# PREQIN INSIGHT: HEDGE FUNDS IN INDIA

November 2017

alternative assets. intelligent data.

# INVESTING IN INDIA THROUGH A DIFFERENTIATED STRATEGY

- Vineet Sachdeva, **Elysium Investment Advisors**

**How differentiated are you from the other India-focused funds?**
The India story is a long-term story; traditionally it has been a story of stock selection with growth being the driving criteria for investment. Most India funds are long-only funds following either of two approaches:

1. Relative benchmarking by being overweight/underweight to the benchmark
2. Concentrated mid-cap stock-picking approach

Both these strategies carry with them certain inherent risks. These risks include managerial bias in security selection, concentration risk, allocation risk, liquidity risk, information risk and transaction risk amongst others.

Additionally, relative benchmarked strategies tend to move together in market cycles. This characteristic results in periodic investor disappointment in adverse markets cycles. Concentrated strategies, especially focused on mid-caps, have the potential to deliver high returns but these can be very lumpy and volatile (especially during down markets when liquidity dries up in several of the underlying companies).

There are some funds that are focused on the traditional long-short, relative value strategies. Given that shorting is very restrictive in India, it becomes very difficult for managers to effectively build a short book. Therefore, long-short India funds are unable to hedge effectively leading to one-sided, high-beta returns. Also, given the nature of the market, it is not uncommon to see significant short squeezes which also make the returns quite volatile.

Elysium is well differentiated from other India-focused funds. We follow a systematic, non-biased approach to investing in the Indian markets. This helps us in delivering durable returns with low volatility. Elysium uses a combination of proprietary factor-based models and qualitative human inputs to build a long-term, high-quality portfolio. This enables the strategy to consistently generate investment performance across business cycles. We believe we are the only firm that offers this unique style of investing in the Indian markets.

**What is your investment process and portfolio construction mechanism?**
The core of our investing process is to be disciplined and have a low managerial bias. The firm follows a fundamental and rigorous stock selection process based on intensive research. The research focuses on factors that are relevant to the Indian equity market structure. Our investment process can be broken down into five steps:

1. Identify fundamental factors essential in an ideal portfolio
2. Test each of these factors through intensive in-house research
3. Assign weights using proprietary systematic model
4. Test for sector concentration and tail risk
5. A qualitative check for management and governance issues

The systematic portfolio construction method focuses on constructing baskets with different underlying themes. Each of these baskets individually beats the market across longer time periods. We ensure that there is very low correlation between the baskets so that the portfolio delivers superior performance across all market cycles (in addition to long-term performance).

A critical differentiator of our portfolio is that our portfolio is equally weighted, compared to benchmark-weighted portfolio construction for the majority of Indian asset managers. This eliminates bias in allocations and is another key characteristic of our portfolio construction process.

To effectively manage risk and liquidity, we predominantly have exposure to large caps (75-80%) with a smaller exposure to mid-caps (20-25%).

The large-cap strategy (75-80% of the portfolio) prefers firms with conservative financial management, a demonstrated history of operations, quality growth, operating businesses rooted in cash flow and a history of generating consistent shareholder rewards. Due to our rigorous approach, businesses exposed to high degree of regulation, and balance sheet indebtedness, tend to not get selected. This quality-focused orientation leads to a lower beta positioning relative to the market and most peers.

The mid-cap strategy (20-25% of the portfolio) focuses on quality growth companies, which have a history of rewarding shareholders. The qualitative intensity in gauging management quality is higher in the mid-cap strategy, and therefore the bar for selection is much higher. Here again, the focus is on selecting long-term outperformers with very low correlation between them so as to enable sustainable returns. Since inception (2014), the mid-cap strategy has delivered annualized returns (gross in INR) of 31% versus the NSE 500 return of 13%.

Risk management is a critical element in our investment process. Our proprietary risk models serve as an important force in risk identification and mitigation. We seek to minimize risk through diversification, bias elimination and large-cap orientation. Our ears-on-the-ground approach through on-ground presence and extensive relationships with senior management and corporations act as a further differentiator.

**The Indian market is known to be volatile, how do you manage this volatility and risk?**
When managing money in India, one has to ensure robust risk management practices with systems that are equipped to deal with volatility.

