



Opalesque Roundtable Series '16

HONG KONG

Opalesque Roundtable Series Sponsor:



Editor's Note

China's fund management industry sees massive growth and transformation ahead Asian growth factors still in place but PE is challenged

The obvious opportunity in Asia is still the higher growth rates in Asia versus the rest of the world, which leads to more rapid rates of wealth creation. The **growth factors are still in place**: the underlying structural growth, improvements in income, improvements in wealth and consumption. In any category or sector, the penetration levels here are abysmally low (page 10).

The big question is how to tap into that opportunity without tripping up over the risks, which are also greater in Asia versus the traditional developed markets, particularly **governance risks**. Management and the controlling shareholder are frequently the same party. Therefore, investors need to put at least as much effort into evaluating the alignment of interests between shareholders and management as they do looking at traditional valuation metrics (page 9-11).

Fierce competition moulding next generation of global managers which is coming from Asia

Eurekahedge has a database of around 10,000 global hedge funds, and there in China you have roughly 7,000. The 10,000 offshore hedge fund managers globally trade on 150 exchanges, 50 different currencies, and a countless number of strategies. Now let's compare that to 7,000 managers in China running one currency, two exchanges, and five strategies. So the competition is fierce, and players and markets mature fast.

The 2015 China crash led to a series of regulatory changes that quickly wiped out a number of less qualified managers. Approved registrants dropped from a peak of over 25,000 asset managers to less than 10,000 today. This is more positive than it sounds. Some teams who wear the printed "I survived 2015 crash" t-shirt saw an **increase in AUM from maybe \$100 million to almost \$2 billion over just 18 months**. And this means that now they have enough capital to seed offshore products. Most of them are China long-short, but a surprising number of them are quants, trade global with the China spin. A platform set up by OP Investment Management and the Oriental Patron Financial Group expects to launch over 20 HK hedge funds for mostly PRC managers to help them build offshore track records through a proper structure. OP is convinced that the next generation of global managers is going to come from Asia.

Why PE managers in Asia tend to sell their winners and hold onto their losers

Private equity in Asia also has its fair share of opportunities and challenges. Practitioners point out that the advertised IRRs in Asia are not really the same as distributions going back to investors. Distributions from Asian private equity funds back to their investors lag distributions from US PE funds by a very substantial margin. The fundamental reason for this is that the predominant transaction form in Asia is growth capital which generally has the issue that you can exit your winning deals, but it is very hard to exit your mediocre and your underperforming deals.

A private equity fund might have a portfolio of 15 or 18 companies, and of those maybe only one-third are easy to exit through the conventional IPO and subsequent placing route, but it is challenging to exit the remaining companies. And because private equity managers need to raise their next fund, they exit the companies they can exit, which tend to be their better companies. So PE managers in Asia tend to sell their winners and hold onto their losers, and therefore the IRRs managers report may be an illusion because their valuations on the unrealized portion of their portfolios may not be achievable. On average only about one-third of the portfolio companies by number have actually been exited, and so there is a very long queue of un-exited private equity invested companies in the Asia-Pacific region, many of which frankly will be very difficult to exit.

The Opalesque 2016 Hong Kong Roundtable, sponsored by Eurex and WTS, had the following speakers:

1. Alvin Fan, [OP Investment Management](#)
2. Anuj Sehgal, [Manas Capital](#)
3. Brian Pohli, [CQS](#)
4. Cina Lee, [Eurex](#)
5. Howard Wong, [Doric Capital](#)

6. Hugh Dyus, [Navis Capital](#)
7. Richard Warfield, [OTS Capital Management](#)
8. Steffen Gnutzmann, [WTS](#)

The group also discussed:

- How large is the universe of really “investable” listed companies in Asia? (page 10)
- How to get an upside from investing in private equity without the disadvantages of traditional private equity structures, namely illiquidity and high fees (pages 14-15)
- Development, opportunities and anomalies in Asia’s credit markets (page 11-12)
- How to launch a HK hedge fund in six weeks (page 20)
- How to identify emerging blue-chip companies in Asia (page 12-14)
- How to offset risks in investing in Asia through investing with the economic trend (page 12)
- Do Asian hedge funds make money shorting stocks? (page 16-17)
- How not to get trapped looking at the rearview mirror of historic performance (page 22)
- Why deflation and collusion make a strong case for Asian equities (page 23)
- How overinvestment in China affects the markets (page 24-26)
- Which are the new sources of capital for the Asian private equity industry? (page 21)
- How the growth of RMB denominated PE has changed Asian opportunities forever (page 19)
- Will passive management, smart beta and quants win over the traditional active managers? (page 28-29)
- What quants are missing when investing in Asia (page 29)
- Machine-learning technology can run funds, but what is the one important thing they cannot do? (page 20)
- Why every hedge fund will find it easier to onboard German clients (page 30).

Enjoy!

Matthias Knab
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Participant Profiles



(LEFT TO RIGHT)

Steffen Gnutzmann, Howard Wong, Anuj Sehgal, Hugh Dyus, Brian Pohli, Cina Lee, Richard Warfield, Alvin Fan, Matthias Knab

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Introduction

Cina Lee
Eurex

My name is Cina Lee, I represent Eurex, the Frankfurt-based international futures and options exchange. I joined Deutsche Börse about five years ago in the market data department. I am now a member of the Asia sales team at Eurex in Hong Kong, mainly focusing on business development within the Greater China region. My role involves daily sales and promotional activities amongst the buy-side and sell-side client community.

Prior to joining Eurex and Deutsche Börse I was working as a Premier Relationship Manager at an international bank in Canada, dealing with individual high net worth and corporate clients.

Richard Warfield
OTS Capital Management

I am Richard Warfield representing OTS Capital Management. OTS is a value-oriented long-short equity hedge fund with a somewhat unconventional way of looking at “value” as it applies to companies in Asia. We believe that *in Asia, value investors need to put at least as much effort into evaluating the alignment of interests between shareholders and management as they do looking at traditional valuation metrics.*

Prior to OTS I was with Deutsche Bank for eight years in a structuring role focused on macro investing strategies and risk management. At OTS I serve as the Chief Risk Officer in addition to running the business operations.

Alvin Fan
Oriental Patron Financial Group

My name is Alvin Fan. I'm Chief Executive of OP Investment Management and Head of Asset Management for the Oriental Patron Financial Group. The division that we look after focuses on hedge funds, although the Group's 23-year history is very deeply ingrained in private equity and equity capital markets.

I've been in Hong Kong since 2000, running alternative portfolios in both PE and hedge since 2006 after receiving my MBA at Ivey.

