acuiti management intelligence

Systematic Hedge Fund Management Insight Report

IN ASSOCIATION WITH

HKEX 香港交易所

Foreword

Global investors have been braving a tough market environment in 2022 as uncertainty about inflation and rising interest rate have compounded the challenges posed by broad geo-political risks. To gauge how quant funds have reacted to the surge in market volatility, HKEX is delighted to be sponsoring this, Acuiti's inaugural Systematic Hedge Fund Management Insight Report, which surveyed senior executives at close to 40 systematic hedge funds from around the world.

As home to Asia's leading global capital markets, HKEX is particularly interested in understanding how fund managers trade China and the role that exchanges can play in facilitating this. The survey shed light on the top considerations fund managers factor in when they evaluate an exchange as a trading and investment venue; and the findings on two major considerations when entering an emerging market – **product diversity and liquidity** – found to be particular relevant for exchanges and service providers in facilitating access to China.

Across survey responses, it has become evident that adopting new strategies and uncovering opportunities in new markets are key to navigating today's volatile markets.

Looking to the future, HKEX remains fully committed to **Connecting Capital with Opportunities** through its expanding product ecosystem, enabling our customers to better access both Asian and international markets; and **Connecting China and the World** – by further enhancing the pioneering Mainland-Hong Kong mutual market access programmes.

To learn more about our product offerings please visit: www.hkex.com.hk; or do get in touch with any of the team – we are always interested in hearing from you.

Kevin Rideout, Co-Head of Sales & Marketing, HKEX

Introduction

Welcome to Acuiti's inaugural Systematic Hedge Fund Management Insight Report. As with our publications for crypto derivatives, sell-side clearing and proprietary trading, we are providing managers of systematic hedge funds with a gauge of sentiment in their industry, as well as a view into the main operational challenges they and their peers face.

We have quantified these attitudes by surveying our Systematic Hedge Fund Expert Network, a group of senior executives from systematic hedge funds from around the world. We will survey this network once a quarter, to highlight the issues facing the industry and how firms are dealing with them.

The network is interactive and members of the Systematic Hedge Fund Expert Network are invited each quarter to pose questions and topics for inclusion in the report.

While the last decade has seen some dramatic sell-offs, it has mostly been characterised by long periods of low volatility. As inflation surges across the world and central banks raise rates to combat it, that is changing. All market participants have been forced to adjust and hedge funds are no different.

This shift in conditions is the focus of this inaugural report. We have surveyed the Expert Network on how the return of volatility is changing approaches to the market. We have also investigated how market turbulence is affecting fund operations, looking at the pain points and where issues have most often flared up.

We also asked which regions are ripest for opportunity, as well as hiring plans for the next 12 months and take a special look at trading exposure to China, in partnership with this report's sponsor HKEX.

We welcome any feedback on this report. If you have any, please don't hesitate to get in contact.

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Navigating market volatility

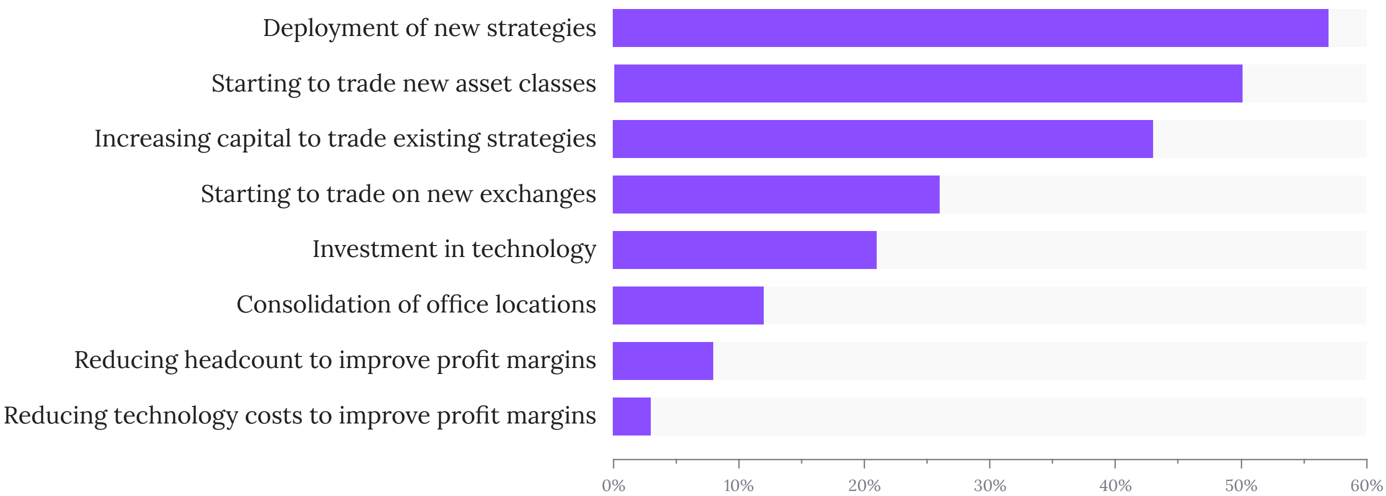
Markets have experienced sustained volatility in 2022 to date. Central banks are prioritising the fight against inflation over accommodative policy and a gloomy global outlook is taking hold. Meanwhile, Russia's invasion of Ukraine has sent shockwaves through global commodity markets. Instability is set to persist for the foreseeable future.

