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Thriving in a disrupted market: a study of Chinese hedge fund performance☆

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ABSTRACT

We study a group of newly-emerged hedge funds in China, focusing on their performance and growth under a series of recent regulatory changes. These include the implementation of short sale restrictions and a circuit breaker. We find that the funds in our sample generally outperformed the stock market despite these regulatory disruptions. The best-performing equity-related strategies were *long-short* and *multiple* strategies. Our results indicate that the ability to sell short is important for all funds adopting equity-related strategies other than the *long* strategy. The imposition of short sale restrictions significantly reduced hedge fund performance, and the performance differential between "winner" and "loser" funds converged over time. The evidence suggests that the regulatory changes have greatly affected the hedge fund industry in China.

1. Introduction

The private investment fund industry in China has seen massive growth over the past ten years. "Hedge-fund-like" financial products have thrived and their growth has been fueled by increasing demand from high net worth individuals seeking alternative investment strategies. While it is not surprising that many Chinese investors have switched to privately-managed funds instead of self-managed speculation on roller coaster-like stock markets, the risk-return trade-offs of hedge fund investments remain mysterious. The Chinese financial market is far from being mature. Consequently, China's new hedge fund professionals must learn to deal with some unique challenges, such as unpredictable regulatory changes and trading tool limitations.

One of the most distinctive skills of hedge fund managers involves taking advantage of leverage and selling short so that they can trade against market trends and achieve profit even when the market is in extremely negative states. In an effort to further develop the financial market, in 2010, the Chinese Government permitted margin trading and the trading of futures contracts on the CSI 300 index. In 2013, the trading of government bond futures was resumed. All these measures literally provided fund managers with the possibility to sell short. These regulatory changes led to a surge in borrowing for the purpose of stock trading, and short-selling became a popular investing strategy. On the other hand, it is recognized that unconstrained short-selling and excessive leverage may also put financial institutions and the financial market at greater risk, which in turn may hinder further financial reform. Following a massive market plunge in June 2015, the Chinese regulator attempted to dampen market turbulence by placing stringent restrictions

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on index futures trading.[1] As a further effort to prevent the fear and panic-selling which caused the rapid decline of the market, a circuit breaker mechanism was implemented in January 2016,[2] but got suspended in four days. The mechanism effectively accelerated selling pressure, and many managers had to dump holdings due to stop-loss agreements with investors.

These market disruptions were the unintended consequences of top-down regulatory changes and caused acute problems for hedging. They undermined the proper functioning of the market and even threatened market stability. In this study, we focus on the performance of China's nascent hedge fund industry during the last few years, especially after the market experienced a paramount plunge followed by abrupt regulatory changes. Our motivations are two-fold. First of all, we are curious how China's hedge funds, which are heavily dependent on their equity positions, survived the recent dramatic market developments. Hedge funds are able to profit from both ups and downs in the market as they can short their positions. However, it is not clear whether this holds true in China, in a market subject to unexpected changes in regulations. Given the controversy surrounding short-selling activities, allowing managed funds to take the short side is one of the most important and brave steps for many emerging markets, as it can promote the development of their financial services industries. In this regard, a close examination of the Chinese case may shed new light on a burgeoning hedge fund industry in an emerging market, and provide valuable policy implications. Second, we aim to investigate trading strategies and fund performance differentials during the last few years when the market experienced disruptions due to regulatory changes. It would be of great interest to uncover the extent to which hedge funds are affected by trading curbs and market downturns. Given the urgency and importance of further liberalizing the financial market and developing the managed funds industry, a study of hedge fund performance under the impact of regulatory changes has both academic and practical implications.

Our empirical investigations yield some interesting results. First, we find that the hedge funds in our sample were able to produce significant risk-adjusted returns. The best-performing strategies turned out to be *long-short*, and *multiple* strategies. Second, since the imposition of short sale restrictions in mid-2015, the performance of these funds has suffered a blow. Not surprisingly, the *long-short* strategy funds were hit the hardest. Third, after the episode of the short-lived circuit breaker, Chinese hedge funds suffered a prolonged decline in performance, causing a convergence in performance across different strategies. Our results suggest that the ability to short is a dominant driving force in determining hedge fund performance in China and that regulatory disruptions to the market had detrimental impacts on these funds.

The remainder of this paper is organized as follows. The next section provides an overview of the newly-emerged Chinese hedge fund industry. Section 3 discusses hedging activities and short selling regulatory changes in China, and we also develop our hypotheses. In Section 4, we introduce our data and lay out empirical models. In Section 5, we present our empirical findings, followed by a conclusion in the final section.

2. Institutional background of the Chinese hedge fund industry

The earliest form of hedge funds in China was known as “sunshine” funds, and appeared in the early 2000s. These privately-offered funds were brought under public scrutiny when they were required to issue their products through eligible trust companies with a special investment account at a custodian bank. Until now, this has been the primary channel by which private funds raise their capital. In 2014, the Asset Management Association of China (AMAC) was established, and all managed funds are required to be registered with them. This registration requirement, which was later refined in 2016, also requires “hedge-fund-like” entities to report their basic information on a monthly basis, including their size, net value and investor number, and provide an audited financial report prior to the end of April each year. Another noteworthy development of the hedge fund industry in China is that the new Securities Investment Funds Law (known as the “New Fund Law”) came into effect on June 1, 2013. For the first time in China, there is law that regulates private funds in addition to public funds.

These “hedge-fund-like” entities, which are generally referred to as “private funds” in China, share a lot of similar features with traditional hedge funds. However, unlike their US counterparts which are usually established as limited partnerships, the structure of a typical hedge fund in China is much more complicated. At present, there are four major entities that are eligible to issue “hedge-fund-like” products, namely, securities companies, mutual fund companies, futures companies, and investment advisory companies. The products issued by these entities are called *Private Asset Management Plans* and are sold to a limited number of investors (usually 200 people) who satisfy income threshold and minimum investment criteria. The investment is subject to a lock-up period, usually six months. There is no specific limitation on the strategies used by the funds which issue these products. Some funds may charge a redemption fee and a subscription fee; nevertheless, the fee structure resembles the conventional 2–20 structure used by the US hedge fund industry.

One complication in the Chinese private fund industry is that “hedge-fund-like” products developed by different financial institutions are subject to different regulations and oversight agencies. Among all entities issuing these kinds of products, only investment advisory companies are solely dedicated to wealth management for high-net-worth investors and are most akin to US hedge funds. Therefore, our study focuses on this particular group of alternative investment products. As pooled, privately-organized funds, the investment plans issued by investment advisory companies are highly flexible, with no restrictions on the range of investment targets (albeit, in reality, most of them are dedicated to the stock market), position limits or size. They are also more concentrated than other private funds. Other similarities of these investment advisory companies to US hedge funds include their higher minimum

[1] The restriction phased in during July and August of 2015, with the daily new contract limit cut down from 1200 contracts to 10. Other rules included an increase in transaction fees from 1 basis point all the way to 23 basis points within the two-month period, and an increase in the margin deposits ratio from 10% to 40%.

[2] The rule stipulates that if the benchmark index CSI 300 falls 5% in a day, trading will be halted for fifteen minutes, and a 7% decline will trigger a halt in trading for the rest of the trading day.