The very nature of our portfolio construction process ensures that we have these robust systems in place. Our portfolio is composed of highly liquid stocks with the large-cap portfolio focusing on those companies with an average market cap of around $7bn. The mid-cap portfolio has an average market capitalization of $1bn. Concentration risk, leverage risk and counterparty risk are minimal as we invest in a large number of stocks (average 60), have no borrowing against the portfolio and only use well-established multiple institutional intermediaries to trade with.

For the market neutral strategy, the use of highly liquid options and derivatives allow us to hedge long portfolio against any perceived future risk. Since inception (December 13), our market neutral strategy has delivered returns (gross in INR) of +19% compared to the much more volatile long-only MSCI India which has delivered returns of +11%. This strategy works very well for investors that believe in the India story, but are averse to the high volatility that comes with it. These returns have been achieved with a net of just 2% and no leverage. For investors that are not averse to leverage, this provides a superior return stream with very low volatility and drawdowns.

Over the duration of our investing history, we have encountered numerous periods of volatility. In the Taper Tantrum, May to August 2013, our long-only strategy returned +7% compared to -8% for the index. Between the months of March to August 2015 when the broad market index was down 10%, our long-only strategy returned +3% (INR), while the market neutral returned +13% (INR). In the EM meltdown in January to February 2016 when the broad market index was down 12%; our longs were down only 9.7%, while the market neutral was down only 1.5% (INR). These are just examples of instances when our portfolio has outperformed under extremely trying market conditions.

**As Indian stocks continue to outperform other major stock markets, do you foresee an increased interest from foreign investors in India-focused hedge funds?**
There has been considerable interest over the past few years from foreign investors in India. Given stable macroeconomic conditions, sound regulatory infrastructure and an investor-friendly policy environment, this interest is expected to grow further.

Till now, the majority of the options available to the investors were long-only funds (relative benchmarked and concentrated). For investors that invest in alternatives outside of long-only strategies, there was very limited choice. Recently, India has seen emergence of differentiated funds, both in long-only (systematic, factor based, theme based) and alternatives (long-short, market neutral, stat-arb, HFT). As the market matures, we expect the number of the alternatives to grow further. This will give a wider canvas of investors the ability to participate in the India growth story.

**In your opinion, which strategies will be highly employed by Indian hedge fund managers in the near future?**
As investors investing in India are becoming more sophisticated, they will look for a diversification of strategies in their portfolio. The long bias of the Indian market and the dearth of shorting opportunities have led to a slower evolution of classic hedge fund strategies. Though some of these strategies are employed by prop books and boutique funds (systematic long, CTA, HFT, stat-arb, volatility trading etc.), these will become more mainstream with the evolution of the market.

**How do you see your strategies evolve over the years with the maturing of the Indian hedge fund industry?**
We invest a lot in our strategies and try to continuously evolve with the emerging market scenario. We look at our future evolution across both dimensions – fine-tuning our existing strategies and researching new strategies that will fit into our long-term thinking. We believe that we are just at the beginning of the evolution of the Indian hedge fund industry and therefore we need to keep investing in cutting-edge research to stay ahead of the curve.

**Can you replicate your strategies to other markets?**
It is extremely difficult to identify factors that work in the developed markets and try to replicate them for emerging markets. Our models identify and appropriately size the factors that have worked and are expected to work specifically for the Indian market. Some of these will definitely work for markets that are in similar stages of evolution as ours. However, before we do that a lot of on-ground work needs to go into fine-tuning these models for that specific market. Once we consolidate our India business, we would definitely look to expand to these markets.

**ELYSIUM INVESTMENT ADVISORS**
Vineet Sachdeva is the co-founder and CEO of Elysium Investment Advisors LLP. Established in 2013 in Mumbai, the firm was seeded by Amit Patni, promoter of Patni Computer Systems. Elysium provides investment advisory services to commingled funds and managed accounts investing in the Indian equity market. The firm specialises in factor based systematic investing and advises clients on investing in a long only and a market neutral strategy. Vineet was formerly co-head of DE Shaw in India and has over 20 years' experience in the Indian financial markets. He has an MBA from IIM Lucknow and is a director on several boards.