While low volatility markets had been challenging for hedge funds, today's trading conditions are bringing their own difficulties. Previously reliable correlations have broken down. Interest rate hikes have led to major drawdowns in previously popular sectors such as US tech stocks.

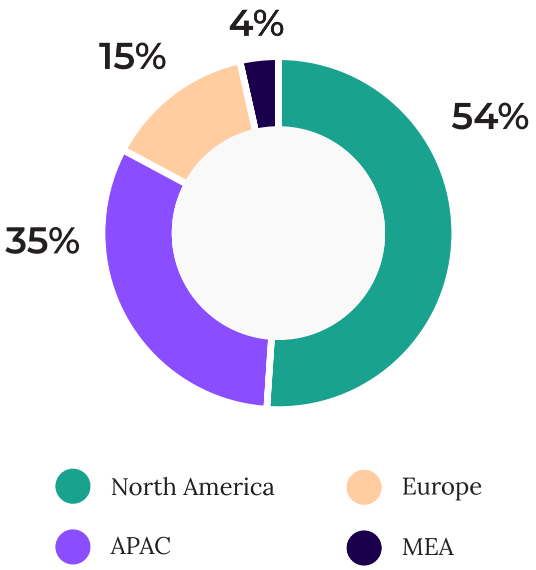
The recognition of a strong shift in trading conditions was supported by this quarter's survey. 57% of the Acuiti Systematic Hedge Fund Expert Network saw the biggest opportunity for growth in profitability in the deployment of new strategies. This change has also been observable among some investors in hedge funds, who have moved from systematic to discretionary management styles this year.

For systematic strategies, respondents saw most opportunity in North America, with 54% seeing the biggest opportunities for the next 12 months in the region. 35% saw better opportunities in APAC and only 15% in Europe.

Where do you see a big opportunity for growth in profitability for your business over the next 12 months?



In which region do you see the most opportunities for systematic hedge funds over the next 12 months?



More fund managers are also looking to trade new asset classes, with 50% of respondents saying they were doing so. In recent years, moving to new products has often included trading in cryptocurrencies and their derivatives.

