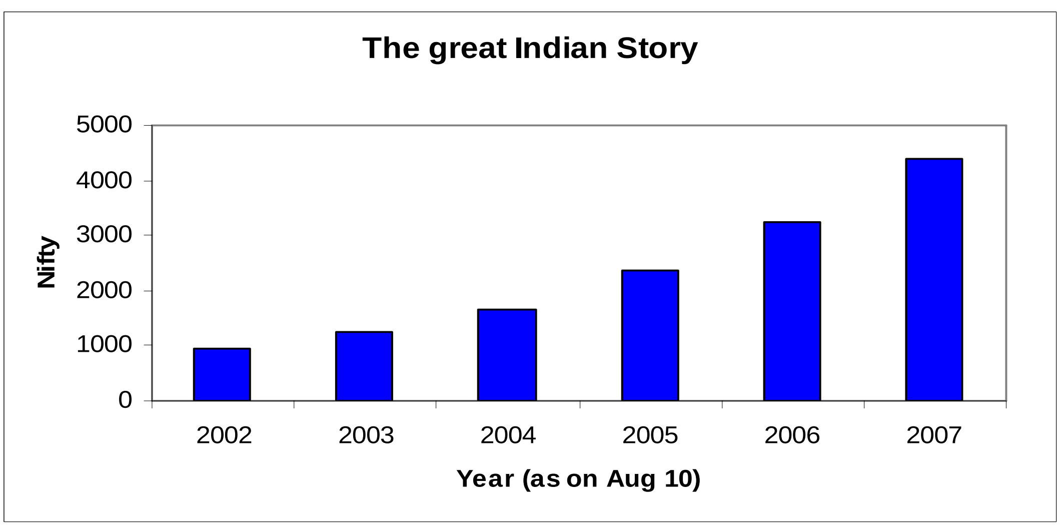
Section II

Ironically, Hedge Funds came to limelight with the LTCM debacle. In 1998, investors across the globe took notice of this investment arena, with more awe and curiosity than enthusiasm. Hedge funds have become one of the fastest growing asset class- from an asset size $50 Billion in 1990 to around $1.6 Trillion today.



Source: Hedge Fund Organization

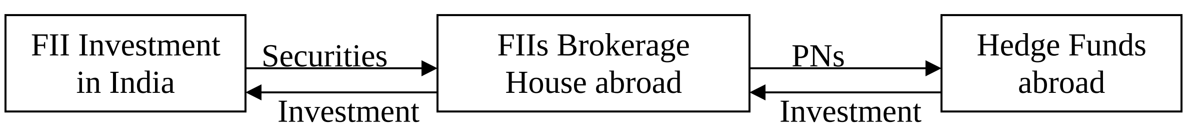
India, of late has been an integral part of investment strategy of the hedge funds. The phenomenal rise in the asset size and consistent returns can be significantly attributed to investment by these funds in emerging markets like India. The very term Hedge Funds had made Securities and Exchange Board of India (SEBI) uncomfortable. As time passed by, along with other market participants even the regulator accepted that Hedge Funds played an important role in the Indian capital market; either because they had risen to such a level that any decision to limit them could have grave consequences or SEBI couldn't figure how much of FIIs Hedge Funds are.



Though one can't say how much of the growth is backed by corporate earnings and how much due to the directional take of hedge funds, market participants agree that a significant part of the story can attributed to the inflow of the hedge fund investments in the form of the FIIs, resulting in surging stock prices.

Hedge Fund Investment in India

Foreign Institutional Investors (FIIs) have to get themselves registered before they can deal in Indian securities. Registered FIIs can also register sub-accounts which are trading accounts created by FIIs on behalf of their clients. One of the qualifying criteria for being recognized as a FII is that it should be regulated at its place of incorporation or operations. Since most hedge funds are not regulated in their home country, they do not qualify for registration as an FII under SEBI's regulations. Thus the Hedge funds use FIIs as an intermediary to access the Indian Capital Market using instruments called *Participatory Notes (PNs)*. Even if they qualify to be an FII they prefer this route as being a FII makes them face numerous regulations (This explains why in spite of SEBI allowing their registration, most funds have not turned up yet). The following figure explains the movement of hedge fund corpus into India:



Investing through PNs has its own pros and cons. Through PNs, the investor (Hedge Fund) circumvents the regulators, but at a cost. The cost of transaction through this route could be as high as 4% of the traded value as against .15% incurred by registered FIIs.

