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Interview with Eddie Tam of Central Asset Investments

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Central Asset Investments (CAI) is an Asia focused multi-strategy investment firm licensed by the Securities and Futures Commission (SFC) in Hong Kong. Founded in April 2005, the firm is headquartered in Hong Kong with a research office in Shenzhen, China. The CAI team consists of 17 professionals working across portfolio management, research, risk management, operations, and investor relations.

The firm currently manages one principal strategy - the CAI Global Fund, which invests dynamically across equity and credit opportunities. Since its inception in September 2005, the average annual return of the fund is 23%. As the fund is not a retail fund it has not been authorised by the SFC.

Mr. Eddie Tam is the CEO and CIO of CAI. Prior to that, Mr. Tam also held positions at Fore Research, Merrill Lynch, Salomon Brothers and AT&T Bell laboratories. Mr. Tam received his MPPM from Yale School of Management in 1993, holds an M.A.Sc. and a B.A.Sc. in Electrical Engineering from the University of Toronto, and is a member of the Greater China Advisory Board at the Yale School of Management. In October 2010, he was named one of the 25 most influential people in Asian hedge funds by *Asian Investor*.

1. ***Your fund has delivered admirable performance since its inception, what is it about your investment style that gives you the competitive edge to deliver excellent returns?***

   As an Asia focused multi-strategy fund, we are able to dynamically allocate our asset across equities and credit opportunities, which we believe plays a significant role in generating long-term returns. This ability to remain flexible and nimble, combined with the team's extensive experience across markets and asset classes allows us to identify and capitalise on market inefficiencies, and generate long-term absolute performance for our investors.

2. ***Being a multi-strategy fund, what are the different investment strategies that you employ? What portion of your fund's portfolio do you allocate to each of these strategies?***

   We invest across credit (including convertible bonds), equity long/short (core and trading), market neutral (including convertible bond, capital structure and merger arbitrage), quantitative and volatility strategies. Asset allocation is a dynamic process beginning with credit - specifically, we focus on investing in short duration instruments on a buy and hold basis, which generate a risk-adjusted base return for our fund. The idea is that this base return acts as a hurdle rate for us to look through the rest of the investment universe (e.g. in equity long/short) and generates ideas which beat this base return. It is important to note that while top-down macro factors drive the asset allocation between credit and equities, the security selection process within different sub-strategies is a bottom-up fundamental-driven process.

3. ***Could you tell us about the geographical diversification of your fund's portfolio? Which regions do you allocate to and on what basis do you determine your exposure to each region?***

   We invest across Asia including Japan. Our credit strategy is almost entirely driven by fundamental research. Consequently, it tends to be more geographically diverse, spanning Greater China, North Asia, ASEAN and India. Our equity portfolio on the other hand, is more focused on Greater China and North Asia since they are the more liquid and active markets in the region, which we are most familiar and experienced with.

4. ***What kind of qualitative and quantitative research do you perform on stocks and/or sectors before they are added to your fund's portfolio? Could you tell us a little about the process from idea generation to actual investment?***

As mentioned earlier, asset allocation starts with top-down analysis on macro trends such as geopolitics, socioeconomics, fiscal policy (budget, growth, and unemployment), monetary policy (interest rates and inflation) and foreign policy (currency and trade), to provide an investment framework for the team to work within. Areas of focus vary depending on macro trends and include, but are not limited to sectors, upcoming trends/themes, countries, sub-strategies and asset classes.

Having lived and prospered through several crises and severe market corrections, the team will then use their extensive investment experience as well as leverage on their wide local network of relationships with sell side, industry professionals, and local banks, to gain a better understanding of the relevant investment landscape and identify potential investment targets. This process is further supported by a recently developed quantitative model, which monitors and screens the entire Asian universe to keep an eye out for inefficiencies, anomalies, and mispricing using specific parameters set out by our portfolio manager. This acts as a quantitative filtering mechanism in sourcing new ideas to serve as a starting point for examining different ideas.

Once a potential investment opportunity has been identified, a more comprehensive and granular bottom-up analysis begins. This fundamental research process is tailor-made to each opportunity and strategy, and includes industry analysis, competitive positioning, business strategy, cash flow analysis, financial models, leverage analysis, understanding banking relationships, sell side research, shareholder structure, management track record, company on-site visits, communicating with top management, and monitoring ongoing news flows. Driven by our portfolio manager, the process is supported by our research team in Shenzhen.

Opened in early 2011, the Shenzhen research office has already proved to be a valuable asset to the firm. The additional manpower and access to local Chinese intelligence has further strengthened the firm's research capabilities, and helped the investment team gain a deeper understanding of new investment opportunities, as well as monitor and conduct ongoing due diligence on existing portfolio companies. While the initial area of focus was on Chinese companies, our analysts are already studying opportunities throughout Asia. Using this fundamental research in combination with the investment team's experience, the team identifies the 'best in the class' method to express and execute investment ideas across the capital structure.

5. ***Do you use leverage to enhance your fund's returns? If so, to what extent?***

Yes we do use leverage to enhance investment returns when the right risk-adjusted opportunity presents itself. Gross leverage usually ranges from 100% to 300% while net leverage ranges from 0% to 150%.

6. ***On average, how many different investments is your fund invested in at any point in time? What is the usual holding period that you observe in your fund's portfolio and how often do you review, and accordingly alter (if at all), the portfolio?***

The average number of positions in the portfolio ranges from 100 to 200. This includes thematic basket trades, quantitative strategies and pair trades, which tend to be more diversified in numbers, as well as more concentrated medium to long-term positions.

