

SURVIVING IN THE NEW NORMAL

Positioning on credit in the medium and long term

Central Asset Investments' founder and CIO Eddie Tam predicts that the markets will be facing gloomier times, but insists that hedge funds who are in it for the long haul still have opportunities to be found in what may seem like a hopeless environment

— By NINA PABLO

For investor Eddie Tam, there is no need for investors to panic over China. “The especially tough part this year has been credit. It’s suffered quite a large sell off in the last two months because of this sudden panic over China, but [credit] is where the opportunities lie,” he says.

Tam, who has had stints at Merrill Lynch, Credit Lyonnais, and Fore Research and Management prior to founding his multi-strategy investment firm Central Asset Investments (CAI) in 2005, claims that the recent panic over China and the resulting selloff have been overblown.

He is not worried about the mainland for several macroeconomic reasons, among them the relatively low gross domestic product (GDP)/capita (still at US\$4,420; historical precedent suggests that nations typically slow down at around US\$17,000) and the strong support system among the government, banks and corporates. He does not see why China, with its major shareholdings in the big four banks and as the world’s largest creditor, would

ever give up on these banks and why the latter in turn would not support corporates.

Tam adds that the parallels being pointed out between China and Japan before the latter’s bubble popped 20 years ago are largely untrue. “I don’t know if the comparison is apt. When the bubble burst, the Nikkei Index was at over 100 times P/E. The Hang Seng Index is less than 9x, domestic A-shares, less than 12x. That’s very different from 100x. To what degree are these markets a bubble?” he challenges. “And even if it were a bubble, all countries mature and slow down. Again, I argue that China is not even at that point yet.”

Making the most of inefficiencies

He posits that because of the recent rapid selloffs, liquidity in the credit markets has been “ephemeral,” or pro-cyclical. “When times are good, there

is lots of liquidity in the bond market; when times are bad, suddenly there’s a vacuum. Dealers especially don’t want to take much risk now, so they don’t keep inventory. Basically, there’s a tradeoff between the yield, returns, liquidity. Because of that [and other factors], there’s a large degree of inefficiency in the market. As hedge funds, we’re looking for arbitrage, we’re looking for inefficiency.”

Working with and around such inefficiencies is something that hedge funds will have to get used to, it seems. Because of distorted monetary policies around the world and a pro-cyclical problem-solving approach, governing bodies have inadvertently accelerated the economic and market cycles.

“It is no longer appropriate to talk about the black swan or the 100-year flood. They happen every year or every other year now. That is the new normal, which is very unsettling. It will be a rolling crisis, a low-level fever for many more quarters, if not years,” he says, adding that markets need to be allowed to correct themselves.

Tam believes that the current bailouts are not the solution because “you cannot bail out everyone, and it’s even worse if you only bail out the fat cats and not the man on the street. We’re going to have to let the markets adjust a little bit more on its own.” He argues that it is somewhat hypocritical for the International Monetary Fund (IMF) or the US or the EU to “now basically say that ‘we must give more money to these countries,’ or in the case of the US, ‘let’s do QEIII.’ They are using more debt to solve the problem of too much debt, which is very ironic. They’re not prescribing the same medicine for themselves [as they did to us during the Asian financial crisis]. Whether they come up with the will and determina-



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tion to really tighten their belts and engage in austerity, I don't know."

Creating opportunity

CAI, since its inception six years ago, has done quite well thus far by seizing opportunities out of the market chaos, with an internal rate of return of about 23%. At present, CAI has over US\$200 million in assets under management (AUM). Credit dominates a large share of their investments with about 75%, followed by equities at just under 25%.

Credit will continue to be of great interest to CAI in the long term, with the expectation that credit will still outperform equities in the next three to five years even in emerging Asia, where the latter might typically be expected to be the faster-growing asset class.