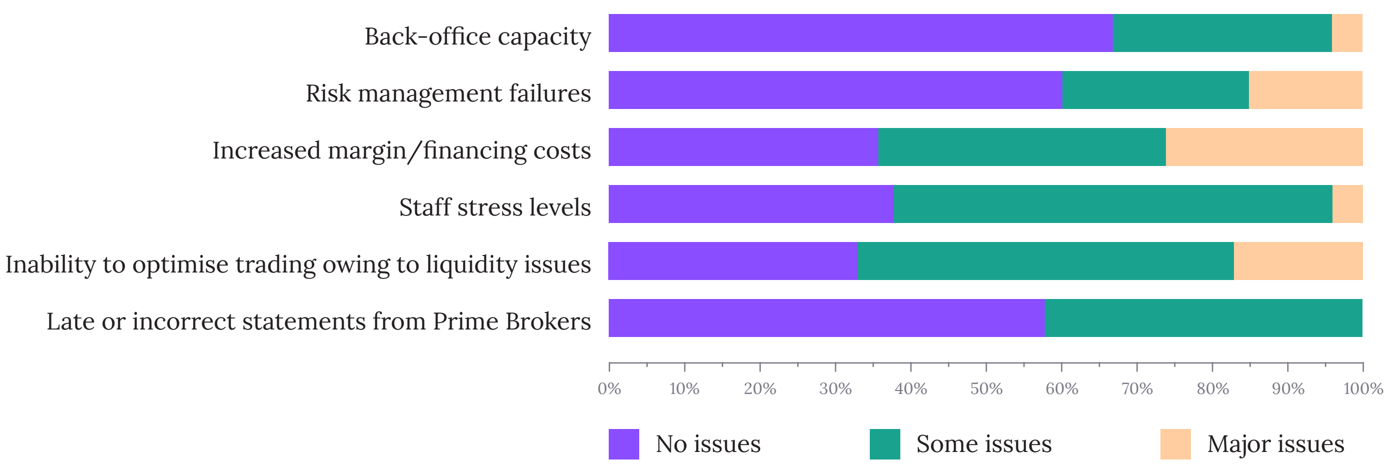
Despite recent large falls in the price there is still a lot of interest in this space, with market neutral strategies growing in popularity as the number of available strategies increases.

What is clear from the views of the Expert Network is that managers remain bullish on their ability to profit during these periods of volatility. Defensive moves, such as cost cutting through reduction of technology costs or headcount pale in comparison to expansion to new asset classes, exchanges and increasing capital deployed.

Operational challenges

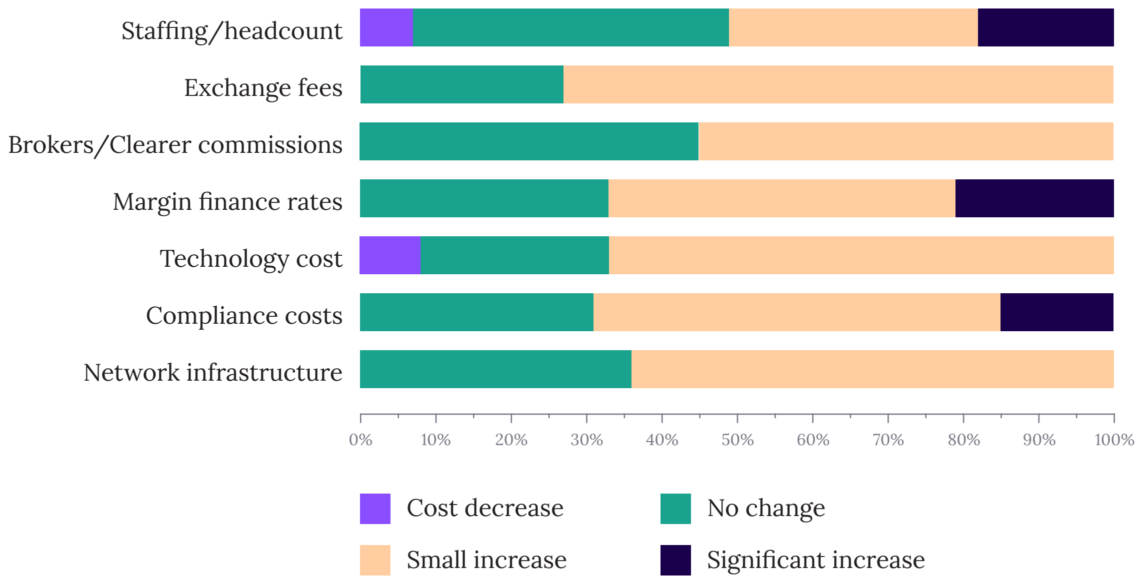
However, while the volatile market conditions are bringing new opportunities, they are also throwing up difficulties on the operational side. The two biggest challenges reported by firms was increased margin financing costs and issues with liquidity. Over half of firms also reported high levels of staff stress.

What operational issues has the recent volatility posed to your business?



Hedge funds have also seen costs rise on several fronts.

How has your cost base change in the following areas over the past 12 months?



The most significant increase has come from margin finance rates, where 67% of respondents have seen an increase. 21% said that these increases were significant.

Rates had already been increasing before this year, as prime brokers became more selective about the levels of finance they offered. This trend began in the wake of Covid-19 and the Archegos collapse.