Steffen Gnutzmann
WTS Group

My name is Steffen Gnutzmann of WTS Group in Germany. We are a 650 people tax legal consultancy group, our base is Germany. We have a subsidiary here in Hong Kong and a subsidiary in Shanghai. The focus of our Financial Services team within WTS is to advise all types of financial services clients, funds, hedge funds, administrators, banks and fund investors. We deliver tax advice starting with market entry into Germany, be it on the investor side or on the asset side of the fund, to exit strategies and fund regulatory matters. So, we help regulated funds in Germany or maybe Cayman Island unregulated funds, which would like to attract German money.

I am a lawyer. In addition, I have a degree from a government university in Tax Law, and before joining WTS I was with PwC in Frankfurt for 8 years.

Brian Pohli
CQS

My name is Brian Pohli. I'm responsible for CQS' Asian operation, CQS is a global alternative asset manager based in London with about \$12 billion under management. I have been with CQS for 13 years and started their regional office in Hong Kong in 2004.

Hugh Dyus
Navis umbrella

I am Hugh Dyus. I have been in Hong Kong for over 25 years, of which the last 16 years have been in private equity. I am here under the Navis umbrella. Navis have about \$4 billion under management and are currently investing their seventh private equity fund. However, I am not part of their core private equity business. *I have developed a new strategy designed to give investors exposure to the upside from investing in private equity without the disadvantages of traditional private equity structures, namely illiquidity and high fees.*

Anuj Sehgal
Manas Capital

My name is Anuj Sehgal. I am the founder and portfolio manager of Manas Capital. We manage the Manas Asian Equities Value Fund which invests in publicly listed equities around Asia excluding Japan with a very fundamental bottom up long term value approach. We essentially invest in good quality businesses run by good management taking a very long term view. We run a fairly concentrated portfolio and hope to capitalize on the underlying structural growth in this part of the world.

Prior to starting Manas Capital in 2012, I had over 10 years of investing experience in Asia-ex Japan having worked at JPMorgan, North of South Capital, Nomura and Anand Rathi across investment banking, equity research/sales, public equities investing and investment risk analysis.

Howard Wong
Doric Capital

My name is Howard Wong. I represent Doric Capital. Doric Capital invests in what we call emerging blue-chips in Asia in the public equity space. I have been with the company for 15 years, and the company started about 18 years ago. Before joining Doric, I started my career in an investment bank in New York, and after that I started my own independent research company about 20 years ago.

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percent of the world's surface is covered by water.



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Eurex Exchange – the home to the euro yield curve.



Matthias Knab

Many of you were referring to opportunities “in this part of the world”. Can you tell us more about the opportunities you are seeing and how you access them? Or simply, what have you been doing lately?

Alvin Fan: We had a stellar year in terms of new fund launches - 16 new funds this year alone, and by the end of the year we will have about 22 to 23 funds actively managed on our platform.

Our mission is straight forward – to **partner with talented emerging managers in the region and together build great products**. This year we’re intensely focused on PRC managers, to help them build offshore track records through a proper structure. We are convinced that over the long term we can show global allocators, that **the next generation of global managers is going to come from Asia**.

A big part of the influx of new managers is due to the A-share crash in the summer of 2015. Roughly, \$1.5 trillion left China in the last 18 months.

So how does that impact the managers? We did a survey with some of our clients there, and found that on average the industry suffered redemptions of 10% to 14%. The depreciation of the RMB exacerbates the matter and investors start demanding diversification. Suddenly managers are having this very difficult conversation with their investors who are understandably practical, “Look, I’m taking some of my capital to Hong Kong or Singapore. I can either ask HSBC run it or I can let you run it. I trust you, but you have to have your product there.”

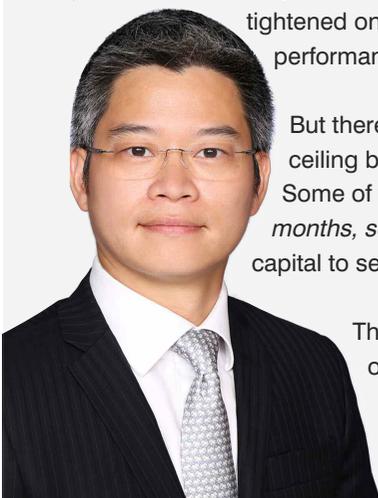
And, of course, these managers don’t readily have products offshore because there’s been enough liquidity onshore for decades, not yet anyway.

The crash led to a series of regulatory changes that quickly wiped out a number of less qualified managers.

AMAC, the SRO in PRC, seeing the wide skew of quality in managers, raised the bar on license requirements almost overnight. **Approved registrants dropped from a peak of over 25,000 asset managers to less than 10,000 today**. This is more positive than it sounds.

Earlier this year we saw something really interesting. Capital that couldn’t make it out the door due to capital controls starting finding homes with managers who were resilient against the crash.

Anyone who wore the printed “I survived 2015 crash” t-shirt saw an increase in AUM. But then the government further tightened on shorting instruments like the index futures market, and that is why we’re not seeing as strong performance we did years ago. Strategies were hamstrung.



But there’s still so much talent. A lot of them came from Wall Street. These guys were hitting a glass ceiling back in early or mid-2000s, so they came back to China and built onshore track-record instead. Some of them have grown tremendously. *We are working with a few teams who have, over the last 18 months, scaled from maybe \$100 million to almost \$2 billion.* And this means that now they have enough capital to seed offshore products.

They still have to prove their mettle offshore, because even if they run on one and-a-half billion onshore, it’s still not a track record that will attract big allocators.

Cina Lee: From the perspective of an international derivative exchange and clearing house, the current regulatory changes present vast opportunities and challenges amongst our industry peers and market participants. Basel III, EMIR and Mifid II, even if focusing on the G20 or Europe, significantly impact our client base and market structure in the region generally. We see, among other things, major opportunities in the promotion of central clearing of certain OTC derivatives and in the futurization of other OTC products.

Against the backdrop of the regulatory developments globally Eurex has been responding to the respective market structure changes by launching products and services to facilitate the transition from OTC to either exchange trading or central clearing.

For example, we have been promoting the transformation of Index Swaps to Index Futures through recent MSCI Futures and Options listings. Another example would be the promotion of EuroStoxx50 Total Return Futures, the listed counterpart to the respective Total Return Swaps.

