The AlphaWeek & Sussex Partners Japan Hedge Fund Survey 2024 Edition

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Contents

Editor’s Letter

Welcome to the 2024 edition of the AlphaWeek and Sussex Partners Japan Hedge Fund Industry Survey.

This year’s edition is the fifth iteration, and it continues to grow in terms of participation. This year, 28 managers completed the survey, the largest number of participants to date, and we are grateful to those who took the time to complete this year’s survey.

The macroeconomic headline in Japan in 2023 was, of course, the TOPIX ending its 30-odd year drawdown. Public equity market performance is notable in the Japanese market due to equities being, by far, the largest underlying exposure of the funds that comprise the industry, and Patrick Ghali, Managing Partner at Sussex Partners, co-producer of this report, has some interesting observations about how Japanese hedge funds compared against the TOPIX – and why – in his annual Japanese Hedge Funds Review And Outlook article for this report.

The inflation rate in Japan crept up over 4% at the beginning of the year, something that hadn’t been observed since 2014, but has since been on a downward trend, mirroring the trend of other developed economies. On December 19th, the Bank of Japan left its benchmark interest rate negative at -0.1%, a widely expected decision, as it continues to try and encourage lending and borrowing. But, while that might seem like a fairly stable macroeconomic environment, in terms of the equity market, the aforementioned rally was driven by a small number of stocks, similar to what was observed in the USA, so the equity waters were more choppy generally than what might appear on the surface.

Some results in our survey are rarely a surprise. Japanese hedge fund managers continue to be strongly of the opinion that global investors don’t pay them enough attention (82.14%) and this year, it’s even worse for domestic investors, with 96.43% of survey respondents saying that local capital doesn’t give them much of a look in.

Other results are more notable. 57% of respondents this year don’t consider ESG when entering into a position, a reversal from last year, and perhaps indicative of the broader pull back in ESG more generally. And a strong majority think that both the Japanese Stewardship Code and the Corporate Governance Code (85.71% and 89.29% respectively) have been a benefit to their strategies.

Last year, there was something of a blip in confidence, as ‘only’ 82% of survey respondents were bullish about their opportunities for alpha generation in the coming 12-24 months. Those naysayers are no more, as 100% of survey respondents said they were bullish when questioned this year. It will be interesting to see whether or not 2024 proves them right.

I hope you enjoy reading the 2024 edition of the AlphaWeek and Sussex Partners Japan Hedge Fund Industry Survey.

Greg Winterton

Greg Winterton
Founder, Managing Editor
AlphaWeek

Japanese Hedge Funds Review And Outlook 2023/4

2023 has been a year dominated by macro factors, especially the perceived path of global rates, and particularly the US. This dynamic has been the main driver for equity markets in Japan and has created a challenging background for active managers, notably those focused on deep fundamental research. Given that the Japanese hedge fund industry continues to be somewhat biased towards low net exposure fundamental managers (in other words, alpha heavy strategies), any environment which is driven by macro flows rather than idiosyncratic/company specific factors creates headwinds and challenges. The same constraints, of course, also applied to hedge funds in other geographies this year and it is interesting to see that, despite this, Japanese hedge funds as a group have once again outperformed their North American peers (+4.9% through the end of October versus +2.2% respectively for the same period as measured by the measured by the Eurekahedge Japan Hedge fund index and the Eurekahedge North America Index).

Performance dispersion also continued this year. Long biased managers, or those with more flexible net exposure management and/or the ability/willingness to run with larger net long exposures, have done significantly better at capturing market beta this year, with some generating double digit returns YTD. However, those managers who came into the year defensively positioned, a tactic which served them well last year, have not participated in the (albeit very narrow) rally in Japanese markets. The macro flows driving this year's markets also led to significant flow and factor rotations of growth versus value (most recently again in October/November of this year). The fact that many Japanese growth stocks tend to be small caps further limited the opportunity for hedge funds to participate, due to their inherent volatility and often questionable fundamentals. For an industry where many PMs remain biased towards fundamental analysis, getting comfortable with such positions is therefore challenging. Additionally, managers were also all too aware of the violent short squeeze risk in a non-fundamentals driven market, which further limited their willingness to engage.

Managers that were not exposed to very specific companies consequently weren't able to capture this year's upside in any significant manner, which was not dissimilar to the situation in the US where 7 stocks drove most of returns so far in 2023. Until such a time as markets are driven by fundamentals again, the opportunity set for long/short equity hedge funds globally, especially those narrowly constrained in their net and factor exposures, may continue to be limited. Once there is more clarity on the path of global rates, the environment for these types of strategies should significantly improve.

Longer term structural changes in Japan, such as the improved treatment of shareholders, the restructuring of the Tokyo Stock Exchange and pressure being put on companies to increase dividends, are all tailwinds that should remain with the industry for years to come. Some managers feel this will provide an opportunity for the next 10 years, and though on the face of it this may seem like an argument for a long only approach to Japan, this should also provide plenty of short opportunities for managers.

The resurgent interest in Japan more broadly has certainly also led to more inbound enquiries for Japanese hedge fund managers. It appears, however, that international investors may still not fully grasp the alpha opportunity that the Japanese markets provide and instead seem very much focused on factors favoring long only strategies. Themes such as shareholder engagement are certainly very trendy with foreign allocators, but they are often surprised to find that Japanese hedge funds, though aware of this trend, are not solely focused on this and rarely will make it their core theme. There continues to be a disconnect, therefore, between the expectations of foreign investors and where local managers see the best opportunities. The resulting risk presented by this is that foreign flows may reverse, as they have done in the past, should the current upward trajectory in markets reverse, which could accelerate declines. Perhaps a more prudent approach would be for allocators to focus their research efforts on understanding the inherent alpha opportunities that Japanese hedge funds can provide.

In terms of more granular performance attribution, just as in prior years, multi-pm funds have generally done better. The issue here though remains the same as before in that there is both an extreme lack of capacity as well as a lack of institutional grade (in a global sense) managers that are available for investment.