Since then, it has strengthened for many - 26% of respondents said increased rates during the recent volatility were causing major issues while 38% said they were causing some issues.

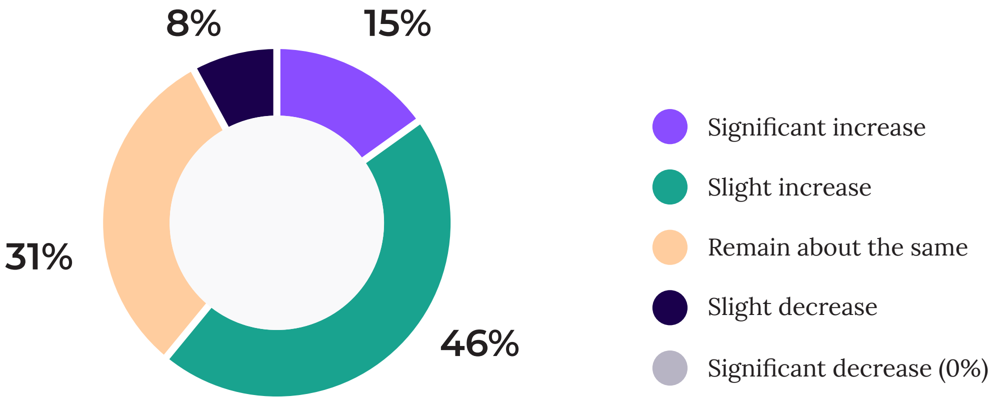
Compliance costs were also increasing significantly for 15% of respondents, while over half of respondents reported increased headcount costs.

Hiring plans target developers

While markets may be challenging, our research found positive signs in the data, especially in hiring trends. As noted above, only 8% of respondents are looking to reduce headcount and 3% technology costs to improve their profit margins.

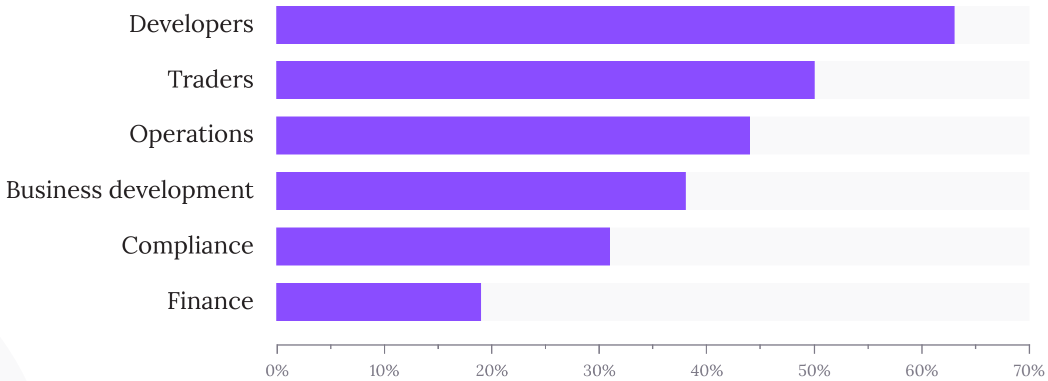
Indeed, most survey respondents expected to increase their headcount in the next 12 months. 15% are planning a significant increase and 46% a slight increase. Only 8% were considering a slight decrease while none were anticipating significant decreases.

How do you expect headcount to change at your business over the next 12 months?



One point flagged by the network has been a lack of data points to help design strategies for an inflationary environment. Given funds' prioritisation of new strategies, it makes sense that developers are the main skill set that executives are targeting in their plans, as they try build up the necessary infrastructure - 63% are prioritising developers while 50% are focusing on bringing in new traders.

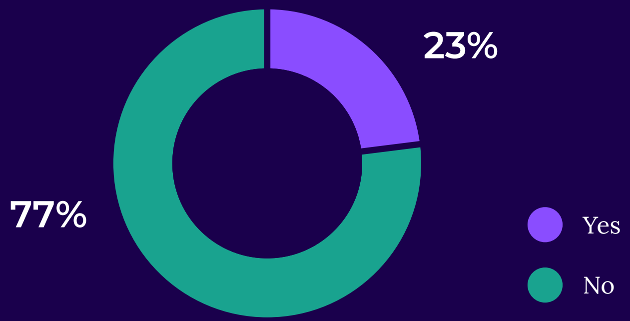
In which areas are you planning to increase headcount?