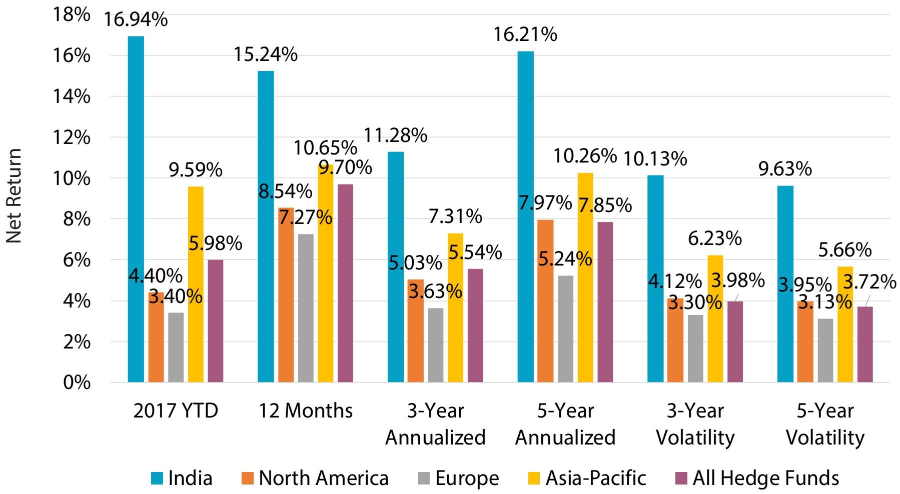
# PERFORMANCE

India-based hedge fund managers have seen significant outperformance across the long and short term compared with both their wider Asia-Pacific-based counterparts and the Preqin All-Strategies Hedge Fund benchmark (Fig. 3.1). India-based fund managers have generated an annualized return of 16.21% over the past five years, and 11.28% over the past three years, but such investments have carried a substantial degree of risk: volatility for these periods is at 9.63% and 10.13% respectively.

H1 2017 has seen India-based hedge funds continue to outperform all main regional benchmarks, achieving their highest return to date (+16.94%). However, while these funds have achieved significantly higher three- and five-year annualized returns than the MSCI Asia-Pacific Index, they have slightly underperformed the public market index over the past 12 months and so far in 2017 (Fig. 3.2).

> ***H1 2017 has seen India-based hedge funds continue to outperform all main regional benchmarks***

### Fig. 3.1: Performance of Hedge Funds by Manager Location*

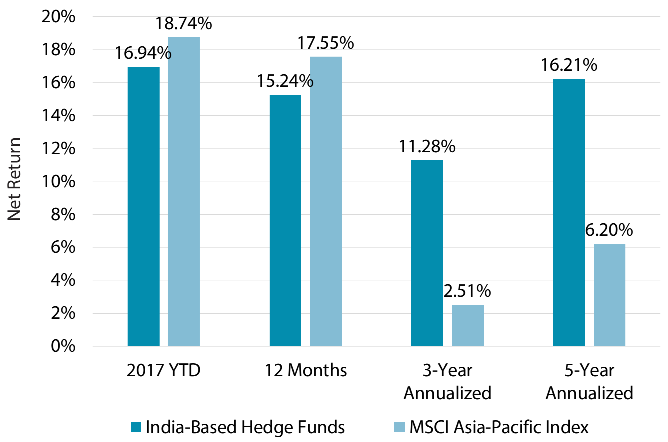



*Source: Preqin Hedge Fund Online*

In terms of hedge fund managers based in the wider Asia-Pacific region, those based in Hong Kong have also performed well over the past 12 months (+13.52%) and in 2017 YTD (+12.58%), as seen in Fig. 3.3; this is likely a reflection of the size of the hedge fund industry in the country and experience of such managers.

