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Why Hedge Funds Are Looking to India for Greater Upside Potential

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A few years ago, hedge funds were barely on the radar screen in the Indian marketplace, and they were highly secretive investment vehicles even in the U.S. Today, it's a different story. As big returns are no longer easy to come by in domestic markets, international hedge funds are increasingly looking to countries like India and evaluating investment opportunities and the potential gains to be made. With near-daily headlines in the media about deals in India, limited partners are pushing hedge fund managers to see what kind of upside might be possible in this market. For example, Hedge Funds World is holding its first conference on Indian opportunities this year, though the forum itself will be in Singapore. To understand what factors affect their success, India Knowledge@Wharton talked to several experts about the attractiveness -- as well as the risks -- of the Indian marketplace for hedge funds.

Why India?

Unlike China, where stock markets are not well developed and company information is relatively opaque, experts note that India has much of the necessary institutional framework for hedging, including a regulatory regime and good information disclosure standards. "Investors look at multiple markets around the world," says Marti G. Subrahmanyam, a professor of finance at New York University's Stern School of Business. "There is a sense that the changes taking place in India are going to result in superior performance in the economy, and that the corporate sector will be a big beneficiary. Now, obviously the Chinese economy is larger, but the capital markets are better developed in India. If you look at the stock market, even if you were to include Hong Kong, the market cap in China relative to its GDP is lower. So if you're looking for investment opportunities where you won't suffer the consequences of illiquidity, India is the more attractive opportunity."

In addition, notes Subrahmanyam, India is the largest market for single stock futures in the world and has a well developed derivatives market in index futures and options. "This gives you hedging possibilities not available in other emerging markets," he says. There is also enough liquidity in the big stocks for [domestic] investors to sell short. Even though there are restrictions, these are less binding than in other emerging markets. "Doing so is much more difficult in the U.S. If you are an ordinary investor with a bearish view, you can't do that as easily," Subrahmanyam says.

Short sellers bet that a company's share price will decline over a contract period. They borrow shares from those who own them, sell the shares and hope to buy them back at a lower price, pocketing the difference as their profit. Of course, the share price might rise during the contract period if, say, the company did unexpectedly well, or won an order that it was not expected to win. If the share price runs up, short sellers would be bidding against each other to acquire

enough shares to "cover," or return, the shares they had borrowed. That bidding would create volatility in the shares of companies and, possibly, the entire stock market.

The primary reason hedge funds are going to India is the bandwagon effect, according to Arvind Acharya, a principal at Virtus Global, a boutique investment banking firm in New York City focusing on U.S.-India cross-border transactions. "They are going there with the idea that they'll get extraordinary returns, and of course with India being a growth story, those returns are definitely possible. Investors are looking for such emerging market plays. If you go back to the time when China started moving, it took people by surprise. Now that India is moving, everybody wants to be there. They don't want to have missed the bus."

People are looking at the experiences of players who are in the market already and want in. According to Acharya, some funds focused on India have been claiming returns of 9% to 10%, and this attracts other funds that are eager to earn similar returns. "Then there are the regulatory factors that [suggest a] cautious approach, so it all depends on a fund's charter," he says. "What are they seeking to do, and how aggressive is their management?"

The promise of big returns might be something of a red herring, Acharya adds. "If you balance the risk inherent in investing in the U.S. with the expected returns, you may have the same opportunities in the U.S. So it's really the herd mentality that is [driving this trend]."

Returns, with a Side Order of Comfort

Not all hedge funds that have tested the waters in India have been optimistic. What, then, can be done to alleviate the risks? In part, it depends on the fund, says Subrahmanyam. "Hedge funds are a catchall term for everything from the most sophisticated to the least sophisticated players in the world. Some are just going to be seat-of-the-pants investors. My suspicion is that a large proportion of players in emerging markets may fall into that category. If you look at the extent of oversubscription to IPOs in India, it's obvious that there are some hedge funds trying to flip them."

Hedge fund managers are morbidly afraid of volatility and so are investors, according to Wharton finance professor Vinay B. Nair. "Their single biggest concern is that the fund should not blow up. Before you grow the capital, you need to make sure you can preserve the capital. That is the reason for the fear."