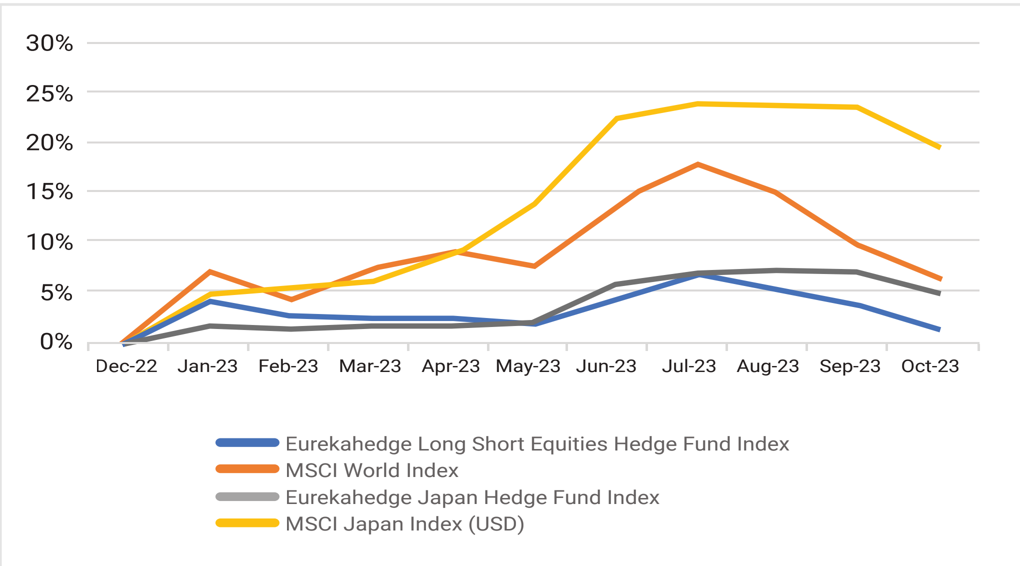
Last year's comment therefore remains valid also in 2023:

"2022 validates our view that holding a diversified portfolio of Japanese managers would have insulated investors to some extent from manager specific volatility and provided investors with smoother returns, notwithstanding the above-mentioned caveats of capacity and infrastructure which make investing in Japan challenging for all but the most sophisticated allocators with deep knowledge of the Japanese hedge fund industry. "

Every year we compare Japanese hedge funds as a group with their long-only benchmarks as well as with their North American and European peers. This allows us to judge their relative performance, and their net of fee value add versus cheaper long only investment.

After significantly outperforming both the MSCI Japan and the MSCI World indices last year, and materially protecting capital in 2022 versus long only investments, (Japanese hedge funds as a group were roughly flat in 2022 at +0.3% while both MSCI indices lost -26.4% during the same period), 2023 has painted a somewhat different picture. While Japanese hedge funds measured by the Eurekahedge Japan index were up +4.9% through the end of October, the MSCI Japan and the MSCI Word index were up +19.5% and +6.3% respectively. Hedge funds have therefore not kept up with their long only benchmarks this year, which can be attributed to the aforementioned reasons.

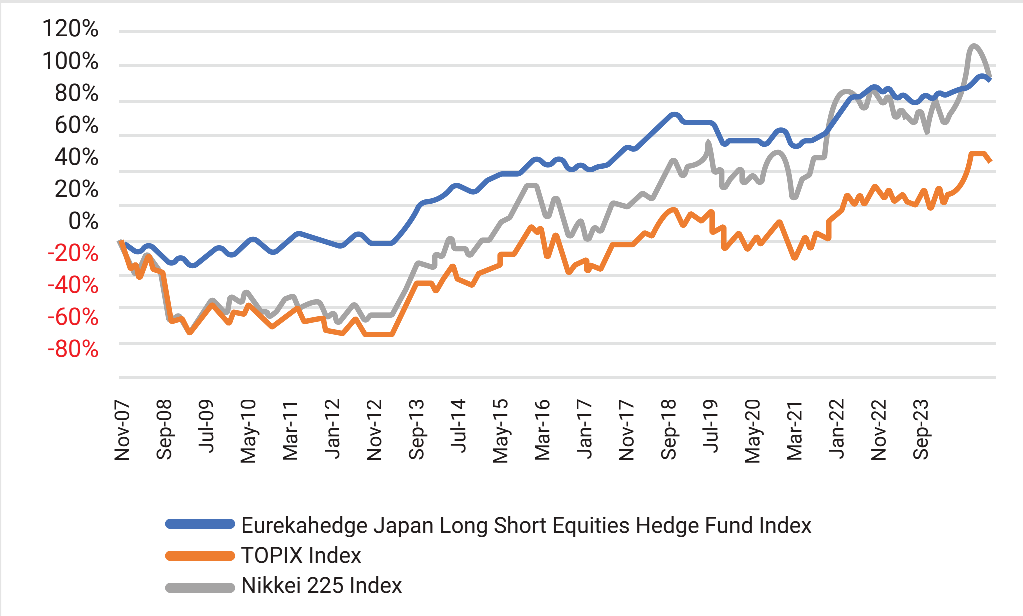
Figure 1: Cumulative Returns, Equity vs Hedge Funds, 2023 Through October



Source: Eurekahedge, MSCI

Longer term (since 2007), and despite this year's rally, Japanese hedge funds as a group have significantly outperformed the TOPIX index and have generated returns which are comparable to the Nikkei index on an absolute basis. Importantly though, they have significantly outperformed both indexes on a risk adjusted basis (see Figure 2). While the TOPIX index suffered a maximum drawdown of -53.03% and the NIKKEI 225 index a maximum drawdown of -51.74%, the Eurekahedge Japan index only lost -12.76% over the same period. The volatility profile of Japanese hedge funds is also much more benign at 5.69% versus 17.58% and 19.19% for the TOPIX and the NIKKEI 225 indices respectively. Japanese hedge funds therefore have continued to provide a much better risk adjusted way to invest in Japan (net of fees!).

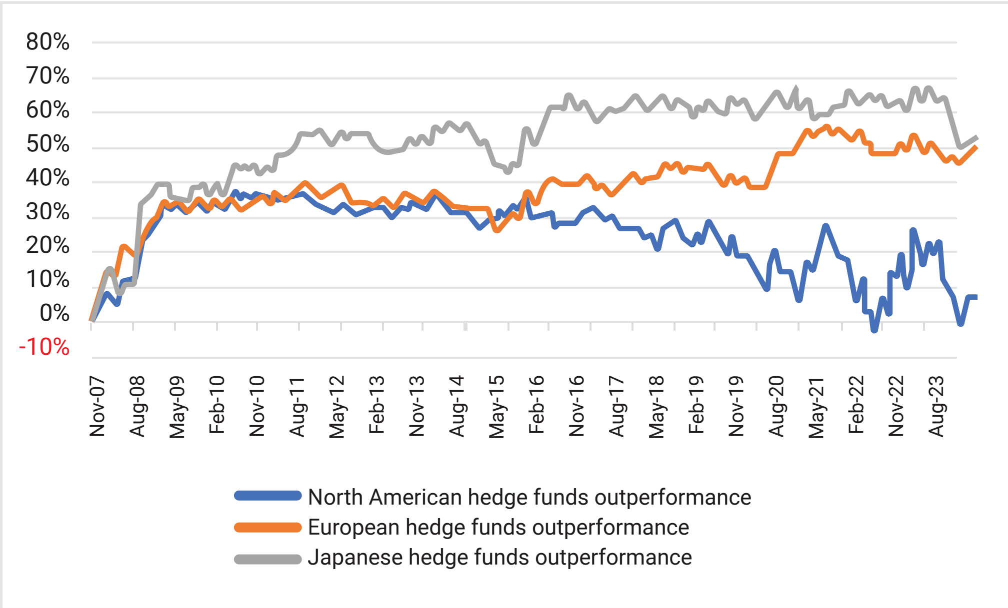
Figure 2: Historical Cumulative Performance of Equity Hedge Funds Relative to Equity (December 2007 - October 2023)