The end of the high watermark?

Recent drawdowns across some major hedge funds has led to calls to end the high-watermark principle that has long held in the industry. However, just 23% of the members of the Acuiti Systematic Hedge Fund Expert Network thought the industry should move away from it.

Do you think that the hedge fund industry should move away from the high watermark principle?



Contracts and markets

The table below, based on data provided by Euromoney TRADEDATA, profiles the performance of the top 20 new futures and options contracts launched in Q2 2022 based on average daily volume during the quarter.

Exchange	Contract Name	Type	Volume	Open Interest	Average Daily Volume	Launch Date
Asia Pacific Exchange	Bitcoin	Future	277,843	1,092	4,410	Apr-12
New York Mercantile Exchange	Micro Copper	Future	130,331	1,603	2,036	May-02
Coinbase Derivatives	Nano Bitcoin	Future	117,553	3,545	1,896	Jun-27
Multi Commodity Exchange of India	Gold Mini	Option	64,807	1,409	1,012	Apr-25
Chicago Mercantile Exchange	Russell 2000 Annual Dividend Index	Future	6,087	11,034	95	Apr-11
New York Mercantile Exchange	Micro WTI Crude Oil	Option	2,266	1,178	35	Jun-06
Chicago Board of Trade	1-Year Eris BSBY Swap	Future	1,000	-	15	Apr-11
Dubai Financial Market	Micro DME Oman Crude Oil	Future	204	3	4	Jun-01
Chicago Board of Trade	Canadian Western Red Spring Wheat FOB Vancouver Financially Settled (Platts)	Future	150	50	2	Jun-13
Cboe Europe Derivatives	Cboe Sweden 30 Index	Future	101	66	1	Apr-27
New York Mercantile Exchange	Copper Week 3 Wednesday	Option	80	7	1	May-02
Chicago Mercantile Exchange	Nasdaq-100 Annual Dividend Index	Future	57	62	-	Apr-11
Cboe Europe Derivatives	Cboe Norway 25 Index	Future	35	35	-	Apr-27
Cboe Europe Derivatives	Cboe Italy 40 Index	Future	20	10	-	Apr-27
NASDAQ PHLX	Nasdaq 100 Volatility Index	Option	18	-	-	Jun-14
New York Mercantile Exchange	Micro NY Harbor RBOB Gasoline	Future	11	9	-	Jun-27
Dubai Gold and Commodities Exchange	Israeli Shekel-US Dollar	Future	10	-	-	Jun-16
Chicago Board of Trade	3-Year Eris BSBY Swap	Future	4	-	-	Apr-11
New York Mercantile Exchange	Micro NY Harbor ULSD	Future	3	1	-	Jun-27
Tokyo Commodity Exchange	LNG (Platts JKM)	Future	3	1	-	Apr-04

In focus: Accessing exposure to China

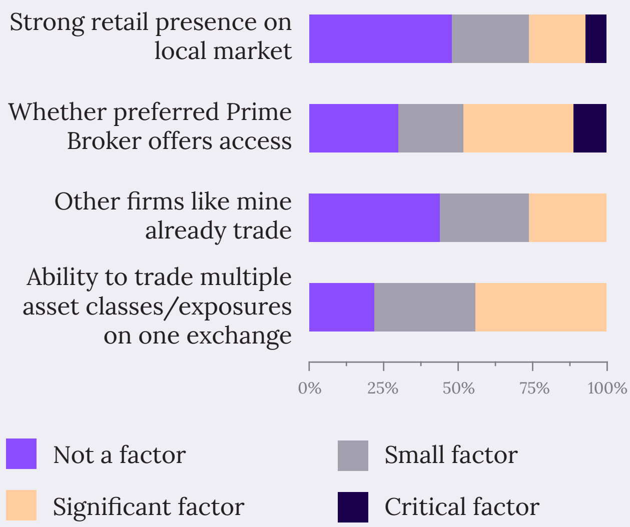
The Chinese market offers many lucrative investment opportunities for hedge funds. 86% of the Acuiti Systematic Hedge Fund Expert Network that traded exposure to China said that doing so was more profitable than their typical strategies.