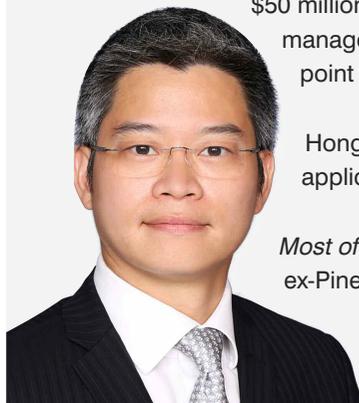
MSCI Indexes are some of the world's most widely tracked benchmarks, with about USD 10 trillion linked to them. They also serve as the basis for over 500 ETFs. The significant amount of capital benchmarked against MSCI Indexes and the improved tradability of index based products via ETFs has led to the increased need for futures and options. The reason is they help managers facilitate in- and outflows of funds, hedge existing equity exposure and enhance portfolio performance. Since 2013, Eurex has been expanding the MSCI product suite and now offers 72 futures and 15 options on most regional and single country MSCI index around the world. The recent uncleared swap margin, capital and segregation requirements have generated significant interest in the Eurex MSCI Futures and Options complex. This has manifested itself in both the increase in enquiries made to the exchange from new locations and in the steady climb of open interest in MSCI Futures and Options, that as of November 2016, stands at over 920k contracts equating to in excess of USD 22.6 bn of market exposure. To put this in perspective, the Open Interest at the end of November 2015 was 254k contracts, which represents almost a fourfold increase this year.



Matthias Knab

What is the average AUM now of the managers on your offshore platform?

Alvin Fan: Initially the AUM was pretty-small, under \$20 million. The last few managers that we brought on board are targeting \$50 million to \$100 million which gives them a bit more breathing room. There aren't too many emerging managers who can start off with more than \$20 million these days, and as you know, the break-even point for running any fund is pretty-high now, with the rising cost in infrastructure and compliance.



Hong Kong SFC is inundated with applications. The rumor is that there is a backlog of hundreds of applications, and this created a lucrative market for acquiring existing licensed companies.

Most of them are China long-short, but a surprising number of them are quants, so like ex-Millennium, ex-Pine River, really smart guys, and they have actually fleshed out and proven their strategy onshore before coming off.

Matthias Knab

Are those quants trading China only or are they already global?

Alvin Fan: The natural inclination of those quants is to trade global with the China spin because that's where they come from, but as you know a lot of these quants technology-based so they don't necessarily need to be focused on China alone.

People in our industry often talk about fund flows, when is it going to come back, and there is a lot of transitional capital coming back from Europe and the US, but honestly for us **the big elephant in the room is the capital coming from China and how that is going to be allocated**, especially since those investors are not brand-conscious yet and they are still looking for novel ways of generating yield.

Their first destination is obviously multi-strat and fund of funds. And this should trickle-down to hedge funds, and the first ones to benefit will be the trusted Asian and big US hedge funds.



Hugh Dyus: From our perspective, the obvious opportunity in Asia is still the **higher growth rates** you get in Asia versus the rest of the world, which lead to more rapid rates of wealth creation. The big question is *how to tap into that opportunity without tripping up over the risks, which are also greater in Asia versus the traditional developed markets.*

I think the opportunity is obvious, but the tricky bit for all investors is managing the risks. Probably the biggest risk that is greater here than in the traditional developed markets is **governance risks**. *Management and the controlling shareholder are frequently the same party.* Plus, arguably this region is more dynamic and volatile and less predictable than the traditional developed markets.



Matthias Knab

So how do you do it? At your shop, how do you address the governance risks?

Hugh Dyus

That is a complicated question. But, I would say that the most important things are depth of due diligence and the people you work and invest with. You need to be investing with the right people and you have to do a lot of homework.

Anuj Sehgal: I agree with Hugh. We are trying to do broadly the same thing but in the publicly listed space, essentially looking to invest in good quality businesses, which are run by good management, and as Hugh said, the corporate governance risk and dealing with the right people is of utmost importance.

So the growth factors here are in place, it's the underlying structural growth, improvements in income, improvements in wealth and consumption. If you look at any category or sector, the penetration levels here are abysmally low. For example, forget about comparing Asia to the western countries in Europe and the US, a lot of countries like Indonesia, India are way far behind let's say even Thailand and other more developed places within Asia itself.

The big opportunity set is still to capitalize on that growth. The question is what kind of companies do you invest in, who

would you back? Because we are not going to be the ones who are running those businesses, it's the managements who are running the businesses. They know the business better than we do. The thing that we need to do as Hugh said, is to basically identify the right kind of people we want to be invested with, and back those. And as they compound their businesses, we ride along with them.

At our fund, we invest in Asia ex-Japan in the publicly listed space focusing on broadly quality, consumption, manufacturing, industrial and services businesses. We don't invest in real estate, commodities, or in government-linked companies or SOEs, and we don't invest in conglomerates because it's almost impossible for us to understand them.

So what we are investing in are very simple consumption, manufacturing, services businesses where balance sheets are clean and where the principals are running the business prudently with good capital allocation. And then when we overlay our own criteria of return on capital, cash flow, dividends, and I can tell you that *our investment universe is not more than 250 companies, and we wouldn't dare to touch any company outside of it at any price.*

Of course, off these 250, there are some which are always expensive and so you wait for market dislocation opportunities like Brexit, US elections or other events to get an opportunity when you get to buy those companies.

Again, there is opportunity in Asia, but you have to be very careful and invest in the right companies. And of course, a lot also depends on your specific strategy. In our case, we aim to take a genuinely long-term view. For example, we have just been up and running for 4.5 years but our average holding period is more than 33 months and half of the 25 names in our portfolio are in the portfolio since inception. We hardly churn our portfolio, our average annual churn is less than 10%. So some of these things also come down to your strategy as well. There are various ways to invest in the market and trade but if you are genuinely investing with a long-term view, you have to be very mindful of the corporate governance risk.



Richard Warfield: As I mentioned earlier, we believe strongly is that investing in Asian equities requires intense focus on and monitoring of alignment of interests between shareholders and management.

It's interesting that if you look at the relationship between GDP growth and returns in equity markets in developed markets over the past decade, you get something like a straight line, with high-growth economies having strong stock market performance. Whereas, if you look in developing Asia, you get this kind of messy scatter plot with little apparent relationship.

When we decomposed these results, found that most of the discrepancy could be explained by the prevalence of two kinds of companies in the region. First you have many state-owned enterprises in Asia where there is a clear misalignment of interests between managements, who generally answer to the state, and minority shareholders. On the other hand you have the many family-owned companies who often have complex shareholding structures that separate management control from economic ownership, which relates also to Anuj's point that there are a lot of companies you wouldn't touch at all.

Therefore we actually put a lot of weight on looking at where the owners' pocketbook is, *basically where their economic interests are.* Do they own shares? If it's a pyramid structure, at what level do they own the shares? What is their salary relative to their share ownership? We think that looking at these and other kinds of metrics can help weed out companies whose managements don't care much about shareholders' interests versus those who do.



