CAI's strong returns show how multi-strategy can work in Asia

Never one to rest on his laurels, Eddie Tam is already planning to take his organically grown Asia Focused Multi-Strategy Fund to the $500m mark by proving its worth in regional markets

When Eddie Tam co-founded Central Asset Investments in April 2005 and launched CAI's Asia Focused Multi-Strategy Fund a few months later, there were plenty of sceptics who didn't share Tam's hunch that multi-strategy was the way to deliver sustainable attractive returns from the Asian markets.

However, those who did subscribe to Tam's idea, and to the fund, have seen their assets grow 342% in five years. Even taking into account the events of 2008, by January this year the fund was 60% above its 2007 high watermark, and assets under management were fast approaching $250 million.

"We've grown very much organically, we've never been big asset gatherers," says Tam. "Because of our good performance we've attracted capital from like-minded long-term investors. The fact that we've built good performance is not a fluke. A lot of outside investors didn't believe that multi-strategy was the way to go, they thought Asia was all about equities. It was hard to prove it then, but now we have."

The team behind CAI is now 16-strong, and includes co-founder and chief operating officer Vishal Tourani, who knew Tam from their former days at Credit Lyonnais and Fore Research, and Stephen Yip, vice-president for risk management, who joined the same year. Armand Yeung came on board as managing director and portfolio manager a year later, previously having been a senior research analyst with PMA Investment Advisors. Tam, Tourani and Yeung are the principals and partners of the firm.

More recently James Chang left Deutsche Bank's prop desk to join CAI as managing director for quant strategies. Now CAI has 12 people in its Hong Kong office, and in January this year branched out to Shenzhen, with a three-man research team and ex-Longridge Capital man Bill Tsai as head of office.

With its existing infrastructure, beefed-up risk management and existing capital base, the logical next step for CAI is to take the fund to the $500 million mark, and Tam aims to do that by telling the story of how CAI's multi-strategy approach to Asia has been proven to work, and how it can make the most of future events in regional markets.

Eddie Tam

Vishal Tourani

CV: Eddie Tam

2005 to date: CAI – founder, CEO and CIO
2004 - 2005: Fore Research and Management – chief portfolio manager
1994 - 2002: Credit Lyonnais – head of sales, structuring & marketing, Asian derivatives
1989 – 1994: Merrill Lynch – equity derivatives
Education: University of Toronto – Master's and Bachelor's in electrical engineering. Yale School of Management – Master's in public & private management; member of the Greater China Advisory Board

While individual position selection is very important, the majority of returns come from asset allocation, so much so that this is a form of risk management in itself, says Tam. "People think they can do their own asset allocation and diversification at a higher level, and it did take a long time for investors to believe we can do it at the fund level because it requires more work. We trade 24/7 and work hard to look at a variety of opportunities in credit, long/short equities and arbitrage strategies."

Looking back over last year, the benefits of being able to switch between strategies within one fund become apparent. The fund went up 48% for the year, which divided into two distinct phases, says Tam. From January to August, the fund allocated two-thirds of AUM to credit and the remainder to equities. "Even then we were not purely in equity long/short, but also in market-neutral arbitrage positions," says Tam. "Our strategy focuses almost exclusively on short-dated credit. A lot of positions were just maturing from January to August so there wasn't much impact from what happened to Greece in April and May."

By the end of August, the fund had already gained 20%, just over half of which came from credit. "But we did also have core deep-value stocks, especially gold jewellery retailers in Hong Kong such as Chow Sang Sang and Luk Fook, which went up a lot in the first half of the year," says Tam.

A shift of strategy in the past few months made 2010 a banner year for the fund. "In August, we made a macro call. Our thinking was due to two main factors — anticipation of a second round of quantitative easing in the US, and also of loosening of the renminbi. We felt it was the right time to shift more into equities and by the beginning of September we were two-thirds in equities, mostly directional, and only one-third credit."

The fund rode an Asian market rally from September to November, then de-risked as the year came to a close. The fund also shifted away from China and towards North Asia, including Japan, during the course of the year.

Continuing their cautious stance into this year, the CAI team kept the fund 50-50 in equities and other asset classes, with overall net leverage of just under one time. The fund has been shifting away from emerging Asia, particularly Indonesia as well as other South-East Asian markets, but is now back in the region looking for bottom-fishing opportunities.

"The first wave of an emerging Asia sell-off may be over. But it's data-dependent — if food and energy inflation rage on, there could be more selling," says Tam. "Historically, less-developed countries like India and the Philippines can't afford to subsidise staples and people get hit hard when they have to contend with high food-price inflation."

The CAI team has a somewhat less alarming view of China. The size of the Chinese economy has surpassed Japan, the country is in a better position to withstand high food-price inflation, has a strong enough government to subsidise food and fuel and, if they need to, put in price and wage controls to avoid a vicious cycle of wage and price inflation.