"It's certainly puzzling and counter-intuitive, opposite to what the textbooks tell you. They tell you "equity risk premium is high, therefore equity should be the high risk high return asset class," but it's not been the case for the past five, six years," he admits. "But the good thing about equities long/short is that it is more liquid; you can get in and out quicker. But they are very open ended and in this environment, there are not too many buy and hold opportunities. Even if something is cheap, it may remain cheap or get cheaper in the next year or two. From an investment point of view, medium- to long-term, we're positioned on credit."

He is aware that defending this unusual point of view to investors might be hard, especially since most current investors have a strong bias towards equities. "They think either that credit is not liquid, the size of the market is too small, or that nobody really knows Asian credit. They are very sceptical about it." In spite of this, he is confident that they are taking the right stance despite the fact that the Asian credit market is small.

"I think that's why it's quite exciting. If [managers] want to deploy maybe US\$20 billion, maybe the market's not big enough. But if you want to deploy US\$200 million-US\$500 million, or even a billion, I think it's very inter-

esting. In investment, I'm not necessarily looking for size. I'm looking for profits; I'm looking for inefficiencies; I'm looking for arbitrage opportunities. Because the Asian credit market is not very big, it's not very widely understood, and it's not the most liquid, I'd like to think there are inefficiencies and profitable opportunities there."

With the future looking bleak, however, CAI's plans for the future are all about toughing out the rolling crisis by keeping their nose to the grindstone. Tam places special emphasis on knowing the markets inside and out in these especially tough times. While he acknowledges that CAI has achieved good returns for both its internal and external investors, six years in the game is not enough to call it a success.

"This is a marathon," Tam says. "I think I still have to keep doing what I'm doing. Six years with 23% return is good, but I have to keep doing this for another 10, 20 years in order to say 'wow, I've achieved something, I'm a world class investor.'"

Performance to Tam is first and foremost on his priorities, not accolades or anything else. "It's very hard to say what a milestone for this business is. I can tell you "oh, this trade, I made this much money." But I don't think that's really the standard. The standard for me is the long term performance. In our game, the proof is in the pudding. It's in the money... just the fact that we've achieved a relatively good rate of return for our investors, both external as well as internal, is satisfaction."

The future and its changes

He is nonetheless proud of CAI's achievements beyond just their financial performance, and gushes about CAI's solidly built system and strong investment team, which is comprised of colleagues Tam has known or worked with for many years before and, he believes, will be able to take over his business decades from now.

The fund's COO Vishal Tourani, for instance, has been with the firm since its inception and worked with Tam for several years at Fore Research and

at Credit Lyonnais. The head of their Shenzhen office, Bill Tsai, has known Tam for over 20 years since they were at Yale University.

He notes these factors have set up CAI for a strong future despite the many sea changes that the world is undergoing. Tam says that the change he has seen from a global perspective is an increased focus on compliance, ethics and structure, an approach he agrees with but believes will make it all the more difficult for new players. "CAI totally enforces this and has strengthened its platform completely. We have full disaster backup systems, among others. [It is fortunate we have all these infrastructure in place,] because it's made it more expensive and difficult to start a fund."

In Asia, he predicts that changes will be more gradual, but that Asians are affected by the same currents, with people similarly becoming more aware of regulatory and operational issues. There will also be greater competition coming into the region, both local and international. "The difference between local and international competitors is permanence. International competition has a habit of coming and going. We are permanent," the seasoned banker comments.

But Tam is not worried about competition. "I'm competing only against myself. I think the markets are big enough to accommodate a lot of different managers, especially in Asia. The markets are still a bit small in some respects but certainly, emerging markets are no longer small."

Asked to summarize his experiences running CAI thus far, Tam explained that "every day, every month, every quarter is like a surprise. The most important lesson I've learned is that it's really difficult. Markets are very unsettled, much more so even than the previous decade. I expect things to remain this way for a long time to come, as a result of all those crazy macro policies around the world, so you better be prepared for a lot of surprises. Crises are opportunities but you've got to be careful about the downtrends." ■