Section III

The Indian Capital market and its participants are affected due to the impact of such investments on the volatility of stock prices, the risk associated for the brokerage houses and the impact on the corporate.

At the same time, Hedge Funds also have certain advantages. Market Participants, regulators and investors have finally started accepting the significance of Speculation and the resulting arbitrage in capital markets. Every market participant brings in liquidity to the market-so does Hedge Funds. The underlying of their diverse investment strategies is to capitalize on arbitrage opportunities in the market (except for directional strategies). Given, that they thrive on arbitrage, hedge funds should have played an important role in removing the market inefficiency. It can also be argued that, in this way, hedge funds have contributed to the further integration of financial markets. Hedge Funds bring with them to emerging markets better risk management tools and expertise.

However, there is more to it than what meets the eye. The inherent features of a Hedge Fund- Lack of regulation and transparency Leverage and Derivatives together is a noxious combination.

In a memorable event of the last century, the Prime Minister of Malaysia Dr Mahathir Mohamad called them *Highwaymen of global economy* accusing them of their strategies that led to South-east Asian crisis. Though, there has been numerous studies both supporting as well as refuting his argument, one has to accept that they accepted played a role in aggravating the situation. A similar experience has been felt in the recent Rouble crisis in Russia.

The following part explains how the investment strategies impact different players in the market:

The sell side- Brokers and Financial Institutions

The LTCM debacle exposed the vulnerability of brokerage houses and financial institutions to the hedge fund strategies. In their pursuit of larger market share, brokers and banks often underscore how hedge fund activities can harm them and markets. As a consequence to the losses on leveraged positions, liquidity shortages come into play, which further aggravate the situation. With excessive leverage, even a moderate price swing could force hedge funds to liquidate their leveraged positions to meet margin calls, potentially leading to ripple effects across a number of markets. Thus, leveraged market risk can, if not supported by adequate liquidity reserves or borrowing capacity, force a fund to default on its obligations to prime brokers and other financial institutions. If the fund's size is large, the spill-over effect on markets could be grave. In an environment where the default rate of hedge funds across the globe is 10%, such instances are not difficult to find. The recent example on Sub-prime crisis in US is an apt example.

The short term approach of hedge funds is questioned many a times by the regulators and the retail investors. An inquisitive reasoning would highlight that such strategies are harmful not only for the funds themselves, but also to other financial institutions. With the entry of these fast-moving funds into the market, other institutional players might be forced to realign their investment style to a shorter duration, in order to remain competitive. They would book profits regularly due to the fear of a sudden sell-off by hedge funds. This, in turn, will further boost speculative trading. Every investor/investor class has his/its own risk appetite. For instance, risk taking capability of a mutual fund would be higher than a pension fund. Given an environment, where the market could rise and fall at the will and fancy of the hedge funds, they would not be motivated to remain invested for a long period, which defeats the larger purpose of Investment.

Investors

One would expect India to be considered as a destination for hedge fund investment, rather than a market for raising corpus. With RBI's monetary policy 2007-2008 announced on April 24, hedge funds have come within reach of the Indian market. The RBI announced that it has increased the present limit for individuals for any permitted current or capital account transaction from $50,000 to $100,000 per financial year. Though one would believe that the hedge funds are still not accessible; a closer look at the hedge fund industry would reveal that with increasing number of fund of funds the minimum investment cap is well within the $100,000 mark. Moreover, SEC the regulator in US is no more stringent regarding the maximum cap of 100 investors in a Hedge Fund. Given this, HNIs have an altogether new Risk-Return matrix before them. The bigger question that arises is should RBI be monitoring the flow. Supporters of Hedge Funds claim the investors in these funds are HNIs and Institutional Investors who are well aware of the market scenario, unlike the retail investor. They argue Caveat Emptor or Buyers beware. Though, this would have worked in US, in the Indian scenario one is yet to find mature investing. The wealth being created was the result of investors riding the wave. Thankfully the wave has been in its favour during the last 5 years. One has to understand that, though the Indices are surging, Indian market is still not mature enough. Thus investing in an asset class without virtually any regulation, transparency and disclosure might not be the best step at this stage.

Given that, even SEC is not clear of its policy towards Hedge Funds its Indian counter part should put in a lot of groundwork before hedge funds are marketed freely in India. SEBI should design appropriate framework, paying particular attention to the marketing of these products to ensure that investors are adequately apprised of the associated risks.