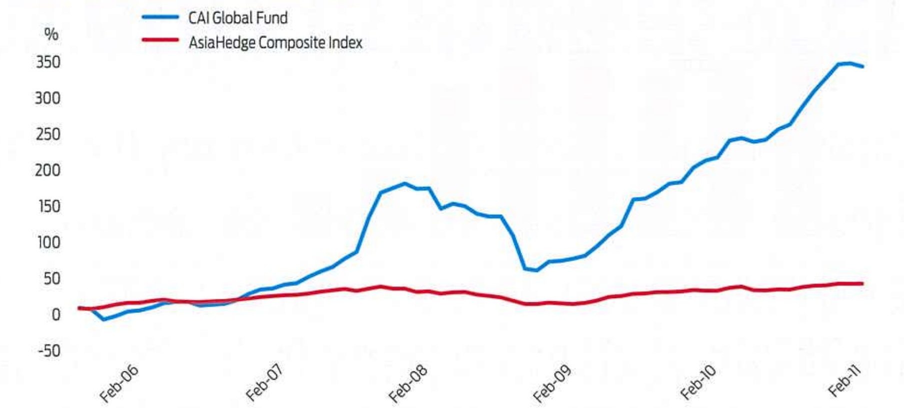
However, the market needs a few more months of data to believe that China can control inflation. Together with unemployment, GDP growth and the trade balance, inflation affects RMB policy, Tam adds. "I expect China will allow the RMB to appreciate 5% or even more gradually this year."

As for Japan, hope springs eternal at the beginning of every year, and 2010 was no exception, Tam observes. Then people's hopes were dashed when the yen not only didn't go down, but strengthened.

"At the beginning it was a mystery why it rose so high given the unsustainable fiscal conditions, but one of the largest marginal buyers of the yen was China. This year, assuming I'm right and Beijing allows the RMB to go up, there will be less need to buy overseas assets and, if so, the Nikkei has a good chance to have a meaningful rebound. If the yen hovers where it is now or even below to 85, the Nikkei can go to 12,000, but if it manages to weaken close to 90, the Nikkei could go to 14,000."

"So, for the first half of the year we are taking a cautious, data-dependent stance, and then hopefully there will be more benign inflation data in the second half. We are also now taking a market-neutral strategy, especially in the absence of a very clear direction in the stock market. We're going to try to find and exploit more quasi-arbitrage opportunities including merger arbitrage. Given the cheap rate of financing, we anticipate there will be more M&A opportunities."

Performance: CAI Global Fund



Source: AsiaHedge

Central Global Fund: at a glance

Inception date: Sep 2005
Managers: Eddie Tam, Armand Yeung
Office: Central, Hong Kong
Strategy: Multi strategy
Assets in strategy: $241 million
Administrator: Prime Fund Solutions
Prime broker: Morgan Stanley
Open to investment: Yes

The latest enhancement to the CAI fund centres on more strategic management of volatility. While historical returns for the fund have been good, they have also been volatile, a natural enough effect of investing in emerging markets, but one that would be good to control. CAI hopes to do this by adding a more explicit volatility strategy that can act as a hedging overlay for the entire portfolio. To do this, CAI brought in James Chang in late 2010.

"It's possible that this is a very cheap form of hedging compared to using put options and static hedges. We're building up that new strategy, and we think it's been the missing piece."

The addition of a Shenzhen office is also an important step for CAI, as it represents a first foray into mainland China. Being close to the border, it is easy for Shenzhen team members to come to Hong Kong and for their Hong Kong counterparts to join them on company visits. In addition to being home to one of China's two stock markets, Shenzhen is also a high-tech manufacturing hub offering access to plenty of interesting companies in southern China, says Tam, who was impressed by the calibre of mainland talent that applied to join CAI.

There are plenty of reasons to consider mainland China as more than just a market for investment opportunities. With the rapid development of the offshore RMB market, Tam looks forward to the listing of exchange-traded funds, real estate investment trusts and other investment vehicles. While the offshore and onshore markets continue to be very segregated, as China starts to see the results of various financial markets experiments it will prompt further opening of the China market, he says.

"Now there is over RMB300 billion ($45.7 billion) offshore in Hong Kong and all the signs point towards that being RMB1 trillion in 2011. Beyond that, is it really possible to control capital flows between Hong Kong and China? Do you have enough investment products and opportunities to satisfy the needs of RMB investors?

"I think China is willing to push this experiment further, it has to let some off some steam and let domestic capital flow outwards. It won't open up completely but it will relax some. We may get involved in helping manage outflows or inflows down the road but that's all really in the longer term."

As for markets beyond Asia that could have an impact on China and the rest of the region, Tam does not foresee a return to the levels of systemic stress that emerged in 2008, but the underlying problems that this stress caused have yet to be resolved.

"Banking capital restructuring is still not sufficient so there's still the moral hazard of banks taking risks: that's a problem that has not been fundamentally solved. Then there is the problem of the banking sector becoming more socialised. All the western countries have this but the smaller countries don't have the resources to solve it. Germany is doing so well, and if it wants to bail out weaker European Union countries it can, but the issue is does Germany want to?"

As with the fight against inflation in Asia, the strongest player in this scenario may turn out to be not Germany, but China. With its massive foreign-currency reserves, it is throwing its weight behind trying to support some of these countries and trying to buy friendship, notes Tam.

"China is very willing to work out its problems with the EU and US — in the long run it has no interest in provoking a trade or currency war. This year could see an improvement in RMB policy and the trade deficit can start to narrow. If China is not going to panic and dump a lot of its US treasury bonds, this will give a chance to the US for its recovery to become stronger."