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**Trends in Market Liquidity in Domestic
Bond Markets – A hedge fund
perspective**

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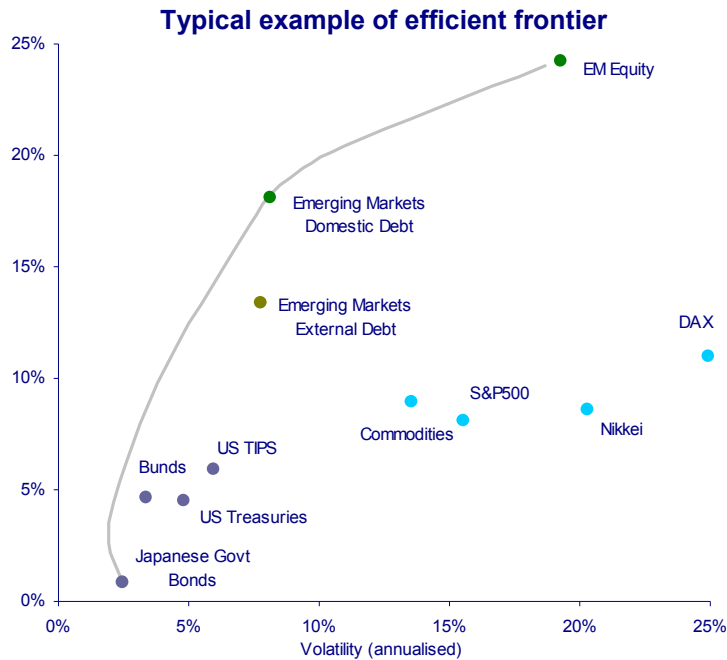


A hedge fund perspective on EM Local fixed income investment

Why do hedge funds invest in emerging markets locally? To make money, but how...

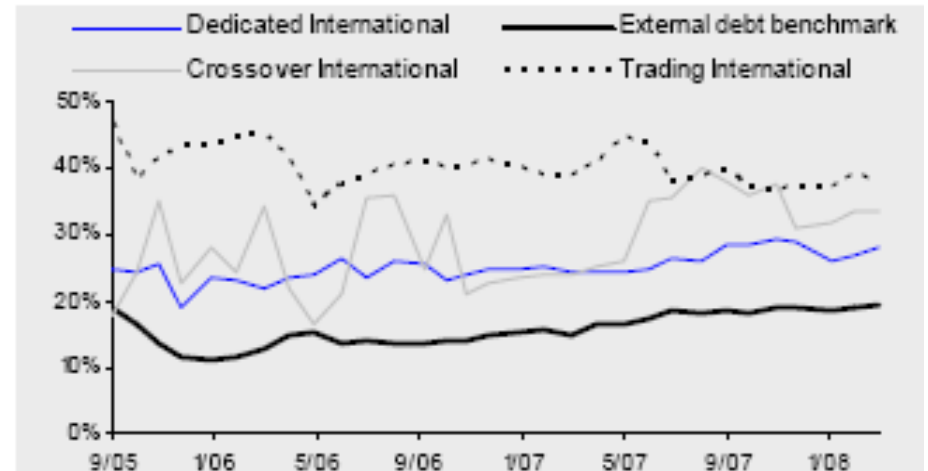
- FX and interest rate differentials. A decomposition of local bond market returns looking at the JPM GBI-EM suggests that picking the right fx/country accounts for roughly 70% of the return and the usually positive interest rate differential vis-à-vis the funding currency accounts for another 15%.
- Only around 15% of a benchmarked local market investors non-levered return would come from picking the right part of the curve for its exposure, or outright curve trades.

Hence, a typical foreign hedge fund, cross-over, or real money investors would normally not take duration exposure unless the market is very liquid in longer tenors unless he is paid for it. Sufficient liquidity is usually only the case once the local market has matured significantly.



Source: DB

Share invested in local fixed income markets



2

Source: JPM, March 2008

What do hedge funds look for in terms of investment attractiveness?