Anuj Sehgal: I agree, there is of course the question corporate governance and wanting to invest in the right kind of people, but I think the biggest challenge also is to understand the philosophy and mentality of the management.

A lot of companies are listed here, but the principals still think that *“this is my business, the cash belongs to me, I own this business.”* I think that mental thought process of acknowledging that the company belongs to the shareholders is very important. And then secondly, once they have that clear in their mind, then of course their way of incentivizing themselves is more in line with other shareholders.

So that disconnect is something that we try to understand, and where we feel uncomfortable, we dare not go, because you can be invested in them and have a good ride for six months, but then that one day of reckoning comes when it all gets wiped out.



Brian Pohli: A number of our investments tend to be in the fixed income and convertible bond space. One of the most important aspects in this space is the rule of law.

As with any credit investment, you need to analyze whether the company you’re lending to will be able to pay you back. Companies have ability to pay, but will they pay? Companies have money in the bank, but will you get paid back on your bonds when they mature? Will you get paid your coupons when they come due? Where do you stand in the capital structure as an investor as opposed to where you stand in terms of the economic interest of the firm?

One of the most important issues and a factor that makes Hong Kong an attractive investment destination is the **English rule of law**. Hong Kong’s strongest centerpiece, especially in dealing with PRC companies, is the rule of law. Entities that are listed in Hong Kong have to follow certain rules that they may not have to follow in other jurisdictions, and that gives you comfort in investing in some of these firms.

The legal uncertainty also offers additional opportunity. You are able to obtain a return based on the due diligence your fundamental research provides by selecting attractive investment opportunities. An example would be when you start looking through a prospectus on a convertible bond you could find that there are certain companies where the CBs are backed by a bank, and therefore they have a stronger credit than what the market is pricing the security at. Or there could be certain nuances in the language where you can be paid a coupon on the convertible and convert the bond into a stock and pick up the dividend on the stock as well.

These **anomalies** offer you an opportunity in Asia, whereas in other markets these processes may have already been priced away. In Asia, you can still have nuances within prospectuses and within the capital structure of companies where you can capitalize on the market inefficiencies, to pick up a return that may not occur in other jurisdictions.



Howard Wong: I absolutely agree with what Anuj and Richard said about picking stocks, and I guess that's what most long/short managers do in Asia. How we are trying to differentiate ourselves over the last 15 years is that we focus on what we call **emerging blue-chips**. These are companies that are probably not yet known to most investors, that they are good quality and have the best products, and while they are still small we can basically see a cycle where, at that country's stage of GDP, these companies will grow pretty fast and that they will become a blue-chip, in the classic, developed market sense.

These companies are already number one in what they do but we think they are probably growing at two to three times the rate of the domestic GDP, and at the same time they are probably making very good return on capital, so they will get re-rated over time.

At the same time, we do invest across all of Asia and although from an outsider's point of view, Asia may look like one economic zone, but in fact it isn't and within Asia there is **huge dispersion**. For example, in 2010-2013, India was absolutely in the dumps, but Indonesia and Thailand were going up like gangbusters. So also from a geographical perspective we have added value by moving around Asia. China has probably less of these cycles, but at the same time, China is large enough and therefore there are always emerging companies coming out of China. From that perspective, we believe that we can *offset risks in investing in Asia through investing with the economic trend as well*.



Matthias Knab

Howard, you mentioned emerging blue-chips, can you please give us more details how you identify them, what are your criteria to be an emerging blue-chip? And then secondly, in the light of what we talked before, how do you manage the risk and the governance risk in those companies?

Howard Wong: We are starting out in our research in the most layman way, which is by going out to see companies, in our case we see about 60 companies a month. So we do about 700 company visits a year, and we have done that for the last 15 years. So we know a lot of companies in Asia and we have been looking at this region in depth over a long period of time. If you think about it, *there is only one winner in anything people do. In sports*, in industries, any corporation, in investments, you know approximately what it takes to be a winner.



Now, we just happen to be looking at these winners when they're still small. I don't mean they are small not because they are a number 5 player, but they are in fact number 1 player in what they do, but the reason because they are small is because that country is small, or that sector itself is small, or because the GDP of that country hasn't gone through that hockey stick, that S-curve yet, but we believe that within the next two, three, six years this company will go through that curve and that they will emerge as a very big company.

Using very basic mathematics, we call them 20/20: 20% return on capital and 20% growth will ensure you a pretty decent value creation over the next business cycle.

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Hugh Dyus: Permit me to provide some background on the Asian PE industry. The median returns produced by the Asian PE industry over the last ten years are about 12%. The open question is whether these returns are good or bad, which depends on your perspective. I would consider these returns to be disappointing because managers represented to their investors that they were going to do at least 20%. On the other hand, these returns still substantially beat the listed markets and the interest rates you might get by putting your money in the bank.

But the real issue with this is that we're talking about the IRR here, which is not the same as distributions going back to investors. When you look at distributions from Asian private equity funds back to their investors, they lag distributions back from US PE funds by a very substantial margin.

And the fundamental reason for this is that is the predominant transaction form in Asia is growth capital, which is where a company takes fresh capital and gives the financial investor a minority stake and normally some negative rights.

The problem with growth capital is that you can exit your winning deals, but it is very hard to exit your mediocre and your underperforming deals. A private equity fund might have a portfolio of 15 or 18 companies, and of those maybe only one-third are easy to exit through the conventional IPO and subsequent placing route, but it is challenging to exit the remaining companies.

And because private equity managers need to raise their next fund, they exit the companies they can exit, which tend to be their better companies. So **PE managers in Asia tend to sell their winners and hold onto their losers**, and that means the tail end of portfolios won't be so good.

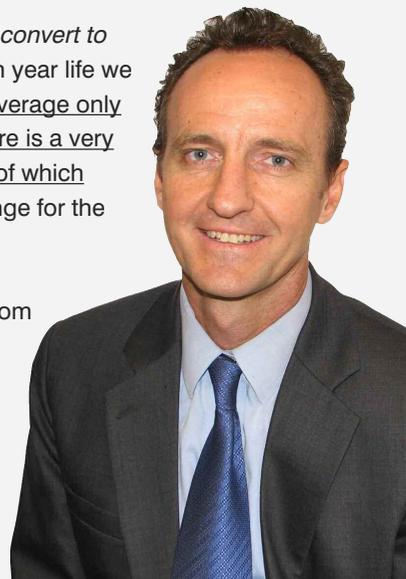
Therefore, the IRRs that managers report may be an illusion because their valuations on the unrealized portion of their portfolios may not be achievable.