Despite the opportunities, China remains under-represented in global portfolios, Just 19% of firms in Expert Network traded Chinese exposures. This may be due to perceived market access challenges deterring foreign investors from China.

In order to understand how systematic hedge funds were approaching investment in Chinese exposures, Acuiti partnered with HKEX to ask the Expert Network about their trade preferences and needs for facilitating their access to China's markets as well as their views on what they look for when trading in emerging markets or on new exchanges.

The survey found that systematic hedge funds generally look at two major criteria when they assess new markets and trading venues: product diversity and liquidity.

What factors do you consider when evaluating a new exchange?



The HKEX View: Product diversity

With its diverse product ecosystem and broad investor base, Hong Kong's cash and derivatives markets offer both product diversity and liquidity. For this reason many hedge funds begin allocating to China via Hong Kong rather than seeking direct mainland access.

Hong Kong's derivatives market offers a range of China-access products that cater to hedge funds' trading preferences. In the cash market, the Stock Connect programme allows foreign investors to trade eligible A-shares via Hong Kong with offshore custody. The inclusion of ETFs in Stock Connect on 4 July 2022 has enabled access to 83 eligible Mainland-listed ETFs.

Furthermore, China Securities Regulatory Commission (CSRC) has recently announced measures to further expand Stock Connect – by including eligible Hong Kong-listed international companies in Southbound Stock Connect and more SSE/SZSE-listed companies in Northbound Stock Connect, and by supporting the development of RMB counters in Southbound Stock Connect.

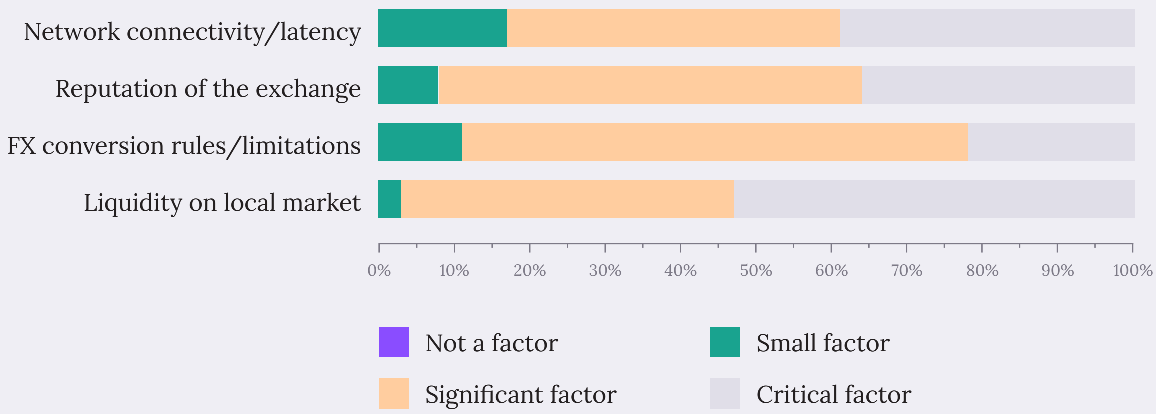
The A-share direct access channel, coupled with a wide range of broad-market and thematic A-share ETFs listed in Hong Kong, provides investors with great flexibility to implement their strategies and achieve their investment goals.

Product diversity, as well as bringing liquidity advantages, is especially important for trading exposure to new or less familiar jurisdictions, where compliance and staffing costs can be cumbersome.

Also important was whether their preferred Prime Broker offers access to the market, again a factor that brings down the cost and complexity of trading on a new market. As hedge funds seek to diversify exposures and capture global trends and arbitrage opportunities, demand is growing to connect to new markets. Once a strategy in itself, emerging markets are increasingly seen by hedge funds as an important part of any strategy. However, firms face a range of considerations over and above the trading opportunities when deciding which markets to trade on.

In addition, with additional costs for trading new markets, hedge funds have to be selective as to what they trade. According to the survey, liquidity is the paramount consideration for hedge funds' trading decisions – 97% of hedge fund executives said liquidity on local market is a significant or critical factor when they evaluate where to trade. Also important is network connectivity and the reputation of the exchange.