### CUMULATIVE NET RETURNS OF INDIA-BASED HEDGE FUNDS IN 2016*


### Fig. 3.2: Performance of India-Based Hedge Funds vs. MSCI Asia-Pacific Index*




*Source: Preqin Hedge Fund Online*

### Fig. 3.3: Asia-Pacific-Based Hedge Fund Performance by Manager Location*

| 2017 YTD | 12 Months | 3-Year Annualized | 5-Year Annualized |
|---|---|---|---|
| India 16.94% | India 15.24% | India 11.28% | India 16.21% |
| Hong Kong 12.58% | Hong Kong 13.52% | Japan 7.32% | Japan 11.11% |
| Singapore 9.38% | Japan 13.06% | Hong Kong 6.71% | Australia 9.95% |
| Japan 6.66% | Singapore 7.86% | Australia 6.68% | Hong Kong 9.63% |
| Australia 4.05% | Australia 6.74% | Singapore 5.65% | Singapore 8.28% |

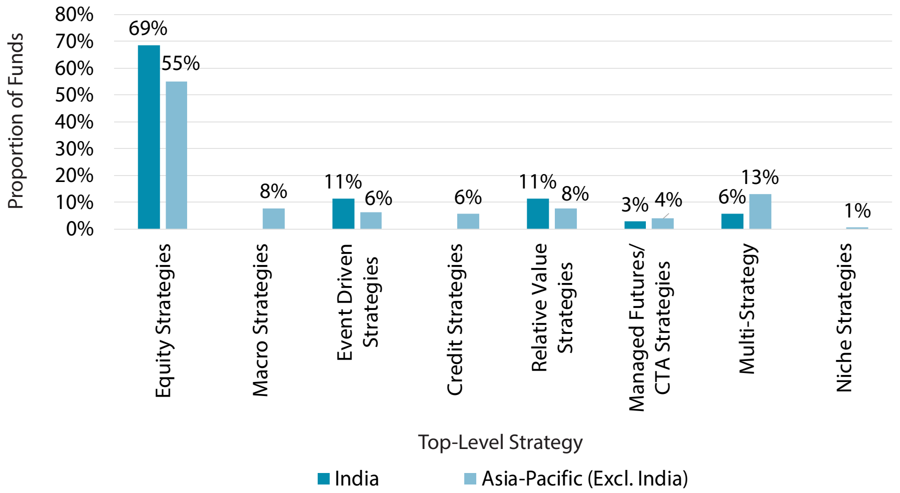
*Source: Preqin Hedge Fund Online*

**Please note, all performance information includes preliminary data for July 2017 based upon returns reported to Preqin in early August 2017. Although stated trends and comparisons are not expected to alter significantly, final benchmark values are subject to change.*

# FUND MANAGERS

There are currently 46 hedge fund managers active in India, collectively managing $1.4bn in AUM. These managers represent 4% of all Asia-Pacific-based hedge fund managers and just 1% of total regional assets; in contrast, Hong Kong-based managers represent the largest proportion of total hedge fund managers (39%) and assets (41%) in Asia-Pacific.

**Fig. 3.4: Asia-Pacific-Based Hedge Funds by Top-Level Strategy and Manager Location**




*Source: Preqin Hedge Fund Online*

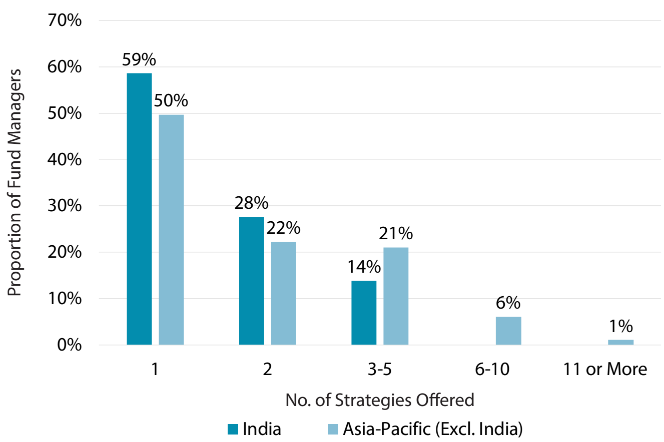
## STRATEGIES

The majority of active India-based hedge funds employ equity strategies, a trend seen in the wider Asia-Pacific region as well as in the global industry (Fig. 3.4). Event driven and relative value strategies are more prevalent among India-based managers, while more hedge fund managers based elsewhere in Asia-Pacific seek to diversify their offerings by operating multi-strategy funds. In contrast with fund managers in the wider Asia-Pacific region, India-based hedge funds do not offer macro, credit or niche strategies.