If you are a minority stake investor in a business that is not performing well enough to list, how are you going to get your money back? Strategic buyers are generally not too interested in minority stakes behind a larger shareholder with a controlling stake. The most likely discussion is going back to the founding entrepreneur and trying to sell your stake back to him, and you are not going to get a very good deal when you do that.

Investors should always question whether reported PE returns are really real and if they will convert to cash. A lot of money was raised in 2006 and 2007 and as most PE funds typically have a ten year life we are now coming to the end of the "original" life of these funds. I would estimate that on an average only about one-third of the portfolio companies by number have actually been exited, and so there is a very long queue of un-exited private equity invested companies in the Asia-Pacific region, many of which frankly will be very difficult to exit. I think that un-exited portfolio companies are a big challenge for the industry to address.

The strategy that we have developed is fundamentally a strategy to minimize the exit risks from investing in private equity in Asia, whilst at the same time ensuring that you have good governance. That is the essence of the philosophy behind our strategy.

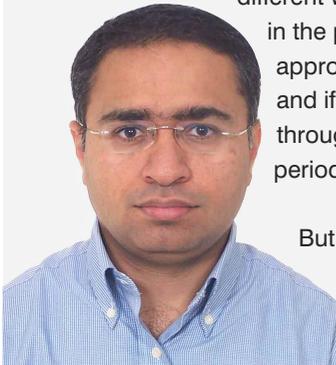
In terms of our methodology, this is something that I prefer to disclose more privately to potential investors. When I speak in public forums, I prefer to keep the discussion at a high level and talk about the generic concepts rather than the specifics as to how we actually do that.



Brian Pohli

I have a question for Anuj. The holding period of 33 months seems awfully long to me, considering the cycle's markets could go through when you are holding assets that long. I was wondering if your investor base is satisfied when you provide a mark to market that can include high volatility with pretty wide swings.

Anuj Sehgal: You are right, Brian, and I think at the end of the day there are different ways to peel the onion and there are different ways to invest. Of course, we tell our investors openly and upfront what we are doing. They believe in the philosophy of investing in this part of the world with a very fundamental bottom up long term approach, and therefore inherently, as you said, it is volatile. But we are investing with a long term view and if you are diligent in your approach and investing in the quality businesses, yes, they also go through all these down-drops, *but over a cycle*, they ultimately do well. So yes, it is volatile, but over a period of time they do well.



But you are right that there has to be a match between our style and what investors expect, otherwise there is a problem.

Howard Wong: Addressing Brian's question I think Anuj's answer referred to the holding period, but there is a second dimension, which is **liquidity**. When investing in equity in Asia, most of us invest in somewhat emerging companies that will not be trading hundreds of millions shares. However, if you have monthly dealing, I would say that liquidity can be pretty much matched with the investors.

In our case, I would say that 90% of the stocks could be liquidated within a week or two. So the liquidity concern is not really there, but you are correct that Asia goes through cycles and that the drawdown can be very painful for investors. That's why we are a long-short equity fund, because we do care about our risk.

We have approximately 50% beta to the market overall in terms of volatility. At the same time, our strategy is also focusing on quality. We do focus a lot on trend, also on the company level. Even a good company can have down cycles, so we need to avoid that. At the same time every single company in the world is affected by various macro trends, whether it be domestic or international. So we have to adjust our risk exposure by country and also over the full portfolio as well.



Brian Pohli

And how do you manage the short fall?



Howard Wong: It's the same thing. As I said, we see literally thousands of companies, and for each winner that I see, I probably also see five to seven losers. Most of my short book is what we call **structural losers**. This means that in the next business cycle these companies are probably worth zero. Not all of them are frauds, but they could have a very questionable business model, or the company may have been created in a bull cycle and when the downswing comes they probably will exit the market.

This is our core short book. We also have opportunistic shorts where, when we see some sector or countries going through a down cycle, we will hedge our risk through such shorts as well.

Brian Pohli

Is it difficult to maintain those shorts especially when an overall bull market can lift the share price of these companies as well?

Howard Wong

Well, absolutely, it's a hedge fund so we do have certain views both on the short and the long side, and the markets can, in the short term, also go against us. When it comes to the short side or such short squeezes, we just want to make sure our longs then outperform the shorts.

Brian Pohli

Right, I understand that, but with my question I also want to touch on the issue of the availability of stock or the availability of companies that you can actually short. *You might find seven losers but you can probably only short two of them.* If you stay short on those stocks, there's a good chance a lot of other folks are short those stocks also. When you do get uplift, those are the first ones to recover.

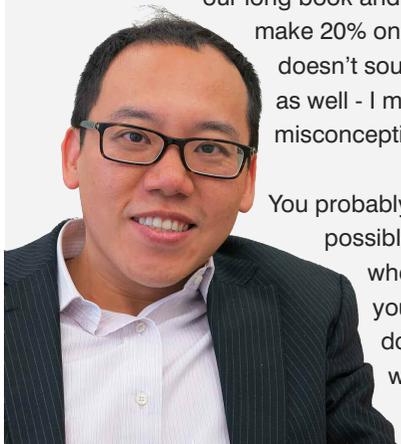
Howard Wong: You are right that out of the seven companies I want to short there are probably only two that I can, but at the same time I do look at probably a few thousand shorts. Say, if from 1500 companies I only short 20%, I still have 300 that I could short, and also I can choose to short them at different times.

Yes, short squeezes happen, that is part of the nature of short selling, but at the same time you have to know where in the cycle you are, and so there are also a lot of technical factors at play as well. You can short in a bull market but some stocks will be having a bull run. The issue is that you can't short a stock just because it is expensive or just because you don't like it. Because when liquidity comes, when people love the sector, even the laggards will go up. That is why I said you have to **short with trend**, that's why I pointed out that trend is very important and at the same time you have to do risk management on the short side. So when things are not going your way, you have to cover your shorts, at least temporarily.



Matthias Knab

We know that a lot of hedge funds in the developed markets don't make money on the short side. Howard, you have been doing long-short in Asia for a long time, were you able to create this so-called alpha on the short side?



Howard Wong: Absolutely! However, there are also managers who just run short funds, but I would say that it is extremely difficult to consistently make money out of it because there is natural cost of equity which is maybe close to 10%. If you take our long book and add to it our short book, we expect we can add 10% alpha on both sides, so then we will make 20% on the long side and we probably break even on the short side. Breaking even on the short side doesn't sound fabulous. If a monkey throws darts at a newspaper listing of stocks, you may make 10% as well - I mean, that's what benchmark-driven investors are doing, in a way. So I do think it is a misconception that you can really make a lot of money on shorts.