The average holding period of the portfolio depends on the nature of the sub-strategy. For example, in credit and fundamental core value equity, holding period ranges from several months to several years. For equity trading opportunities, which may be more thematic and momentum oriented, holding period ranges from a few weeks to a few days. The portfolio is monitored on a real-time basis and the investment team meets daily to review and adjust the portfolio as needed.

7. Could you tell us about the risk management practices that you observe for your fund?

Risk management is considered on many different levels. From a daily portfolio management and execution point of view, the portfolio is closely monitored on a real-time basis by the Risk Manager, taking into account a series of risk metrics and limits. Risk metrics and limits monitored includes quantitative factors such as VaR, position delta, gamma, theta and vega sensitivity (portfolio and position level), leverage, sector concentration, liquidity and position level stop loss limits (defined by the different sub-strategies). As risk alert levels are hit, the relevant parameter or position will be flagged and brought to the attention of the investment team for review and evaluation and preventative action will then be taken. Risk management tools used to counter such perceived risks identified in the portfolio may include cutting back relevant exposure, dynamic hedges and a volatility overlay.

On a more macro level, the Risk Manager works closely with our Quant Strategist to develop more robust risk management capabilities, including looking at different quantitative risk parameters, running regression analyses and developing various forward-looking stress test scenarios. Current stress tests includes static stress tests, taking into account credit spread, interest rates and corresponding price shocks, and dynamic stress tests; taking into account market scenarios using a three-period model to better simulate real life market movements.

8. Has there been a core management/strategy shift in light of the financial downturn to implement the lessons learnt during the crisis?

While our dynamic multi-strategy investment approach has remained constant since inception, we are continuously striving to improve and learn from past mistakes. One area we have worked to improve on is our risk management framework by imposing much tighter risk limits in addition to employing a more dynamic application of leverage. Another key implementation we made at the beginning of 2011 is to add a long volatility overlay to our strategy, designed to be a tail risk hedge for our overall portfolio in times of extreme market conditions. In the past few months, this overlay has worked to help partially mitigate the losses in other parts of the portfolio.

9. What class of investors is your fund best suited for? What sort of time horizon and risk appetite must one have in order to be exposed to a fair balance between risk and return while invested in your fund?

Our fund is suited for a wide range of investors and importantly, the time horizon of investing is crucial. We have constructed the portfolio to take advantage of certain inefficiencies which may take some time to play out. As a result, the strategy likely resonates better with long-term investors. In particular, over the last six years, we have navigated challenging market conditions and achieved a strong annual return of 23% net of fees to our investors. It is important however, for investors to bear in mind that while Asian credit has a number of significant advantages for long-term investors, there are some drawbacks.

Firstly, it is typically difficult to identify the right hedge as credit markets inherently are even more asymmetrical than equity markets. Secondly, liquidity in credit markets is somewhat pro-cyclical in nature. Inevitably, this means that one has to be willing to accept some mark-to-market volatility in credit to take full advantage of these opportunities.

10. Could you give us your outlook on Asian markets both in the near and medium-term? Are there any regions/sectors that you are particularly bullish on at this point in time?

Significant headwinds clearly face the global economy, including the ongoing peripheral sovereign credit weakness in Europe, potential double dip in the US and fear once again over hard landing in China. We do not believe that a V-shaped market rebound is likely in the near to medium-term. We believe that the current set of issues will be more or less drawn out over the medium to long-term, acting as an overhang on equity markets, and meaning markets are likely to be L-shaped. Having avoided a 1920s style depression, a prolonged two-speed stagflation environment *à* la 1970s is likely, with Western economies growing at a lower rate with a lower rate of inflation, and developing economies growing at a higher rate but with a higher rate of inflation.

Given this macro outlook, we believe that credit provides the best risk reward investment opportunity in the medium-term. Asian credit has been a massive outperformer over equities for the last six years (JPM Asia non-IG credit +63% vs. MSCI Asia ex-Japan +27%), and will likely to continue to do so in this stagflationary environment. In particular, we are seeing some especially compelling opportunities in Greater China where credits have been aggressively sold-off recently due to concerns over corporate governance following Sino Forest (to which we have no exposure), as well as fears over a hard landing. Expected default rates that are being priced in Asian credit opportunities at this time are extreme (for example, even among the highest calibre Chinese real estate developers, the expected default rates are 50%). While incidents such as Sino Forest are certainly not a lone occurrence, not all Chinese corporations are fraudulent. The key to filtering out the frauds and distinguishing the real growth engines in China is through extensive experience and hard work, conducting comprehensive on the ground research and analysis, and ongoing due diligence.

Additionally, the Chinese economy has progressed substantially in the last few years, and has become less dependent on external trade (net exports in fact is a slight negative contributor to GDP growth during the first nine months of 2011) and other external factors, especially given that the Chinese government has already taken a number of aggressive steps in the last two years to cool down the economy (e.g. by hiking interest rates five times within the last 12 months, reserve ratios 12 times since 2010, and by allowing the RMB to appreciate by 7% against the USD since 2010). We are guardedly optimistic in China's ability to engineer a 'soft landing,' and in its ability to slowly transition from investments-led to consumption-led growth. This macro backdrop should bode very well for Chinese credit.

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