Source: Eurekahedge, Bloomberg

This year has seen a further increase in the gap between the cumulative outperformance versus equities of Japanese Hedge funds and their North American peers, while European funds have managed to retain their performance (see Figure 3). This is perhaps not unsurprising given the very narrow breadth of the rally in US markets, and the challenges this posed for long/short managers. It does, however, highlight once again that selecting the markets in which to allocate to hedge funds makes a significant difference in terms of value-add. Japan continues to be the standout in that regard, with the long-term gap between Japanese hedge funds and North American peers persisting.

Figure 3: Historical Cumulative Outperformance of Equity Hedge Funds vs Equity (December 2007 - October2023)



Data: North American equities = Eurekahedge North American Hedge Fund Index vs. MSCI North America Index (USD), European equities = Eurekahedge European Hedge Fund Index vs. MSCI Europe Index (EUR), Japanese equities = Eurekahedge Japan Hedge Fund Index vs. MSCI Japan Index (JPY).

Source: Eurekahedge, Bloomberg

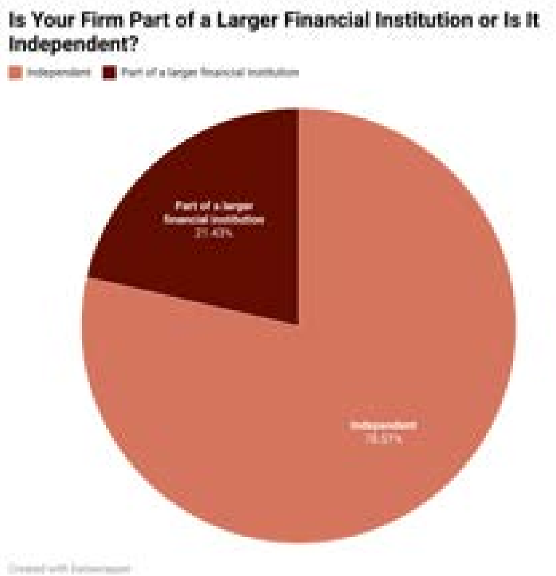
As the world rightly continues to rediscover the opportunities presented by Japan, allocators must be careful not to myopically focus on the recent upward momentum in Japanese markets, and hence only look at long only strategies, but to recognize the compelling long-term alpha opportunity the local hedge fund industry presents.

P. Ghali

Patrick Ghali
Managing Partner
Sussex Partners

Section 1: Firm Information

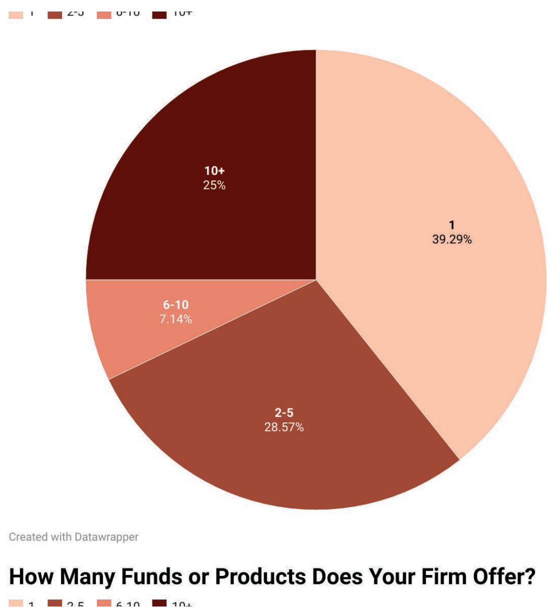
Q1: Is Your Firm Part of a Larger Financial Institution or Is It Independent?



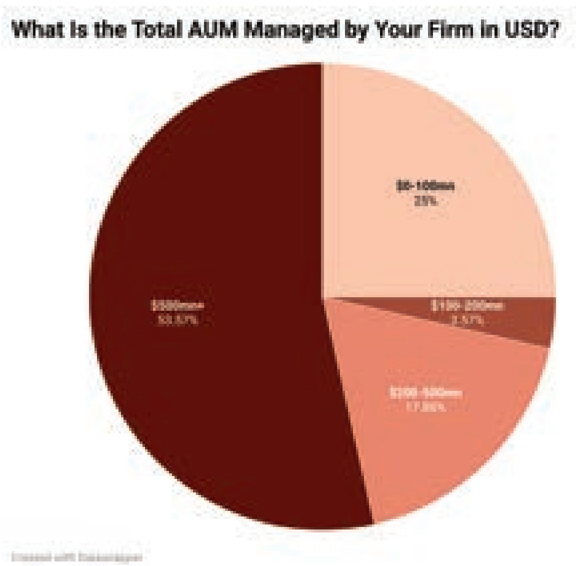
Nothing surprising about the composition of our survey respondents this year, with more than three-quarters representing an independent shop.

Q2: How Many Funds or Products Does Your Firm Offer?

Few changes from previous years here – most firms in our survey manage the one fund.

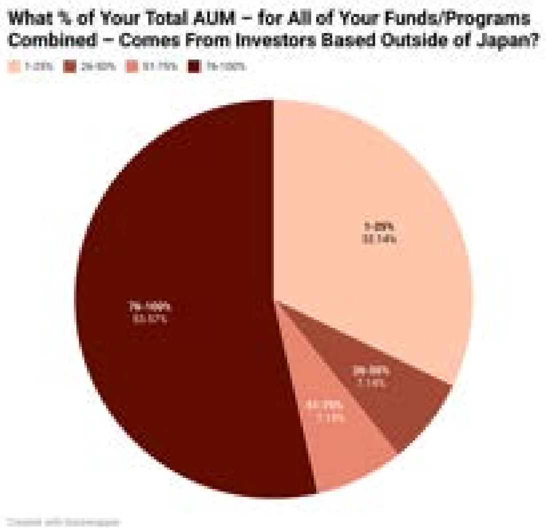


Q3: What Is the Total AUM Managed by Your Firm in USD?



The main change from this time last year is the number of participants managing more than $500mn, with more than half of respondents doing so.