You probably can make a lot of money on shorts in very short spurts. But in my opinion it is very much possible to create alpha on the short side, and I think we displayed it over the last five or ten years where our aggregate return is roughly about 15% and our short contribution, depending where you start, is roughly about zero. On the gross basis it's somewhere in the 20%-25% range, and don't forget that having shorts at the same time also helps us to reduce volatility of the fund as well.

Hugh Dyus: I would like to comment on the point about investment holding horizons. *Most investors in the public markets in Asia have a fairly short-term orientation, they are looking ahead maybe three to four, maximum 12 months.* Most investors are playing the game of trying to identify companies whose earnings will outperform or underperform the market expectation with a view to taking a position. But actually the fundamental long-term value of a stock is not necessarily driven by their next reported earnings. And so, if you are looking further ahead than most other investors, there is an opportunity because too many investors are driven by near term considerations.



Anuj Sehgal: Let me share an observation. When the market corrected in 2008, I noted that if you had the real quality companies in your portfolio, those were down of course as well, but just by September or end of 2009 they were already higher than where they were before the correction.

If you have a quality focused portfolio, good companies, good managements, high return on capital, cash flow, paying dividends, these things matter. *In the short term it doesn't matter, but over longer periods of time it does matter.* Running a portfolio with these quality companies, I can tell you that over the last four and-a-half years our portfolio has invariably outperformed the market when markets have had a big down-drops. And this was not because we have been nimble or smart enough to short or to hedge our portfolio or tried to prevent those down-drops by any bells and whistles that we could add on the portfolio, but simply by the nature of the portfolio.



So once more, it does matter, when you have cash flow, when you have dividends, and the managements are prudent. These things matter over a longer period of time. It might not matter over a quarter or two and as Hugh said, we don't really care what the next quarter is going to be, because that I think is totally immaterial. Sure, markets do go up and do go down, and they do matter in the near term but over a longer period of time, that volatility is just immaterial.

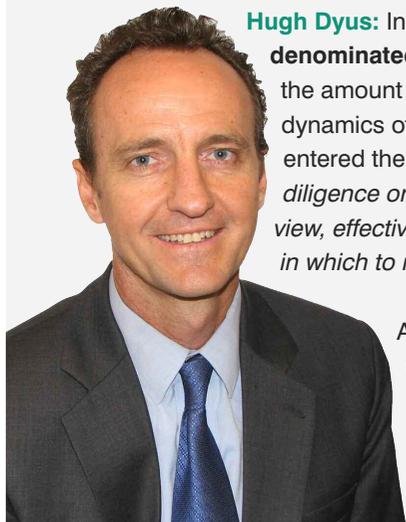
Let's look at how the Asian financial markets have continued evolving over the last couple of years. Brian, you mentioned that CQS is also investing in convertible bonds and fixed income in this part of the world, can you tell us more about the development of those markets in Asia?

Brian Pohli: Credit markets have been fairly robust in Asia as you can tell by the returns of a number of the credit funds in town. We ourselves have been having a good year in Asia. CB issuance has started to pick up again after it had been dormant for quite a while. As we touched on earlier, when doing fundamental research on the fixed income and the credit space in Asia, you need to make sure you have a good understanding of the company management as well as the company. Not only do you need to find out their ability to pay, but also that you'll actually get paid back. You need to be vigilant in your selection of credits. The other thing is to be wary of is how **crowded** the trade is because there can be a lot of competition for a few issues.

This means that you really have to sharpen your pencil and be vigilant in your selection of credits. You also will need to stick to your price when investors start *chasing credits in fixed income*. In fixed income this is a bit different than chasing opportunities in equities. People chase equities all the time, you can buy something that's already been up 30% and may be able to get the last 10%, which is still pretty good. In fixed income it's much more difficult because it is a more nuanced business. Liquidity can be a challenge. This means you need to be very careful about where you are in terms of price and in the cycle when you are buying your credits.

The same applies when you are selling credits. We saw in January and February when oil prices started to go down toward \$20/bbl that the media started talking about credit spreads for what seemed like the first time ever. At that time people were dumping energy credits along with consumer credits. Even though consumer credits were benefiting from lower oil prices, they were still being sold off.

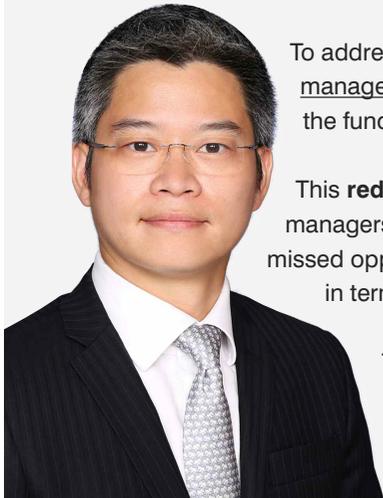
The credit market is almost a little bit like real estate, you need to sell in an uplifting market, because that's where the liquidity is. And when prices are going down, the liquidity tends to dry up. So you need to be cognizant of where you are in the cycle, you need to be cognizant of when you start to sell, and you have to keep some powder dry so that when something unexpected does happen you are able to pick credits up at lower prices. But again, the liquidity in credit is a much different investment space than equities.



Hugh Dyus: In private equity, I think the biggest development has been the development of the **RMB denominated private equity industry**, which probably started in a big way about six years ago. While the amount of RMB capital going into the industry has substantially slowed down, it has changed the dynamics of the China market completely. A whole wave of new capital and less experienced managers entered the market and started competing for deals, not only on price, but also by doing less due diligence or quicker due diligence, sometimes no due diligence. *The wave of new RMB capital, in my view, effectively polluted the market for everybody, making the China market a more challenging market in which to make money.*

A decade ago, there was an attractive multiple arbitrage opportunity in China where you could invest in private business at a single-digit P/E and then IPO at a P/E at 20 – 25x. That opportunity for multiple arbitrage has largely disappeared, and so *private equity in China has become a much more challenging game requiring a much more sophisticated skill set.*

Alvin Fan: One of the big challenges for managers coming offshore from PRC is the capital cost which one thing, but the time cost is a little bit more difficult. The time required just to establish a normal fund is typically around three to six months, if you are lucky, and of course this doesn't include setting up your SFC license, et cetera.



To address this, we created the Sunrise SPC (segregated portfolio company) last year to accommodate managers who want to operate from Hong Kong and launch very quickly with master agreements with the fund administrator, prime brokerage, and auditor, plus an independent board.

This **reduced the launch period from six months to about six weeks**. It's especially good for managers who have visibility on specific a inflection point of the market. Any launch delays could mean missed opportunities and cycles before they can capture that upside. So this is what we have been doing in terms of innovating.

Then, the last piece of the puzzle for a lot of these emerging managers is capital. We're teaming up with a few family offices and fund of fund advisors to build an **emerging managers' fund of fund**, which we will probably launch in end of Q1 2017.