On average, hedge funds based in Asia-Pacific (excluding India) provide a slightly more diverse product offering than India-based managers (Fig. 3.5). While the majority (59%) of India-based fund managers offer one core strategy to investors, only 14% offer three or more core strategies, compared with 28% of managers based elsewhere in Asia-Pacific. This could reflect one of two things: as the market is still in its infancy, India-based hedge fund managers specialize in fewer strategies as they seek to build up their capabilities in the market before moving to employ other, perhaps more complex, strategies; or, with the market opportunities in India fairly limited to other regions (outside India), this may result in fewer opportunities for different products.

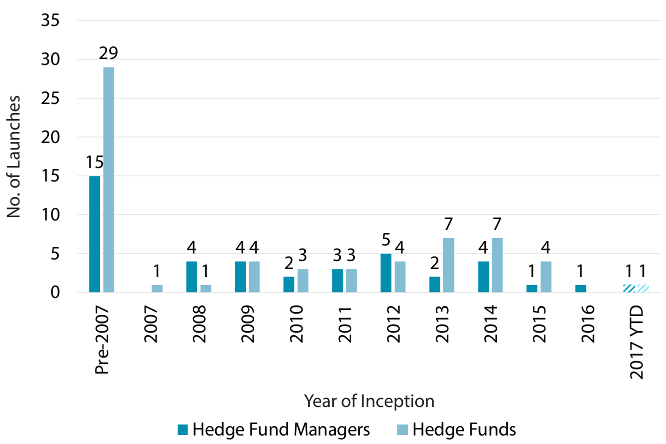
Prior to 2007, a total of 15 India-based hedge fund managers have been established with 29 India-based funds coming to market over this period. After 2007, at least one new hedge fund manager based in the country has been established, with a trend between 2013 and 2015 of a greater number of funds beginning their fundraising process than new managers – an indication that, at present, the Indian hedge fund industry is being driven by a smaller number of managers.

**Fig. 3.5: Number of Hedge Fund Strategies Offered by Manager Location**




*Source: Preqin Hedge Fund Online*

**Fig. 3.6: Number of India-Based Hedge Fund Managers Incepted and Hedge Funds Launched by Year of Inception (As at August 2017)**




*Source: Preqin Hedge Fund Online*

# INVESTORS

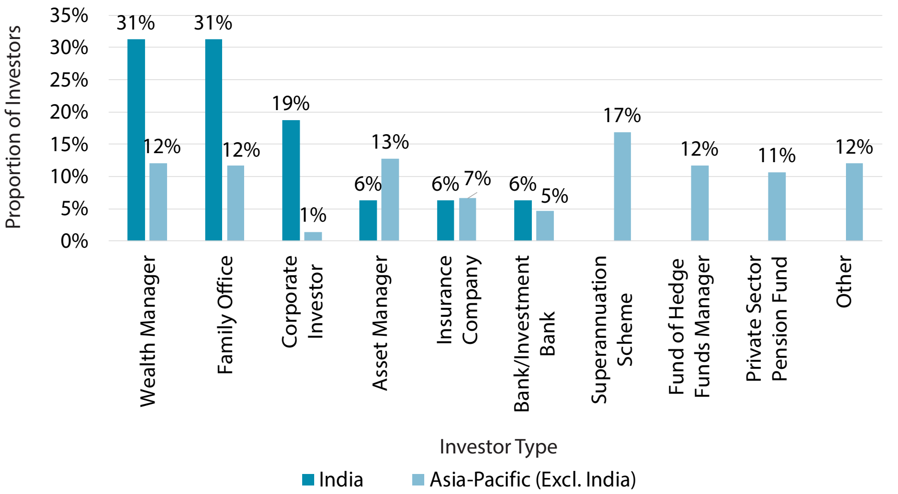
While the hedge fund industry is largely established in regions such as North America and Europe, the market is still very much in its infancy in India, with 16 investors allocating to the asset class in 2017 YTD. Although relatively small in number, this is more than double the number in 2013 and shows how investors are increasingly recognizing the value of including hedge funds in their portfolios to achieve their investment objectives.