What inspires fear is the well-publicized failure of hedge funds that have lost billions of dollars. "The two blow-ups that everyone talks about are Amaranth and Long Term Capital Management (LTCM)," Nair says. He explains that while market volatility contributed to those failures, it was hardly the only problem. "In most of these cases, risk-control systems normally stop trades if the volatility gets too high. There are stop-loss constraints, and the managers stop trading." In the case of Amaranth and LTCM, though, while the risk-control system worked, it also recommended that the funds be liquidated. "But Amaranth and LTCM had huge positions that could not be liquidated easily. It would have had a huge market impact. So the problem was not volatility, it was liquidity."

In places like India, Nair says, it's best if a hedge fund has someone on the ground there. "You have to get a sense of how business is run in India, and you have to get local information." Ideally, Nair says, the fund should hire people who have worked in corporate India. "You can't

take successful fundamental traders in the U.S. and put them India and just expect them to succeed. It helps to have a network set up there."

Subrahmanyam agrees. Like other parts of Asia, he adds, India is a relationship-based society. "If you want to do deals, you need to know the people. A hotshot trader at a hedge fund who turns up in Mumbai won't have much luck. Conventional Wall Street skills -- analytical and trading savvy -- are not as useful. And just because you were born in India 40 years ago, it doesn't mean you'll know your way around. Mumbai may be an entry point, but you have to be able to go to smaller cities such as Coimbatore [in southern India] or Aurangabad [in western India], or wherever the opportunities are now."

What Works, What Doesn't

Hedge funds come in many flavors, with all kinds of investment strategies. Not all of them make sense for emerging markets like India, however. "Activist strategies require a more mature market," notes Nair. "For instance, hostile takeovers will happen eventually, but defenses still haven't been removed, so the market isn't quite ready for those. Similarly, event-driven strategies aren't yet strong, since the number of corporate events is still not comparable to what we see in the U.S." Nair also says that funds are not trying market-neutral strategies in India, "because with the market growing the way it is, you don't want to be market-neutral."

The strategies that do well in India these days take a lot of long exposure, according to Nair. In other words, they do not short too many stocks.

Quant-based strategies, where funds sift through the data and trade thousands of stocks at once, aren't easy in India primarily because there isn't much historical data. "You need data to back-test your strategy. Here in the U.S., we have data as far back as 1910, but I'm not sure to what extent such numbers are available in India," says Nair. "There are no quant funds in India. Everyone does value investing, which is old school, fundamental analysis."

Nair argues that fundamental analysis can work well in India. "In the U.S., fundamental analysis -- where you study a firm closely, decide it may be undervalued, and then take 10% equity, hold and sell -- is largely dying out, and the amount of money to be made is limited," says Nair. "In India, however, people feel there are still a lot of fundamental plays, since the market is more inefficient. That is predominantly the form of investment that everyone does. It's essentially all about who is a better stock picker."

Currently, restrictions exist on the kind of investments hedge funds can make in India. "Foreign investors can't hold debt in many industries, even those open to foreign direct investment," says Nair. "That automatically rules out a credit desk for hedge funds. There are other restrictions as well. Hedge funds today invest in India through depository notes, which also have some regulatory constraints associated with them."

The typical hedge fund wants to get in and get out, notes Subrahmanyam. "You can do this in a reasonably liquid market. Hedge funds make money by buying illiquid assets and selling them. For instance, they might buy small stocks that are more illiquid and short the long stocks -- in the long run, they can earn excess returns." If your hedge fund is facing redemptions, an illiquidity play in India isn't necessarily the smartest move, he notes. "If you want to flip an IPO of a medium-size company and everyone else is trying to do the same, you might get killed."

Since so much of the market information you get will be based on rumor and gossip, it's unlikely you'll get the real information first if you're trading from outside India. "Unless you have your feet firmly in India, it's best to go for strategies that aren't susceptible to short-term information," he adds.

Ultimately, notes Acharya, all the data in the world won't make up for people on the ground who have deep expertise. He echoes Subrahmanyam's emphasis on market knowledge: "You need to have a cultural understanding of Indian management and business. That is far more important than data mining and analysis."

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