Cina Lee: As the result of a number of regulations, derivatives and securities financing, such as repo and securities lending businesses, are becoming more expensive. In addition, the concentration of banks offering client clearing services creates challenges and counterparty risk concerns for CCPs.

One of the key solutions to reduce costs is an alternative direct access model, granting buy-side clients direct access to the services of clearing houses. Eurex Clearing ISA Direct model combines elements of a direct clearing membership and the traditional service relationship in client clearing, tailored specifically for the buy- side. It opens up a new principal client relationship between buy-side clients and the CCP, with the regular Clearing Member acting as a Clearing Agent, providing a variety of mandatory and optional service functions. In the meantime, the Clearing Agents are benefitting from the higher capital efficiencies while maintaining their relationship with their clients. For buy-side firms, direct CCP access is a unique way to meet regulatory requirements with a strong protection for their assets and easier access to a new Clearing Agent in a default situation of the existing agent.

Eurex Clearing also introduced a portfolio-based margining system called PRISMA. Compared to the previous risk-based margining system, PRISMA calculates combined risks across all markets cleared by Eurex Clearing. Cleared products that share similar risk characteristics are assigned to the same so-called Liquidation Group, which results in more comprehensive risk calculations enabling portfolio and cross margining across positions within any Liquidation Group. Our margining method and default management process are closely aligned.

By the end of November 2016, most of our asset classes will be migrated from the risk-based margining system to PRISMA. In some client portfolio simulation involving futures and options of EuroSTOXX 50 and VSTOXX, PRISMA is able to reduce margin requirements as high as over 80%; hence, displaying margin offset advantages.



Alvin Fan

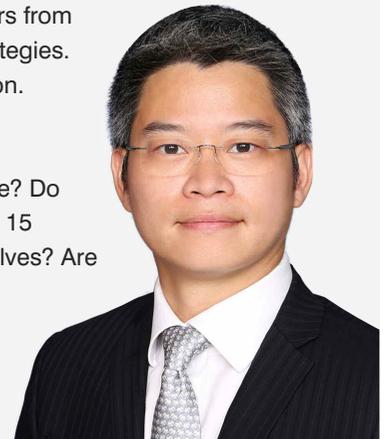
No, we don't use managed accounts. Managed accounts are good for institutional capital or with certain family offices that don't want commingled funds, but to the benefit of the manager, a commingled fund is what they are really trying to build out, because that's where the track record lies. A managed account really doesn't do that for you, although there is an increase in popularity in managed accounts, but that's a discussion for another day, I think.

Matthias Knab

Alvin, you also spoke about the importance of building up capital and raising assets, and this is of course the battle worldwide. I wonder what you can tell us about the investor base that Asian managers are able to tap. How has the homegrown Asian investor community developed? Are most assets for Asian alternative investment managers still coming from the US or Europe?

Alvin Fan: We may be a bit different here because our capital has traditionally come from Asia. Recently though, our funds have been getting some attention from endowment funds and large allocators from Europe. In addition to Cayman funds we also have four UCITS funds which focus on Asian strategies. A couple of our managers have done spectacularly well, and that has increased a lot of attention.

Ultimately, managers need to communicate their edge. *The challenge for managers today is differentiation within same strategic space.* Are you a big data guy? Do you have local presence? Do you have a deep history already? Managers with only a few years track record, they don't have 15 years experience on the ground like Howard, for example. So how do they differentiate themselves? Are they using satellite imagery? Are they fundamental quants? They have to really dig deep about how to position themselves.

**Brian Pohli**

How long do people stay on your platform for? Do they typically get to a certain size or certain metric, and then leave your platform? What's the mechanism for leaving?

Alvin Fan: The ideal scenario, assuming performance is good, is like one of our managers who started out with \$15 million about four years ago and generated solid and stable returns. That manager is now at \$400 million and ready to build his own middle and back office team.

But to be honest, the hard part is getting to the first \$50 million. They've got to show the resilience and mental stamina. Running a fund with an audited NAV is like opening the kimono. You can see edge and issues expressed in NAV, and new managers have got to embrace that.



Hugh Dyus: I will make some comments about the **sources of capital for the Asian private equity industry**. Traditionally, North American investors, ranging from institutions to foundations, endowments and family offices used to be the big backers of Asian private equity. That has substantially changed over the last decade. Sovereign wealth funds are today very big investors in the industry, and many of those funds are based in the Asia Pacific region.

Another major change is that fewer investors are writing bigger checks, which favors well-established managers and makes it much more challenging for emerging managers.

I do have a comment about Alvin's earlier point about differentiation. So obviously, if your strategy is very similar to that of other managers, it is very hard to differentiate yourself. We are new and have an innovative strategy and fund, and nobody else to our knowledge is pursuing this particular approach. So on the one hand, this is a strength because we are differentiated, but on the other hand, the process of educating potential investors, and persuading them that this point of differentiation, which nobody else is doing, actually adds value, remains a challenge.

One thing we show people is a back test which goes back 10 years, but investors are skeptical of back testing. The length of your track record with live money is important. *Many investors pride themselves on creative thinking, but at the end of the day look largely in the rearview mirror of historic performance. That is easy but not necessarily the best way to allocate capital in a dynamic world.*



Brian Pohli

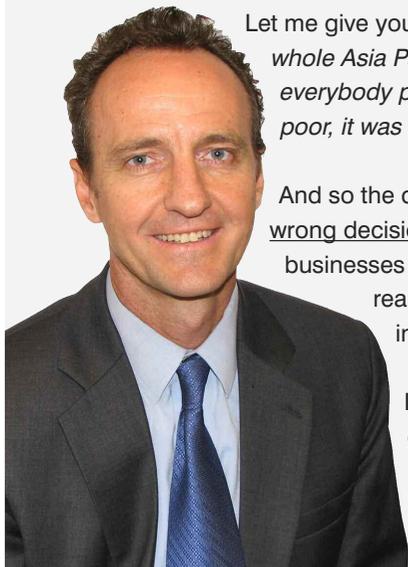
If they don't look at your past it's a pretty big leap of faith in the sense that you have invented a better mousetrap, no?

Hugh Dyus: Of course, all investors will look at the track record and the length of the track record. *But in a dynamic region like Asia, this sometimes leads one to make decisions which are inappropriate because a particular strategy may do well in one phase of the market cycle but not in another.* You need to spend time understanding the underlying risks taken to produce the returns in the track record.

