Meditating on the macro

AsianInvestor hosted a roundtable discussion of some of Hong Kong's prominent hedge fund managers and investors, who talked through the big themes for 2011, from China to raising assets.

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AI: How was 2010?

Geoffrey Barker: We had a mixed year in 2010, and our fund came out average among macro funds. We were up 6-7% in the first half of the year and gave most back in the second half. I was too bearish at the beginning of the year, but worries about double dips and so on were ultimately vanquished by QE2. It was an up and down year for us. We only partially participated in the Asian equity boom and the commodity boom.

Paul Sheehan: It was a pretty tough year for the markets, although we were able to do OK as the opportunity set for event-driven improved quite a bit from last year, and we finished up 11.3%. Gains were pretty evenly spread through the year, though we usually make our best returns in months that are not so good for everyone else. Asian M&A has picked up and remains strong from a structural perspective, and that is more important than market directionality for us. We hope this momentum will continue this year.

David Seex: The majority of our funds are in the resources arena and they had a strong year, backed by good long term fundamentals and, in the case of our energy fund, which is event driven, a series of positive operational events. The energy fund was up 50% and our mining and resources fund up more than 20%. However it was a hard year to raise new assets.

Walter Chang: Last year was a pretty mediocre year after a fantastic 2009. We were up 2%, and that was due to the volatility, especially in January and May. In the second half we were able to make up lost ground. Controlling volatility was the key in 2010, but we hope as we move into the second half of the cycle it will be more favourable to us. We have grown in size a bit, perhaps not as much as we'd have wished to, though.

Eddie Tam: We had a pretty good year. We were up 48 % in 2010, which wasn't as good as 2009, when we were up 77%. The key to that performance was our asset allocation. We did well in short-dated credit as the recovery and rebound continued. We weren't hurt by the early-summer volatility as a lot of our short-dated bonds were maturing at that time. In the late summer we decided to shift from credit to equities. So then we were two-thirds equities (primarily directional) and one-third in credit, as opposed to the one-third equity/two-thirds credit from earlier in the year.

Part of our equities approach is core-value stock picking and we found some gold and jewellery stocks that outperformed. It turned out that the best way to play gold was through the story of retail consumption of gold in China. However, we're now two years into the equity rebound, so technically we are vulnerable to a pullback.

AI: Are you all bullish or bearish for this year?

Chang: It could be a tug of war, with the western world continuing with a reflationary process and Asia in tightening mode attempting to contain liquidity.

Barker: The goalposts have moved since last year with inflation going from not being a big concern, to becoming a big concern. What I'm most surprised about is that people are still very bullish on continued growth. I think that will be tricky, because you either have to deal with inflation, in which case growth will be a problem, or you don't deal with it, in which case inflation comes out a lot higher than expected.

Difficult choices then for this year, and I expect inflation will be high on the agenda for the first half of the year and growth will be challenged for the rest of the year.

Geoffrey Barker

AI: What does that mean for the renminbi?

Barker: I'm turning bearish on Asian currencies and I think they are being repriced through inflation. I don't think Asian central banks will tighten and let their currencies go. They have left it too late. I also wouldn't be a buyer of renminbi, looking at the forwards. Money came into the region because of the growth outlook and portfolio flows can easily go back out.

Tam: If you freed up the controls over the renminbi, would money flow in or out? My bet is that there would be a net outflow. However, in reality, I think it will stay steady and I don't see how it can go down. If it went back to its recent lows it would be tantamount to declaring trade war on the USA.

I concur that inflation is a first-half 2011 issue, but I don't think it will be as bad as in 2007, even though a number of Southeast Asian countries are getting nervous. Better-off countries like China have the money put aside that can subsidise fuel and staples. Food inflation is more serious and has to be dealt with immediately.

I think if the US can establish some correlation between the dollar and the stock market then the S&P index can make all-time highs this year. A rebound in the dollar will also help mitigate commodity-price inflation.

Seex: We think we're in the first half of a 20-year supercycle in metals and resources, driven by the urbanization of the emerging markets. The UN has predicted that urban populations will be 40% higher in 20 years time and that means considerable investment ahead in infrastructure, transit systems, residential and commercial property, as well as a greater need for energy. While nervousness about the pace of growth may make it another volatile year, equities related to commodities should deliver good relative value in the longer term.