Institutional private wealth investors are the most prominent hedge fund investors located in India, representing 62% (Fig. 3.7). As the Indian hedge fund market develops, institutional investors such as pension funds, asset managers and insurance companies, which are active in the asset class elsewhere in the world, would be expected to emerge.

## STRATEGIES

Equity strategies are targeted by the majority (88%) of India-based investors (Fig. 3.8), which is expected for the less-established investors in the hedge fund industry, though these investors would expect to diversify their portfolios as they familiarize themselves more with the market. Macro and multi-strategy funds (38% each) and credit strategies (13%) are also targeted by hedge fund investors in India, illustrative of the typical approach taken by investors in a country where the hedge fund industry is still in its infancy.

**Fig. 3.7: Asia-Pacific-Based Hedge Fund Investors by Type and Location**




*Source: Preqin Hedge Fund Online*

## ASSETS UNDER MANAGEMENT

Fig. 3.9 shows that hedge funds are typically reserved for the largest India-based institutions, with all investors managing at least $1bn in assets, and implies that only the more sophisticated institutions invest in hedge funds. The breakdown of hedge fund investors by AUM differs from the rest of the Asia-Pacific region, where a substantial proportion (38%) of smaller investors (those with less than $1bn) also participate in the asset class.

**NO. OF ACTIVE INDIA-BASED HEDGE FUND INVESTORS**

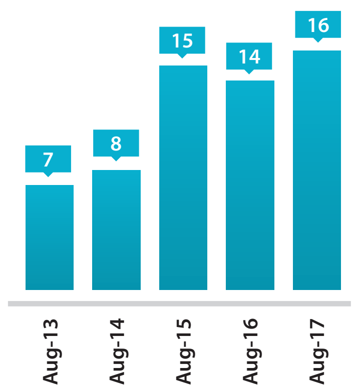
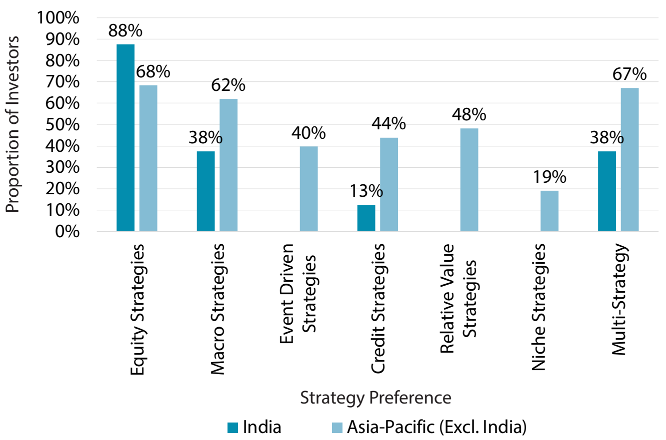
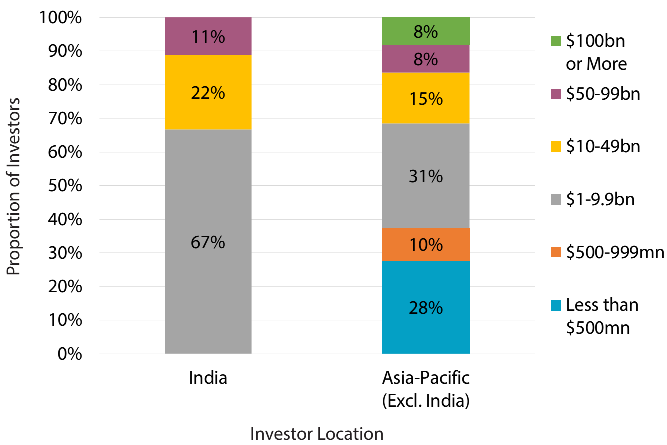



**Fig. 3.8: Strategy Preferences of Asia-Pacific-Based Hedge Fund Investors by Location**




*Source: Preqin Hedge Fund Online*

**Fig. 3.9: Asia-Pacific-Based Hedge Fund Investors by Assets under Management and Location**




*Source: Preqin Hedge Fund Online*