Chapter 1 Introduction

Institutional investors and sophisticated investors have long been interested in hedge funds as alternative investments to traditional portfolios of assets. The continuous change and evolvement of this particular investment vehicle have gained more public understanding and lessen the perception of its mysterious nature. No longer opaque to the general investing public, it is now more accessible for individual investors with growing popularity and interests. Chapter 1 includes the research motive and the research objectives of this thesis.

1.1 Research Motive

The hedge fund industry has experienced enormous growth in the last decade. Based on estimates of the hedge fund advisors Hennessee Group (2004), hedge funds have been growing from as few as 400 funds in 1992 to 8000 today, these hedge funds operate in the United States managing approximately $900 billion in assets. In the next five to ten years, hedge fund assets have been predicted to exceed $1 trillion.

To join the mainstream, Asian hedge fund industry is rapidly developing and steadily changing. The Asian hedge fund advisor Eurekahedge (2004) indicated, the number of hedge funds in Asia has grown from 162 in 2002 to 413 in April 2004 and assets under management from US$14 billion to US$48.5 billion, and in 2003 alone, 97 new funds have been established. These are funds based in Asia with a global investment mandate or those from outside the region with a significant allocation to Asia. The Alternative Investment Management Association (2004) has indicated that Asia-focused hedge funds comprise about 6% of global hedge funds by number and
value, even though Asia-Pacific stock markets represent 14% of market capitalization world-wide.

Hong Kong has maintained its status as a regional financial center in the Asia-Pacific with a more mature market. According to the "World Investment Report 2003" released by the United Nations Conference on Trade and Development, Hong Kong was still the economic hub in Asia for direct foreign investment. Increasing numbers of individuals in Hong Kong have come to view hedge fund as a tool to improve the overall performance of their portfolios while managing risk. This research aims to provide a reference about hedge funds for investors in Taiwan and hence important information for the asset management companies. As Taiwan move towards the opening up of this financial instrument, more and more players will be participating in the market. Due to the likeness of the financial climate in both markets, Taiwan could use existing successful implementations and references in Hong Kong for better preparation for hedge funds to enter.

The aim of this thesis is to provide the hedge fund industry and the general investing public in Taiwan the insightful information of how sophisticated investors in Hong Kong relate to hedge fund investment, to provide more references for individuals’ hedge fund investment decisions and reflections for the industry to improve marketing strategy. A survey is conducted to determine the factors influencing hedge fund selection for sophisticated investors in Hong Kong. In this thesis, the sophisticated investors are regarded to wealthy investors, institutions and financial professionals that have sufficient knowledge and experience with investing and able to evaluate the merits or risks associated to an investment. Furthermore, a discussion of the current market environment and regulatory issues is provided.
The regulatory definition of a sophisticated/accredited investor is not concerned. According to Rule 501 under the U.S. Securities Act of 1933 (http://www.sec.gov/answers/accred.htm), the term “accredited investors” is defined:

“Individuals who have a net worth, or joint worth with their spouse, above $1,000,000, or have income above $200,000 in the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and

Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than $5,000,000 in assets; and many, if not most, employee benefit plans and trusts with more than $5,000,000 in assets.”

1.2 Research Objective

The research objective is to investigate the factors influencing hedge fund investment decision for sophisticated investors in Hong Kong. The first sub-objective is to provide a reliable reference for investors in Taiwan from existing hedge fund market conditions in Hong Kong. Due to the likeness of the financial climate in both markets, Taiwan could use existing successful implementations and references in Hong Kong for better preparation for hedge funds to enter.
The second sub-objective is to evaluate opportunities of hedge funds to investors in Taiwan, hence to provide more exposure and increase investors understanding of this investment vehicle. A section of the literature review is dedicated to what investors should know about hedge funds. From definitions, history, investment strategies, current market opportunities, regulatory issues to the differences between hedge funds and mutual funds.

The third sub-objective is to investigate the marketability of hedge fund in Taiwan based on the analysis of current market environment in Hong Kong. A survey research is conducted to provide the hedge fund industry and the general investing public in Taiwan more insightful information of how sophisticated investors in Hong Kong relate to hedge fund investment.

1.3 Research Question

With progressing transparency of investment activity and structure flexibility, hedge fund has provided investors an attractive investment option. The hedge fund market in Asia appears to have room for further expansion with improving fund investment regulatory environment and increasing availability of different fund products in retail establishments. According to the industry data, more investors are likely to invest in hedge fund. What are the factors manipulating hedge fund investment choices became an important index for the industry and reference for investors in Asia.

The regulations in Taiwan has not yet been opened for the sale and marketing of hedge fund products. How are the investors in Taiwan and the asset management companies to participate in the hedge fund market is crucial once the regulations
loosen. Due to the likeness of the financial market climate to Hong Kong, Taiwan could refer to existing successful examples for better preparation for hedge funds to enter. The research question is to investigate the factors influencing hedge fund selection for sophisticated investors in Hong Kong. In order to provide more relevance on this issue, a survey will be designed to test the most important factors based on the previous researches and surveys conducted by academic scholars and industry professionals.

Up-to-date, not many researches have been focused on determining the factors influencing hedge fund investment choices or selection for individual investors. There are a large quantity of publications today on hedge funds have been introducing this unique investment vehicle. The characteristics of hedge funds are often made with comparisons to mutual funds. The mutual fund has a longer history than the hedge fund and has been widely accepted by the investing public as an investment instrument. Hence, this research will cross-reference the papers reflecting factors influencing both mutual fund and hedge fund investment choices. The following important factors have been identified from previous researches that have influenced investors’ decision regarding making investment choices. Refer to Table 1: Multi-Dimension Constructs of the Factors Influencing Fund Investment Choices.

(1) Investor’s understanding of hedge fund
(2) Expectation of investment return
(3) Expectation of investment risk
(4) Past performance of funds
(5) Level of transparency of funds
(6) Skill and experience of fund managers
Table 1: Multi-Dimension Constructs of the Factors Influencing Fund Investment Choices

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<th>Factors Influencing Fund Choices</th>
<th>Multi-Dimension Constructs/Measurement</th>
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| Investor’s understanding of hedge fund | • Investors knowledge on funds; Alexander, Jones and Nigro (1998)  
  • Investors education; Alexander, Jones and Nigro (1998) |
| Expectation of investment return | • Consistent with prior returns; Schneeweis, Kazemi, and Martin (2001)  
  • Higher Sharpe ratio; Liang (1998)  
  • More dynamic strategies; Liang (1998) |
| Expectation of investment risk | • Consistent with prior volatility; Schneeweis, Kazemi, and Martin (2001)  
  • Lower market risk; Liang (1998)  
  • Provide better risk management; Owen (2000) |
| Past performance of funds | • Higher average monthly returns; Edwards and Gaon (2003)  
  • Higher Sharpe ratios or risk-adjusted returns; Edwards and Gaon (2003)  
  • Performance persistence; Schneeweis, Kazemi, and Martin (2001) |
| Transparency of funds | • Higher levels of transparency and accountability; BARRA Rogers Casey, (2001)  
  • More risk information; BARRA Rogers Casey, (2001)  
  • More information regarding hedge fund advisers on behalf of hedge funds; The Staff Report of the U.S. Securities and Exchanges Commission (2003) |
| Skill and experience of fund managers | • Compensation structure attract more skilled fund managers; Edwards and Gaon (2003)  
  • Fund manager’s investment philosophy and investment performance; The Hennessee Group Survey (2000)  
  • Fund manager pedigree; The Hennessee Group Survey (2000) |