David Seex

AI: Paul, do you agree with that long-term bullishness?

Sheehan: I'm not a macro guy and we are prohibited from investing the fund based on a macro rationale, so this is just for fun, but I'm concerned about global economic management. I see the Western economies have become much more brittle. The idea that nobody should be allowed to fail and nothing bad should be allowed to happen has had the effect of doubling down on the bet at every turn and, particularly in Europe, I think we're at the point – the sovereign level – where it's not possible to double down anymore. It's axiomatic that no bank can be built which survives the failure of its sovereign. The attempt to keep things together ceases when you get potential failures at the sovereign level.

So, if it proves necessary to bail out a

Walter Chang

third of Europe, that will have the effect of either depressing growth for a very long time, or having extremely bad consequences for everyone else in the economy. Therefore I think inflation is bound to come, so I'm bearish on debt and bullish on assets.

I think it will be a volatile year. That's an easy prediction to make.

AI: Anyone want to challenge that?

Tam: Playing devil's advocate, isn't the debt capacity of the USA probably a lot higher than the actual debt is now? Japan still functions even with gross debt to GDP of over200%.

Versus its income, the US debt is high but compared to its tangible and intangible assets, the problem is, as Paul Krugman puts it, not too much debt but too little debt.

Can Central Europe bail out the peripheral European countries? Well, Germany is showing that it can do in peace what it failed to do in two world wars, which is to run the whole show and take over the whole thing by digesting the rest of Europe. I note that the Chinese are also buying lots of BMWs and Mercedes cars.

The Japanese have learned how to age gracefully, which the Americans have not – they're still fighting the inevitable. Europe also has to confront its age with grace, and all go down together.

Remember, I'm being the devil's advocate here!

Sheehan: But you do have social cohesion in Japan to an extent that you don't find in Europe or the US. You can't imagine those countries undergoing the stresses and sacrifices that Japan has already been through without severe political upheaval. That is arguably not good though for Japan, given that the people keep voting into power nonentities again and again and don't seem to care.

At least in America we get upset about the idiots we vote into political office. Even though the Japanese government has borrowed, as some compensation, the rest of the economy has de-geared and gone into cash. Over-gearing is therefore largely a government and municipal debt problem in Japan.

AI: How will the European sovereign debt crisis unfold this year, and could it derail Asia?

Barker: We're not through it yet and the consensus is that we have a difficult first half in which the euro struggles and then an agreement is reached, the Germans cough up and the systemic problem goes away. I don't agree, though: the euro has been strengthening on the hopes a deal will be cut. So it's all the other way round. The Irish could, however, throw out the agreement, while the Greeks won't be able to afford it. The big kahuna is whether the Spanish will be able to keep cooking their books and make out that everything is fine.

The final denouement could well be default and some countries getting thrown out of the union.

What are your observations about China for 2011?

Tam: China has gained $199 billion in its foreign-exchange reserves in just one quarter, and such a marginal quarterly net gain is more than some countries' entire reserves. US dollar-denominated assets still predominate their list, starting with US Treasuries. The latest data shows China marginally selling down its Treasuries, but they are still in the number-one position with $896 billion worth. What will they buy with the rest of their reserves? Over time, that mix will probably better reflect its own trade picture, including European debt. If China decided to support European sovereigns, the latter could muddle through.

Chang: It is an important year for China. The government is due for change next year, so stability is going to be everything. They will try to solve their market volatility as far as possible. It is the first year of a new five-year plan, and a top objective is to change the mix of the GDP to rely more on consumption and infrastructure spending, and less on low-value added exports.

Seex: China is at the heart of the demand equation for metals and other resources through the supercycle I talked about. There is no doubt inflation will be a policy factor but the demand story will prevail. Although we don't run a China specific fund, our resources products give investors exposure to the China story indirectly through this dynamic.

Sheehan: China is helping our event-driven business by buying assets and companies abroad, and moving ahead with its own corporate restructurings. From a macro perspective, China has probably the most credible economic policy and implementation of any major

Paul Sheehan

economy, whereas a number of the others are getting by on unrealistic dreams.

