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Panel 2: Hedge Funds – How Far is it Necessary to Regulate?

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PANEL 2: HEDGE FUNDS - HOW FAR IS IT NECESSARY TO REGULATE?**

PANELLIST - DAVIDE ERRO

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Hedge Fund Growth In Perspective

- **Small base in Asia**
- **Define type of hedge fund you want by characteristics**
 - Size
 - Stability
 - Facilitating allocation of capital
- **Industry growth is positive sum game**

Metrics for Hedge Fund Development

- Merger arbitrage spreads
- Changes in corporate structures to release value

**Continued growth of hedge funds
is beneficial to Asia and Hong Kong**

Regulatory Issues - Macro

- **Systemic issues**
 - Credit
 - Financial system
 - Liquidity
 - “LTCM” issues
- **Barriers to entry**
 - Economics of scale
 - Institutionalization of industry
- **Reputation**
 - Protect good players from contamination of bad players
 - Regulators role to differentiate between actors

**Important but, from my perspective,
adequately dealt with by Regulators and Prime Brokers**

Regulatory Issues - Micro

- Need to facilitate decision-making for investors into funds
- Within context of risky investments, need good infrastructure to make decisions
 - Clarity of pricing and costs of the fund
 - Alignment of interests between GP and LP

Making Hedge Fund Investing Similar to Investing in Companies

- Transparency of ownership and changes in ownership
- Insider investment/transactions
- Compensation and form of compensation (stock vs cash)
- Conflicts of interest (personal dealing, multiple promote fees)
- Relationships with brokers

Appropriate Riskiness of Hedge Funds

- **Great focus on low risk but taking smart risks is important**
 - Problem of asset gatherers
 - Need to allocate capital
 - Higher compensation moving from call to equity to debt
 - Need to find the right balance
 - Returns on motivation and psychology of hedge fund managers
- **Risk is part of investment process (and mandate) but should not be compounded by operational risks and distractions**
 - Consistent theme of under-investment and being penny wise and pound poor on building infrastructure
 - Number of middle office staff
 - size of office
 - experience of COO
 - quality and number of assistants

**Very hard to choose a good investor
but can more easily choose a structure
that should make good risk adjusted returns likely**

Gandhara Best Practices

- 50% of principals' net wealth invested in Fund and substantially all financial assets
- 75% of bonuses reinvested
- No "soft dollars"
- Independent Board with substance

Development of Human Capital in Hong Kong

- **Historical hedge fund investing**
 - Small cap
 - Flow of funds
 - Events
 - Distressed investing
- **Valuation was not a focus**

Characteristics market can provide to attract people ...

- **Liquidity especially in big caps**
- **Fewer controlled companies to ensure economic motivation**

Forward Looking Hedge Fund Investing

- How much is an asset worth?
- What should this company earn?
 - Develop valuable dynamic with management
 - Facilitate allocation of capital
 - Promotes market depth

What Will This Look Like?

- Lower index volatilities
- Lower correlation between stocks/high single stock volatilities (compared to index)
- Wider band of multiples

Conclusion

- Hong Kong is a great regulatory environment because it commands respect as a well-regulated financial center
- Greater transparency surrounding needs/requirements of investors in ensuring alignment w/GP
- Roadmap for development of Hong Kong as a center for human capital