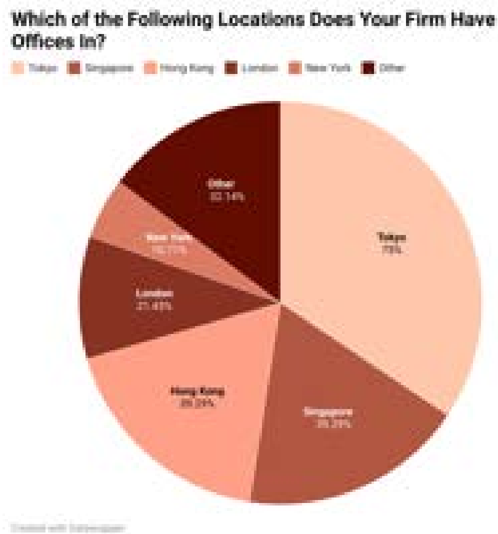
Q4: What % of Your Total AUM – for All of Your Funds/Programs Combined – Comes From Investors Based Outside of Japan?



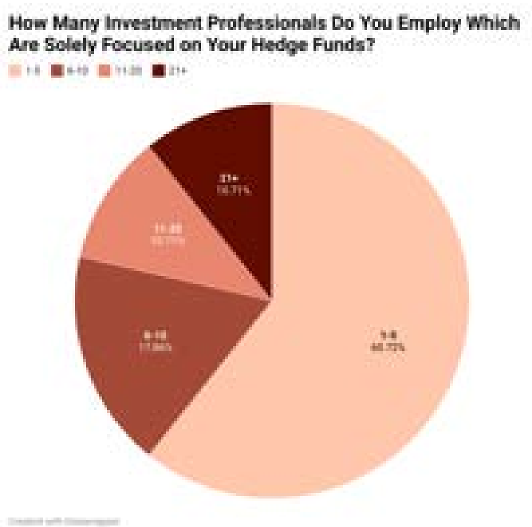
The make-up of the investor base of this year's survey respondents is broadly similar to last year, with more than half having more than three-quarters of their assets coming from outside Japan.

Q5: Which of the Following Locations Do You Have Offices In?

Tokyo is, unsurprisingly, the most common answer here, but plenty of managers have offices outside Asia, including in New York, London, and in Continental Europe.



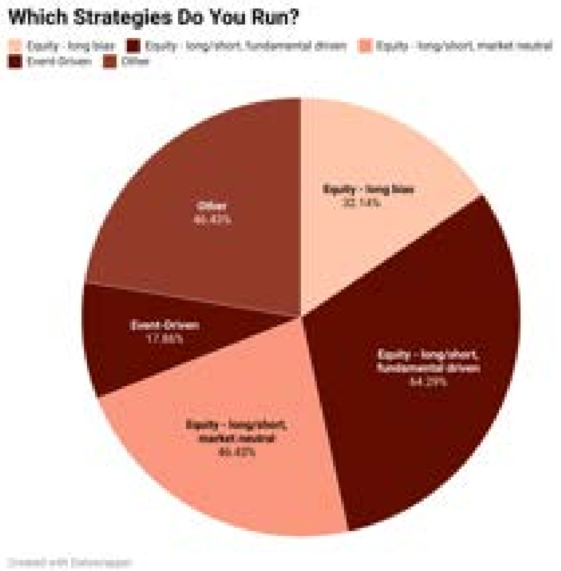
Q6: How Many Investment Professionals Do You Employ Which Are Solely Focused on Your Hedge Funds (Including Analysts and Portfolio Managers)?



Mirroring the hedge fund industry globally, most firms surveyed this year have a handful of investment professionals – including analysts and portfolio managers – working on their hedge fund products.

Section 2: Fund / Program Information

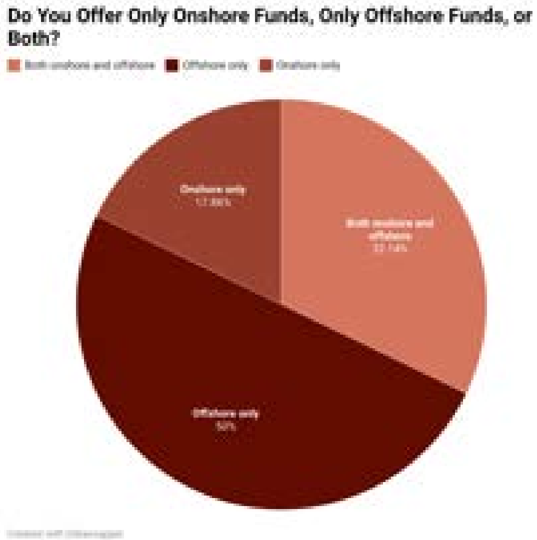
Q7: Which Strategies Do You Run?



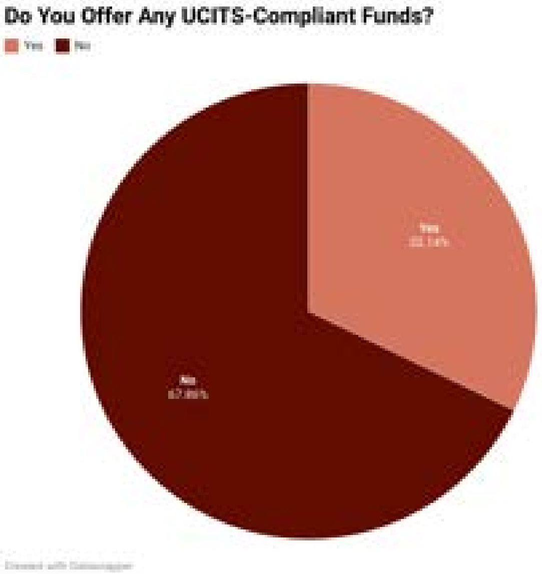
It's well known that equity strategies dominate the Japanese hedge fund market and that's reflected in our survey results this year.

Q8: Do You Offer Only Onshore Funds, Only Offshore Funds, or Both?

Offshore funds comprises the bulk of the products offered by our managers this year, unsurprising, given the investor base indicated in question four.

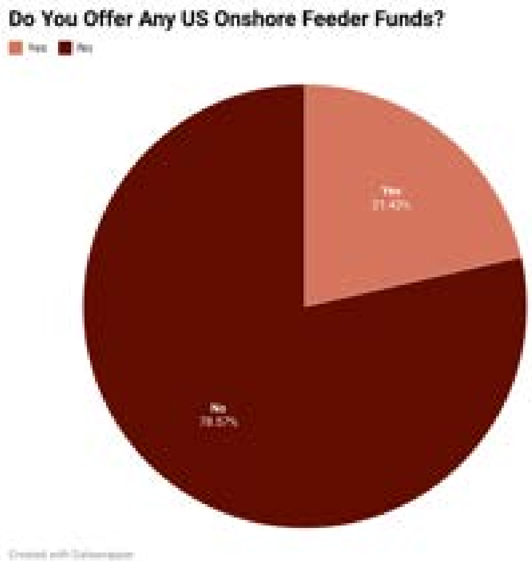


Q9: Do You Offer Any UCITS-Compliant Funds?



