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Emerging market hedge funds in the United States

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ABSTRACT

This paper compares the performance and capital flow to emerging market hedge funds located in the US with those of the funds located in other countries. I find that the US funds on average provided neither a positive risk-adjusted return nor a liquidity premium to compensate for the stronger share restrictions they imposed than the other funds during 1994–2012. Quarterly flow to the US funds was 1.25 to 7.88 times higher but it was less sensitive to past performance. Smart money effect was observed among the Caribbean funds, Hong Kong funds and Singapore funds, but not among the US funds.

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1. Introduction

How well have US investors done in emerging markets? Do past performance influence capital flows to emerging markets? Do flows have forecasting power for future returns in emerging markets? The main objective of this paper is to answer these questions empirically using hedge fund data while different data have been utilized in previous research.

For example, Bekaert and Harvey (2000, 2003) use accumulated capital flow data from the US Treasury to analyze the performance of US investors in emerging equity markets. That is, their definition of US investors is comprehensive, including all US investments covered by the aggregate equity flow statistics. Their finding is mixed; they show some evidence of US investors' ability to choose the right countries but the overall US allocation performance is quite similar to the performance that would have been obtained from market capitalization weighting.

In contrast, Froot et al. (2001) define emerging market investors more specifically and focus only on institutional investors using international settlement data from a large custodian bank. Following the daily

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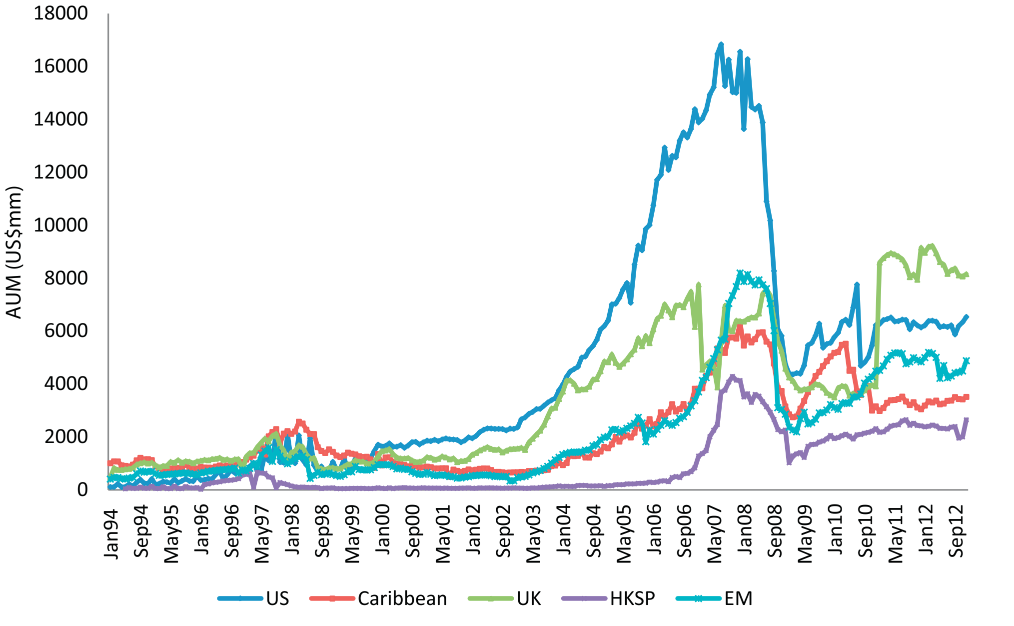
international settlements of institutional investors in 44 countries during 1994–1998, they find that flows to emerging markets are strongly influenced by past returns and inflows have positive forecasting power for future returns. However, their sample of institutional investors combines many different types of institutions such as pension funds, endowments, mutual funds, and governments. Kaminsky et al. (2001) focus on analyzing mutual funds in emerging markets especially during the financial crisis of 1997–1998. They show that there were large withdrawals from emerging market mutual funds during the crisis.

Both mutual funds and hedge funds invest in emerging markets, but hedge funds have more flexibility. While most mutual funds invest only in stocks and bonds, hedge funds can use real estates, commodities, currencies, and derivatives. As emerging market hedge funds can also use leverage, expected return as well as risk can become significantly higher.

Eling and Faust (2010) compare hedge funds and mutual funds active in emerging markets and find that hedge funds outperform mutual funds especially in bad or neutral market environments during the sample period of Jan 1995–Aug 2008. Using the Chow test on structural breaks, they show that hedge funds adapt to changing market environments while mutual funds do not.

As shown in Fig. 1, emerging market hedge funds have grown very rapidly during the past decade especially in the US. According to Tremont Advisory Shareholders Service (TASS) database, the assets under



% of Total AUM by Management Company Location	January 1994 Total AUM ($US 2.32bn)	June 2007 ($US 51.4bn)	December 2012 ($US 26.8bn)
US	5	32	24
Caribbean	43	10	13
UK	20	8	30
HKSP	0	5	10
EM	17	10	18

Fig. 1. Total AUM of emerging market hedge funds by the location of fund management company. US means the management company is located in one of the 50 states of the United States of America. Caribbean means the management company is located in Cayman Islands, British or US Virgin Islands, Bahamas, Bermuda, Anguilla, or Saint Kitts and Ne. UK means the management company is in United Kingdom. HKSP means the management company is in Hong Kong or Singapore. EM means the management company is located in emerging markets: Argentina, Brazil, Chile, China, Czech Republic, India, Indonesia, Malaysia, Mauritius, Russia, South Africa, Thailand, Turkey, or United Arab Emirates.