Corporate

Hedge funds are an important set of investors for a corporate (especially ones with poor fundamentals and pronounced asymmetries) because of their risk appetite. However, corporations are always in a quandary when issuing capital to these funds. The prime reason being the volatility they bring with them. Private equity investors usually invest with a lock-in period and have a strategic motive behind their investment, while Hedge funds investment in distressed companies have no such restrictions (though investment in hedge funds come with a lock-in period). Private Equity invests to avail normal returns, returns from organic growth of the organization in sales, profits etc. On the other hand Hedge funds look for abnormal returns, asset mis-pricings and purchase with an intension to sell immediately.

Regulation

Regulating hedge funds has been as much in news as hedge funds themselves. The flip side of it is that, the argument for regulation creeps up during adverse situations as well as when the fund is giving absolute returns. The underlying reason behind regulators harping on the issue of regulation is the lack of transparency in the investment strategies. The investors in these funds might not get hold of the true situation of the hedge funds until the fund expires one day- the examples of LTCM, the Amarnath debacle, the recent Bear Stearns can provide useful insight in this regard. The hedge fund managers operate in an environment of extreme leeway with very little answerability, virtually nothing if the fund is attaining its objective (even if it is only postponing an eventuality). The funds argue the 'Caveat Emptor' – given the complexity of the kind of investors and take refuge in loopholes in the law as Investment Advisers Act of 1940.

The appeal for regulation often comes from the ones who are directly impacted by these funds- the investors whose money they play with and the emerging financial markets which they 'devastate'. Different countries have different take on these funds. Some countries refuse their participation while some regulators emphasized on indirect regulation which restrict their operation flexibility by regulating the financial institutions, banks and prime brokers (the latter is true, especially in the European context). However, most regulators today fear taking a big step; as a major move towards regulation could end up devastating the capital market itself, because of their sheer size. Though one can never be sure of the Hedge Fund corpus in India, it is accepted that nearly 35-40% of the FII investments flowing into the country could be hedge fund investments.

Supporters of Hedge Funds argue that the business model of these asset classes is based on their inherent features- Lack of transparency and regulation. Regulation beyond a certain limit could end up leading to the extinction of the asset class itself. At an age where, the number of investors (including retail) has been increasing at a pace never before, regulators worldwide have to decide on the extent upto which regulation would serve the purpose, without affecting the operations of Hedge Funds in a big way. As HNIs and Institutional investors in India start allocating their portfolio to this asset class SEBI has to decide the extent upto which it should creep in. If these products are marketed aggressively, it would be a matter of time before they capture a major pie in the Indian portfolio. In such an instance, the regulator would have to clearly spell out its responsibility with regards the safety of the funds flowing out of the country.

The regime of Participatory Notes could soon wane, if one is to go by the recent steps of SEBI. Though SEBI itself has been in a fix when it comes to Hedge Funds and its guidelines have been lacking consistency. As per recent guideline of SEBI on 30th Jul 2007, the government and SEBI have agreed to allow investors such as Hedge Funds to register directly as FII instead of trading as a client of FII through the PN route. Allowing hedge funds direct entry will help SEBI track the source of funds coming into the capital markets more efficiently. It is next to impossible to track the source of funds coming in through participatory notes. The above step is directed towards increasing transparency with respect to the funds coming in and to reduce the transaction cost for these funds. The step is a means to widen the investor base that can access the Indian Capital Market. However, the biggest two policy makers- SEBI and RBI are at loggerheads with respect to the above; with the latter not in favour of liberalizing the capital inflow.

Section IV - Conclusion

Through Participatory Notes or directly as an FII, the truth is that FIIs are here to stay. SEBI has chipped in at the wrong time. The regulation, if any should have creped in at the initial stages when FII were not of this size; so that the impact on markets would not have been this huge.

At a time, when SEC is grappling to deal with these funds with respect to Investor protection and the impact of their investment on market, SEBI has to realize Hedge Funds is largely a uncharted territory in the Indian context. Even in US, academic work and research is constrained by the lack of data regarding the full impact of these funds. Unlike Mutual funds, tracking and analyzing performance of these funds is constrained by lack of adequate and qualitative data. Though Databases like TASS provide useful insights one cannot ensure the accuracy and totality of the information provided. In the Indian scenario, the situation gets even worst. There is no database tracking these funds investment movements. Even the regulator is not sure of their size. SEBI is faced with a difficult situation of deciding on Hedge Funds and its marketing in India. It would be prudent to drill into the impact at a greater level so as to gauge the possible repercussions of each action.

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