A largely consistent response this year with last year, but a notable one, given that many European investors require a UCITS wrapper in order to allocate.

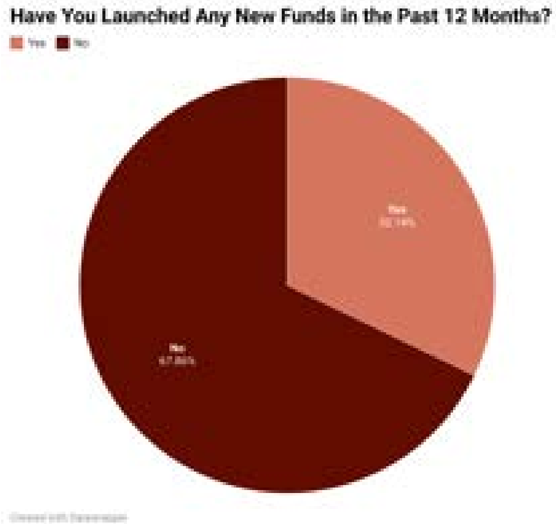
Q10: Do You Offer Any US Onshore Feeder Funds?



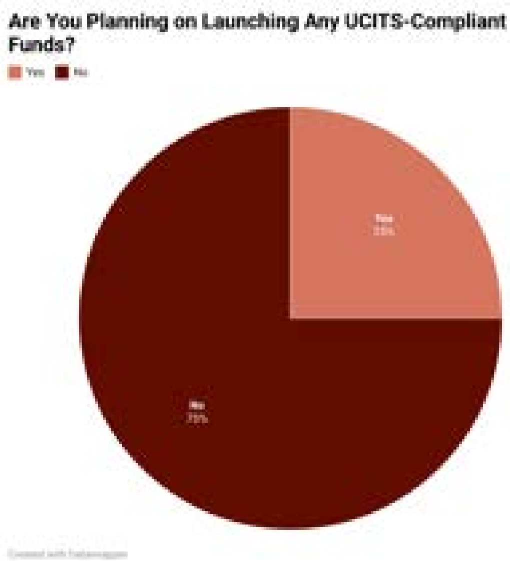
A new question this year. More than three quarters of survey respondents don't offer a US onshore feeder fund, which would hinder their ability to raise money stateside.

Q11: Are You Planning on Launching Any UCITS-Compliant Funds?

Again, despite the general observation that foreign investors don't pay enough attention to Japanese hedge funds, 75% of survey respondents aren't planning on launching any UCITS-compliant funds.

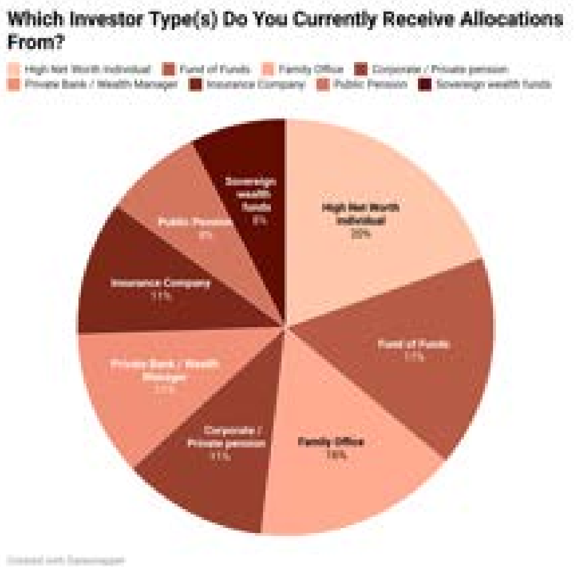


Q12: Have You Launched Any New Funds in the Past 12 Months?



A few firms have launched new funds in the past year, but, by and large, it's something of a status quo.

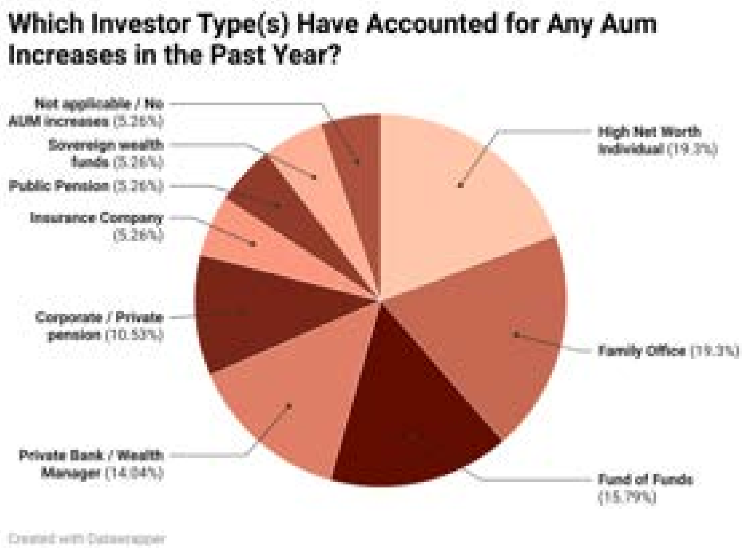
Q13: Which Investor Type(s) Do You Currently Receive Allocations From?



Like last year, a reasonably dispersed set of results, with family offices, fund of funds and HNWI's comprising more than half of allocations.

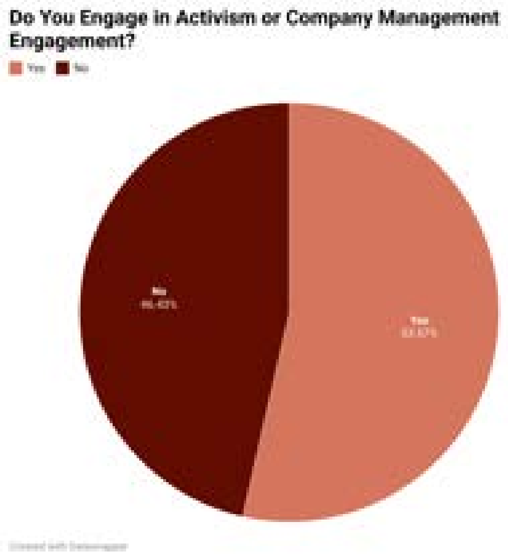
Q14: Which Investor Type(s) Have Accounted for Any AUM Increases in the Past Year?

Mirroring the results from last year, private money – HNWIs, family offices and fund of funds – have contributed more to asset flows this year.