If you were considering trading in an emerging market, what factors would you consider in evaluating where to trade?



The HKEX View: Liquidity

Hong Kong's deep, diverse and liquid market has attracted a broad international investor base. This has allowed investors to take full advantage of growing trading volume for Chinese exposures.

- Stock Connect has been facilitating a surge in Northbound flows, with Northbound ADT reaching a record high of RMB 120.1 billion in 2021
- There are currently 37 A-share ETFs listed in Hong Kong, with an aggregate ADT of around HK$469 million in May 2022
- Average daily volume of MSCI China A 50 Connect (USD) Index Futures exceeds US$1 billion and accounts for around 20% of the offshore A-share futures market
- ADV of stock options contracts reached 637,000 contracts in 2021, a record high, supported by the introduction of new option classes that included several "homecoming" Chinese companies, such as Baidu and Bilibili

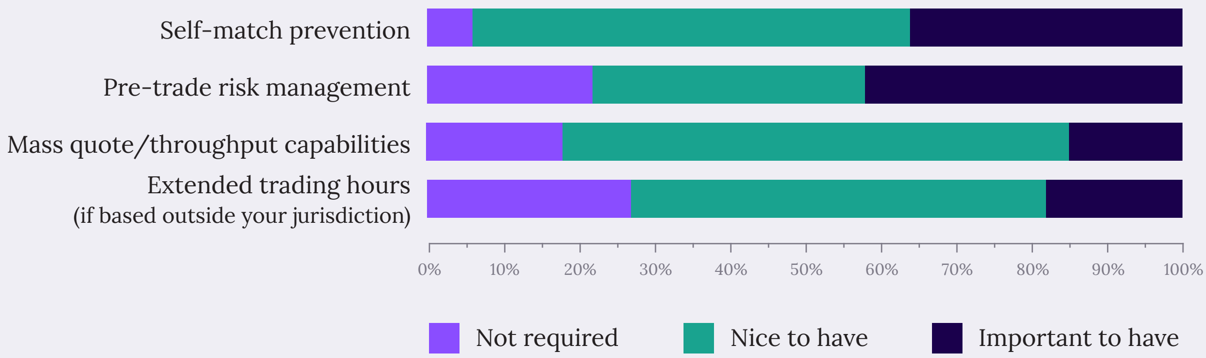
The diversity of Hong Kong's product suite and the growing flows it is attracting allows offshore investors to fine tune their exposure to China.

It also reduces the need to set up onshore, with all of its legal and operational challenges, and in OTC markets, which require more time to develop expertise in.

Hedge funds are increasingly taking more responsibility for their trading architecture and infrastructure. However, there are still several functions that they look to an exchange to provide.

The survey found that pre-trade risk management and self-match prevention were the two main infrastructure-related offerings that hedge funds looked for from an exchange.

What infrastructure-related offerings do you look for from an exchange?



As the Western world enters a new economic paradigm of higher interest rates and soaring inflation, exposures in emerging markets are set to increasingly offer diversity.

Despite the pandemic, China's growth rate is predicted to continue to outstrip that of the US, UK and the EU in 2022. It is no surprise, therefore that investors are increasingly looking to access China and reporting higher profits from doing so.

Hong Kong offers a means of accessing China without the complexities of direct access via the mainland. HKEX offers both product diversity and liquidity, providing hedge funds with a means of accessing Chinese exposures across a range of asset classes and instruments.

The HKEX View: Market structure

On top of the Pre-Trade Risk Management System that 42% of hedge fund executives surveyed considered "important to have", HKEX has also introduced a number of market microstructure enhancements:

- Derivatives holiday trading commenced on 9 May 2022, allowing investors to trade eligible non-HKD denominated contracts on Hong Kong public holidays when the markets of their underlying securities are open. All MSCI futures and options contracts are included in the first batch of holiday trading products.
- Volatility Control Mechanism (VCM) and Pre-Opening Session (POS) enhancements in the derivatives market were introduced in April 2021.
- The VCM enhancement allows multiple VCM triggers per trading session (vs. a maximum of 1 trigger per Morning and Afternoon T-Session previously)
- The POS enhancement introduces a random cut-off mechanism to the pre-opening session and the pre-open allocation session, aiming to deter manipulation of the Calculated Opening Price near the end of the auction process.

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