The China game is being played on so many different levels at once, and its difficult to assume China can continue operating at so flawless an economic level as it has been, particularly with a political transition coming up. The country doesn't have the social outlet that other countries do in which politicians can be blamed.

The legitimacy is all economic, so you can't screw up the economics without impairing the legitimacy of the government and the system. That's a heavy responsibility and even though their team has so far done better than any other in the world, it's hard to keep betting that they will win every coin toss.

I don't see how China can moderate growth and come down from 10% growth in a soft landing without a giant panicky blow-off. It may not seem like much in the long term when you look back, but at the time will seem dramatically bloody.

AI: So, a dire warning. Geoff, would you agree with that?

Barker: Normally soft landings happen if there haven't been overdone excesses. So I can't see how you can soft-land an economy which is 50% of capital investment in GDP, empty cities, and savings represented in empty apartment buildings.

Those are the negatives. Perhaps they can move upmarket faster, liberalise faster. China now reminds me of mid-seventies Japan. I see an upcoming bump in the road for China.

How are you managing with capital raising and preserving the AUM that you already control?

Tam: We've never been a big asset gatherer, and always had more of an ownership orientation. With our good track record in the last five years, we have found gradual acceptance among investors that we can do it, as a multi-strategy firm, out of Hong Kong. At one point, funds of hedge funds felt that their direct investments could emulate a multi-strategy product, but I submit that we have shown that we can construct a portfolio and allocate the assets more nimbly. Since Madoff and Lehman, due diligence has become almost intrusive, but, we too want to find the right long-term investment partners. It's a bit like a marriage.

Sheehan: I wouldn't know about marriage. I guess I've been more successful with capital raising. I suppose it would be like if your wife could leave you on thirty days' notice with no penalty.

AI: How skeptical are global allocators about Asia-based hedge funds?

Sheehan: All of us at this table know why we're here. There's a lot of empirical data which shows that Asia strategies run in Asia produce much better returns than people doing it from elsewhere. Clients want Asian domiciled funds, as we produce better performance and are more focused. On the other hand, investors also want you to have the infrastructure of a large global bank, and that is a requirement which is somewhat in tension because Asian-domiciled funds tend to be smaller in the global scheme of things.

So, the due-diligence side needs to be managed very carefully, as investors need to be absolutely certain that their managers can handle things from an operational and governance perspective, completely apart from an investment perspective. For Asia that is a challenge for us because the comfort level of investors about Asia tends to be lower given that many of them haven't been investing here as long.

Barker: We do plan to grow assets. The platform we've got is credible. We've spent on systems, infrastructure and service providers. Our track record is acceptable. We've benefitted from flows from funds of funds. People want to invest in Asia, and if you can string together some good performance, then money will come in.

Seex: There has been rotation from smaller funds, run by small managers, into bigger funds, run by bigger managers but little net growth in assets. I don't see this rotation as money chasing performance. Risk-adjusted returns have been lower, so the business risk that you take as an institution by placing money with a small firm has become more significant compared to the investment return you can expect.

I don't think we've fully worked through the 2008 shock yet, and investors are still being incredibly careful. There is certainly demand for Asia but much less which is investable. I'd say 95% of managers in Asia have less than $200 million, and a very high proportion have less than $100 million. Expectations of infrastructure are increasing as are the costs of regulation and compliance.

It's hard for most to make money on the assets they have, and even with talented people, and good returns, they are finding it hard to attract institutional money. In this context we are focusing on fewer, larger, core products to leverage RAB's strong balance sheet and institutional grade infrastructure. It will take time to build the Asian business, but we can be patient.

Chang: I am more positive than that. Risk appetite does change over time and I have been seeing an increase in interest. 2008 was a shocker and caused problems for a lot of people, especially funding that came from European sources for smaller funds, and they have found it hard to grow their funds ever since then.

One thing that we emphasise at ROCIM is downside protection. The partners are the biggest investors in our fund, and we've not had a down year in three-and-a-half years. We try to capture most of the upside and capture none of the downside, even as Asia continues to grow. ■

Eddie Tam