Section 3: The Approaches of Japanese Hedge Fund Managers

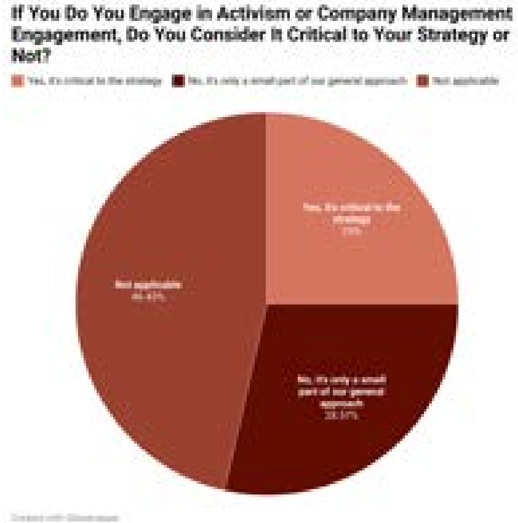
Q15: Do You Engage in Activism or Company Management Engagement?



More than half of survey respondents this year say they take an activist approach, reversing the results from last time.

Q16: If You Do You Engage in Activism or Company Management Engagement, Do You Consider It Critical to Your Strategy or Not?

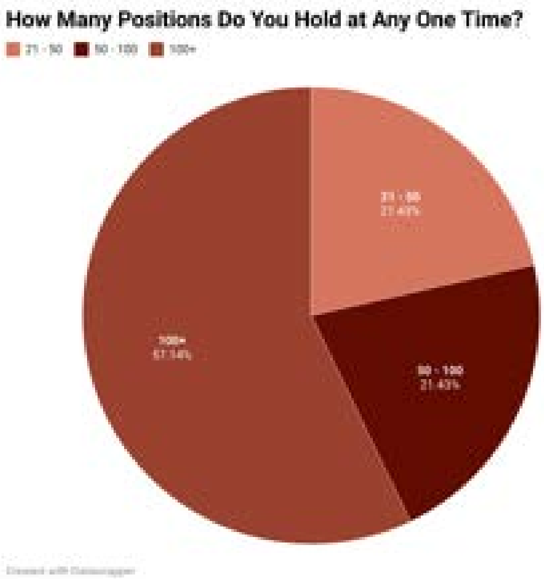
Of those that do take an activist approach, less than half say that it's critical to the strategy, however.



Q17: What Type of Manager Do You Consider Yourself To Be?

Little surprise here – it's common knowledge that systematic strategies in the Japanese hedge fund market are few and far between, with the discretionary / fundamental approach being by far the most common.

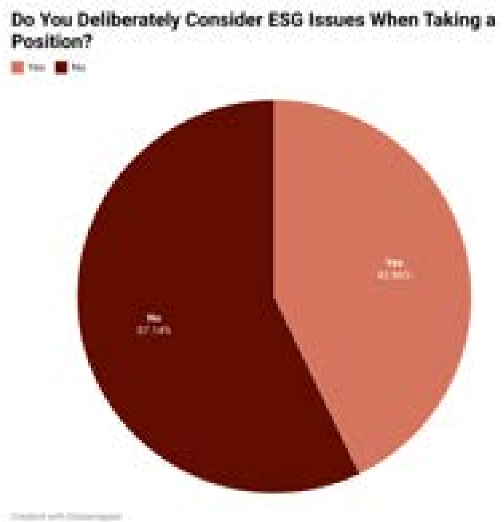
Q18: How Many Positions Do You Hold at Any One Time?



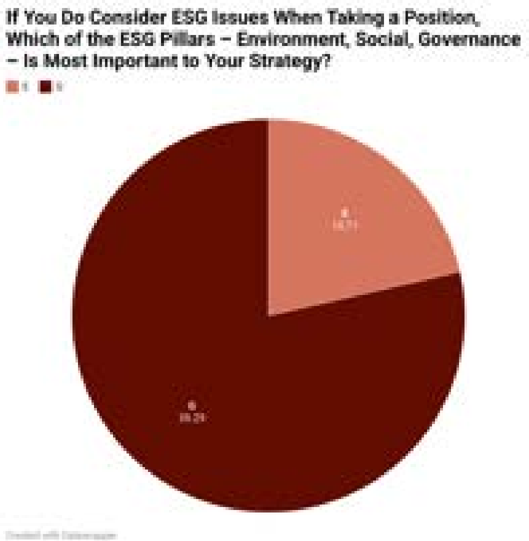
Japanese hedge fund managers maintain a vast number of positions in their portfolios – much more than their western counterparts.

Q19: Do You Deliberately Consider ESG Issues When Taking a Position?

ESG has fallen out of favour a little this year, as more than half of survey respondents say they don't consider these issues, a reversal from last year's report.



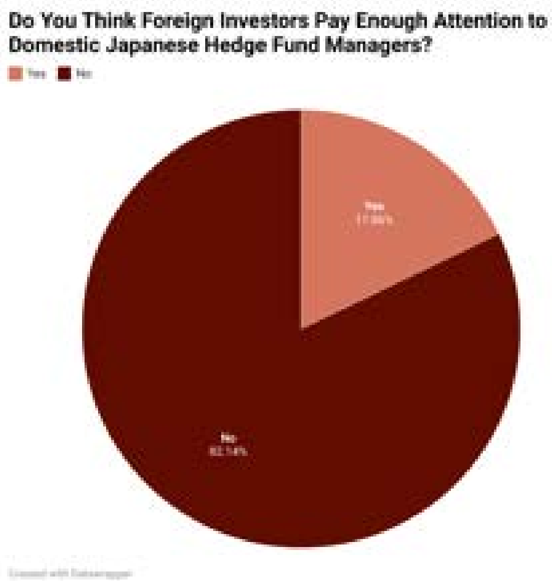
Q20: If You Do Consider ESG Issues When Taking a Position, Which of the ESG Pillars – Environment, Social, Governance – Is Most Important to Your Strategy?



Of those that do consider ESG issues, Governance is, by far, the main leg of the ESG stool that Japanese hedge fund managers focus on.

Section 4: The Views of Japanese Hedge Fund Managers

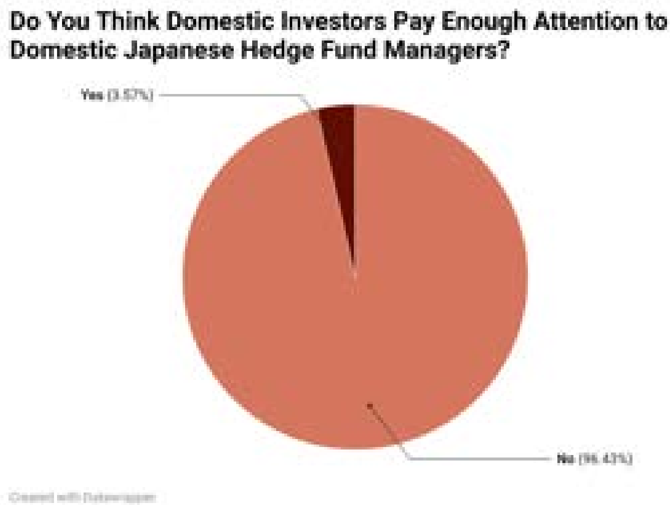
Q21: Do You Think Foreign Investors Pay Enough Attention to Domestic Japanese Hedge Fund Managers?