In addition to the typical factors driving an investment decision, e.g. is the exchange over/under valued, what is the carry, monetary policy path, and general macro/political outlook, additional main factors that would determine how to invest and for how long include:

- **Approach to foreign portfolio investors and foreign IBs.** Are they welcome? Will they be blamed for appreciation pressures on the currency when they enter and, of course, when they exit?
- **Capital controls.** Can money be moved out easily, is there a liquid fx market?
- **Predictability of the investment regulatory framework and pricing transparency.** Willing to take longer-term exposure if there is comfort regarding the regulatory regime and/or that changes, if they occur, are well communicated ahead of time and allow for grandfathering.
- **Taxation.** Many of the different ways foreign investors are accessing local markets are driven by taxation considerations. Many times use of TRS, incorporating in an off-shore destination, reflect a desire to reduce taxes and/or double-taxation. Tax treaties certainly help a lot.
- **Repo markets.** Presumably a major difference between 'real money' and hedge funds is that the latter probably wants to be engaged at both the long and short side of the market. Repo markets increase liquidity and the attractiveness of the market overall
- **Local institutional investors and their ability to participate in derivative markets.** While local institutional investors are playing an increasingly important role in their own markets, they can still play a very useful role in allowing for a liquid market to develop by engaging in securities lending.
- **Liquid swap markets.** An alternative to go 'short' when an interest rate view has developed.
- **Benchmark index participation.** Whether it is the JPM GBIEM, Lehman, or Citi's indices, participation in the indices and meeting the criteria are a useful signal and upcoming inclusion in an index can trigger hedge fund inflows.

What do hedge funds generally care less about in terms of investment attractiveness?

There many issues that are not on the imminent priority list for hedge fund investments:

- **Disclosure of who is the end investors.** Most hedge funds don't mind disclosing to country authorities that they are the ultimate end investors. However, public disclosure of such a position is less attractive for competition reasons.
- **Corporate governance.** Clearly for local fixed income investors corporate governance is less of a concern than for equity and corporate bond investors. However, attention to corporate governance issues is a sign of the overall maturation of the financial system in a country.
- **Local exchanges/markets versus global investment banks.** Investors trade where the liquidity its, whether on-shore or off-shore. Hence, by itself counter-party and settlement procedures probably bias foreign investors towards transaction with the global investment banks and have them deal with local settlement and clearing procedures.
- **Providing more exotic type instruments.** There is a clear hierarchy in terms of what instruments are the most attractive for foreign investors. Macro driven investors tend to favor the short end of the curve as plays on fx and monetary policy expectations. The existence of inflation-linked debt, a fully developed yield curve, is likely secondary to liquidity being pooled in a handful of instruments initially.

Conclusions on a foreign perspective on local market development

- **Liquidity/liquidity/liquidity and overall the overall size of the local markets all matter**
- **Foreign investors can be partners in local market development.** However, their investment horizon feel be a function of the opportunities available. The lower the threshold to entry and exit the longer the duration risk an investors is willing to take (somewhat paradoxically). Market deepness key for duration extension for mark-to-market type foreign funds.
- **Focus on improving local market infrastructure in good times**, such that they can withstand stresses during more challenging times.
- **There are many examples of successful experience to learn from other emerging markets.** The developed country model is not always the best (see discussion of Libor market and the use of it as a reference rate).
 - Recent examples of overall successful local fixed income markets include South Africa, Mexico, and Turkey, plus to a large extend the CE4.
 - Some questionable examples, include Turkey, Peru, Colombia, ongoing discussions in Brazil, and usually relate to either taxation, the introduction of capital controls, tightening of prudential requirements.

Appendix - GLG Partners and the Emerging Markets Franchise

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- GLG Partner, Inc. was listed on the NYSE under ticker symbol GLG on November 5, 2007.
- The EM franchise at GLG manages around USD7bn and consists of a team of 12 investment professionals and analysts headed by Greg Coffey.
- Greg Coffey has been a trader/fund manager for the last 13 years. Since joining GLG and launching the first EM fund in November 2005, his annualised return has been approximately 75%.

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