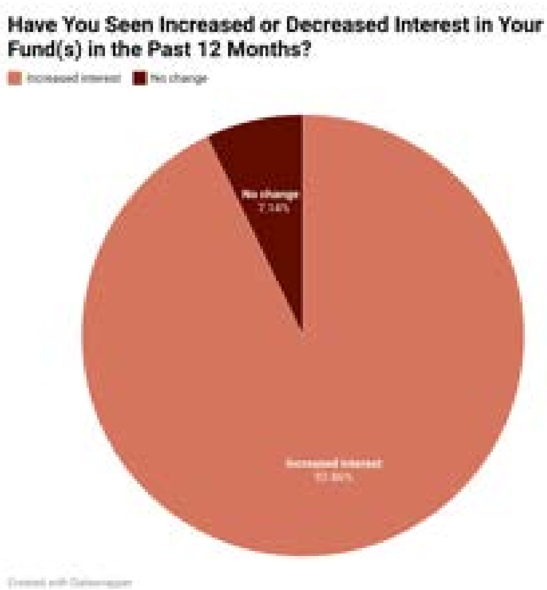
Maybe the tide is turning a little here. Last year, 91.3% of survey respondents said that foreign investors don't pay enough attention to them. That's fallen to 82.14% this time.

Q22: Do you think domestic investors pay enough attention to domestic Japanese hedge fund managers?

A notable change here as less than 5% think that local investors pay them enough attention.

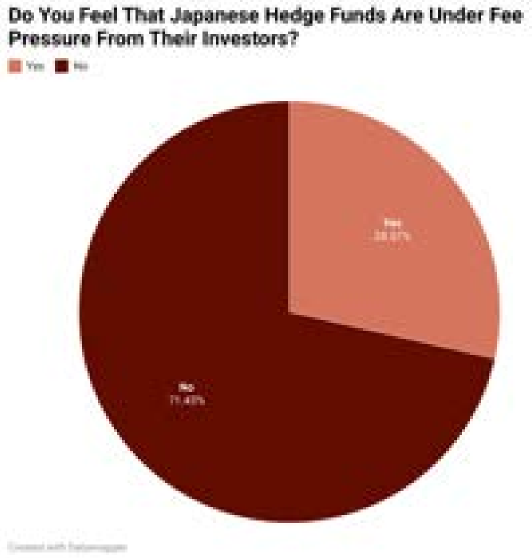


Q23: Have You Seen Increased or Decreased Interest in Your Fund(s) in the Past 12 Months?



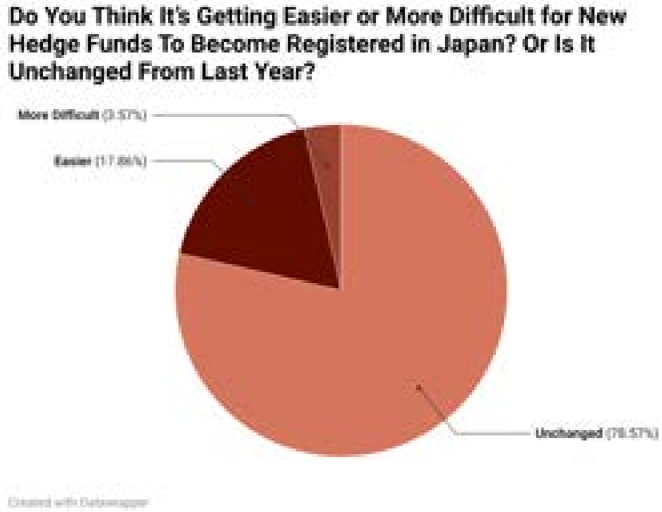
Despite the perceived lack of attention generally, most survey respondents this year say that they have received increased interest, with none saying that the interest level had fallen.

Q24: Do You Feel That Japanese Hedge Funds Are Under Fee Pressure From Their Investors?



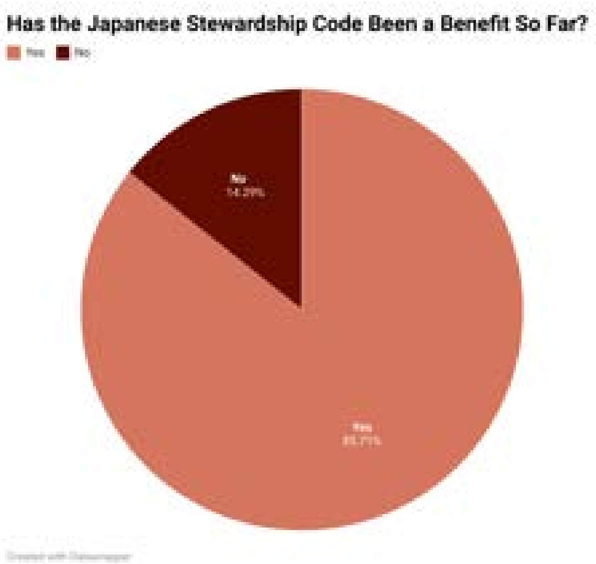
Fairly consistent feedback here – around three quarters of survey respondents don't think they experience fee pressure.

Q25: Do You Think It's Getting Easier or More Difficult for New Hedge Funds To Become Registered in Japan? Or Is It Unchanged From Last Year?



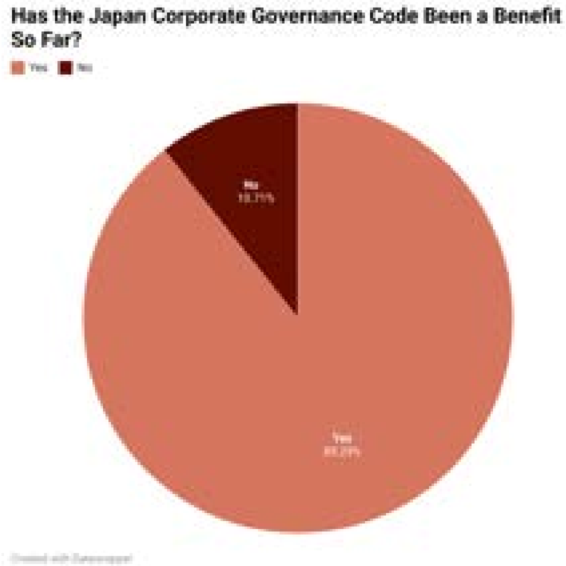
Most Japanese hedge fund managers don't think that it's getting easier or harder for new funds to launch in Japan. It will be interesting to see whether new policies announced in 2023 make a difference here next year.

Q26: Has the Japanese Stewardship Code Been a Benefit So Far?



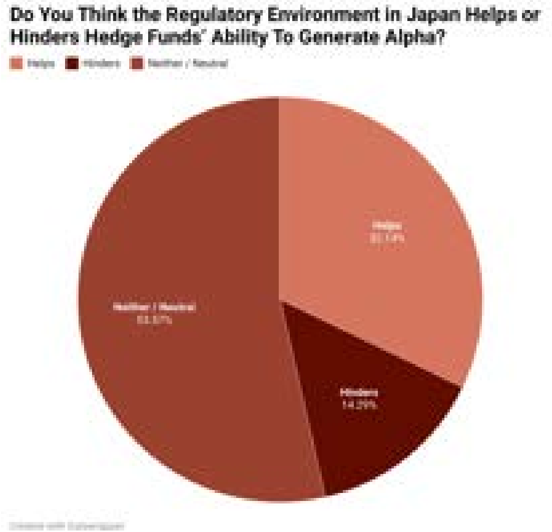
Introduced in 2014, our survey respondents overwhelmingly say that the Japanese Stewardship Code has been beneficial to them, and this has increased from last year.

Q27: Has the Japan Corporate Governance Code Been a Benefit So Far?



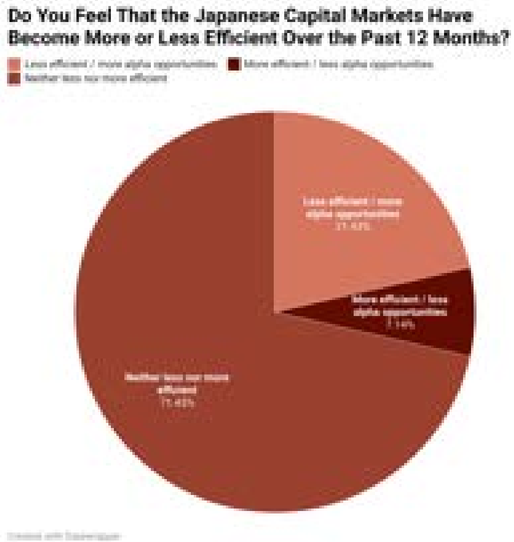
This year's survey respondents also think that the Japan Corporate Governance Code has been a benefit to them as well.

Q28: Do You Think the Regulatory Environment in Japan Helps or Hinders Hedge Funds' Ability To Generate Alpha?



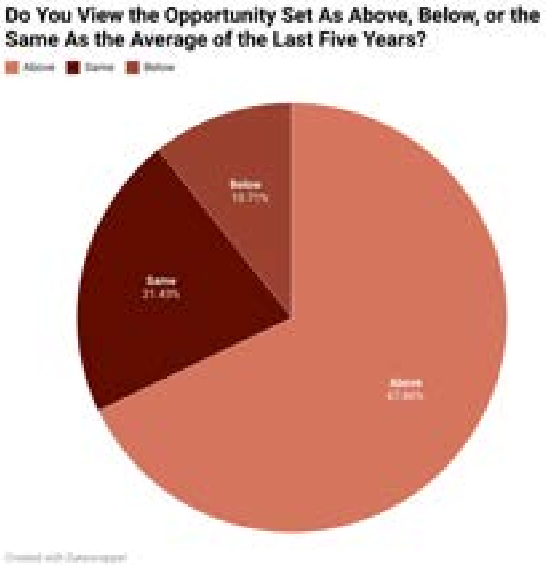
New for this year, we wanted to find out what our survey respondents thought about the regulatory environment. More than half don't think it has much of an impact on their ability to deliver results.

Q29: Do You Feel That the Japanese Capital Markets Have Become More or Less Efficient Over the Past 12 Months?



Similar results to last year – most Japanese hedge fund managers don't think that the capital markets have become more or less efficient.

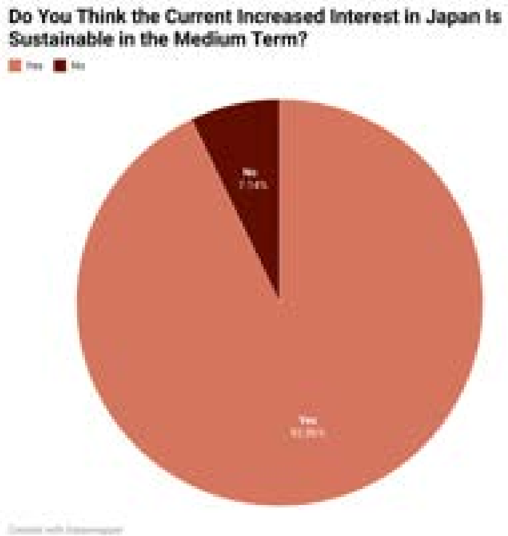
Q30: Do You View the Opportunity Set As Above, Below, or the Same As the Average of the Last Five Years?



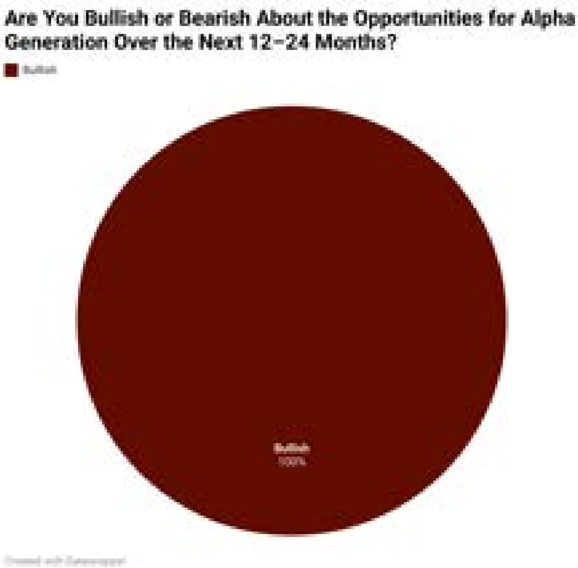
Japan is notable for its lack of sell-side coverage of the small and mid-cap space, which is often touted as something that a manager can exploit. Most think the opportunity set is the same as it has been in recent years.

Q31: Do You Think the Current Increased Interest in Japan Is Sustainable in the Medium Term?

There has been much written in the media this year about foreign investors returning to Japanese equities, so we wanted to find out what the hedge fund set thought of this. Most say yes; time will tell.



Q32: Are You Bullish or Bearish About the Opportunities for Alpha Generation Over the Next 12–24 Months?



The bulls are back. After a blip last year, 100% of survey respondents are bullish about their opportunities to deliver alpha in the next year or so.