Let me give you a very simple example. *There is a very well-known private equity manager covering the whole Asia Pacific region. Their Fund One was fantastic, Fund Two was about three times bigger and everybody piled in because Fund One was good, but then Fund Two was poor. Because Fund Two was poor, it was very hard to raise capital for Fund Three, which turned out to be good.*

And so the conventional rule of looking in the rearview mirror would have actually led you to make the wrong decision every time. But if an investor had dug deeply into the underlying deals, what type of businesses they invested in, what type of valuation they paid, how leveraged were those deals, and really understood the underlying risks, they would have gotten a better insight and basis for an investment decision than simply asking if this manager made money over the last five years.

I guess the point I am making is that there is merit in digging deeply into how people are generating returns and what risks they take to produce their returns and how the environment in which they operate is evolving, rather than just looking at the magnitude of the returns.

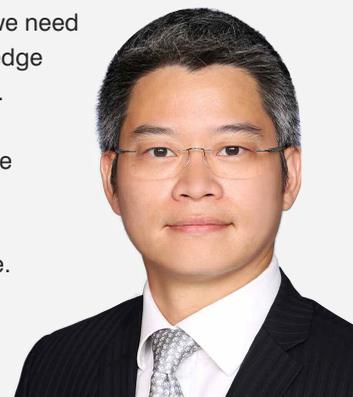


Alvin Fan: We sit on both sides of the fence, so both in the capacity of a manager and as an investor. It's hard to fight for eyeball space. It really is hard to fight for time with seasoned investors who are literally looking at managers every single day.

If you think about it, we are very demanding when it comes to analyzing companies, and I think we need to eat our medicine and ask ourselves those same questions when raising assets - "What is the edge that your management is bringing to this firm? What is your path towards profitability", and so on.

The burden of communication is on the manager, not the investor. Education is marketing, and we need to invest into it.

And even if they don't listen to you now, you've got to communicate, communicate, communicate. Market is down, your positions are holding, communicate. "Look, we survived this, we survived this disaster, and here's the reason why."



Howard Wong: I will put a different spin on what you just discussed and also answer Matthias' question about asset flows. I would say that flows into Asian equity has improved this year versus many of the last few years.

I guess globally equity hedge funds are having a rather difficult time because the performance has been bad. If you look at the biggest market, the US equity market has done well, but hedge funds have underperformed significantly, partially because there is so much risk in the market every year. This year we have Brexit and Trump, and before that it was the Eurozone and all those kind of risks. And thus, most hedge funds are not taking that much risk, while at the same time the market itself is exceptionally concentrated in terms of performance. *Unless you hold the top 10 performers in the US, you are not going to even break even in terms of matching the benchmark.*

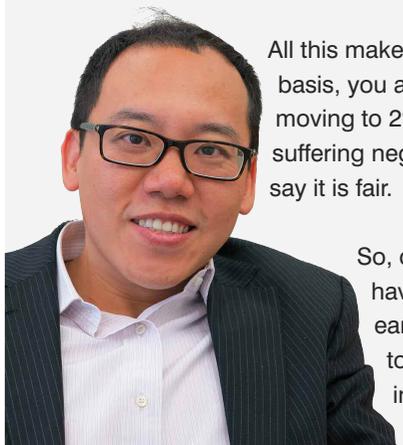
So for a lot of those reasons, the market has basically not focused on equity, also clearly because the bond market has been doing well. The reason why that market has been doing well was because bonds just seemed to be riskless, and at the same time they have been going up.

But I do believe the reasons why this year is starting to look different is the fact that we are actually at a cusp of a turn in the whole cycle. I believe we are going through a **massive deflationary cycle** started by over-investment in China, and I think we are probably close to the very end of this cycle by the beginning of this year when oil capitulated at \$20. It basically showed that the whole world basically has too much supply, and at the same time, when the supply discipline comes in, **collusion** is starting to happen.

What this means is that basically the small guys are already bust and the big guys are colluding, and that cements, in my view, a very firm base that deflationary pressure is over. And that's exceptionally important, because equity cannot perform with deflation. Therefore, as we can see, especially after a couple of days ago, we are stepping closer and closer to an inflationary world, because US is clearly on the investment path. Trump is going to cut tax and he is going to invest. He doesn't have the money, but he will do it.

All this makes a **very strong fundamental case for equity investing** overall. And obviously, on a relative basis, you also see where US 10-year Treasury bond yields are, having already capitulated at 1.5% and moving to 2%, and the fact is that this cycle can easily unwind itself. There is a lot of money parked there suffering negative interest rates, while at least in the equity market, I won't claim it's cheap, but I would say it is fair.

So, on a relative basis there is still a reasonable amount of return left in the equity market. But I have to agree with you, the momentum isn't there, but momentum builds on the sell. When earnings come back, when the funds are starting to improve, then people will say, "Yeah, I want to invest in equity!" I believe there is already a change in momentum and people are looking into equities, and I think that trend will continue going forward.

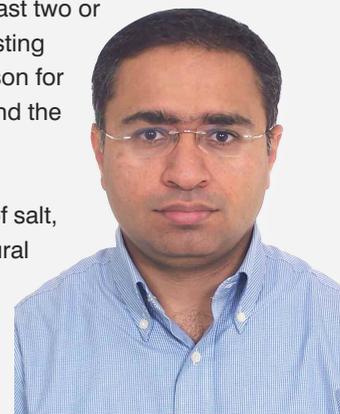


Anuj Sehgal: As Howard said, barring 2016, the last four, five years were pretty bad for equity investing in Asia ex Japan, and obviously in that same time period the S&P went up almost 80%. And I think there is a reason for that. As he mentioned, if you go back before 2016, net growth in Asia ex Japan relative to the US and Europe was actually shrinking, so the delta was actually reducing. And I think now, after four, five years that **delta is beginning to expand again.**

Looking at countries like India, Indonesia, Philippines and of course China which is a big elephant in the room, nobody has much clue as to what's happening there, but even if you assume that they just muddle through, that delta is beginning to expand and that is why this year markets here in Asia ex Japan are up substantially compared to the Western world, and I think that ultimately will drive more money flow. If we couple that with the fact that valuations are extremely cheap relative to the rest of the markets, especially the US, so I just wanted to add that this delta after a long period of time is beginning to expand.

And then just one final point, we just all witnessed the victory of Trump in the US, and I do think that there is a pattern to that. If you look at India, Philippines, or Indonesia, all these three countries have had new leaders in the last two or three years, and all of them are sort of **anti-establishment leaders.** They don't come from the existing political class or families who have governed these countries in the past, and I think there is a reason for that, because these people who now got into power have genuinely made an attempt to understand the real problem.

Now, I agree they are all politicians and you have to always take what politicians say with a lump of salt, but I think even if they do 25-30% of what they are saying, both in terms of fiscal policy and structural reform, I think we could have a situation where there could be more inclusive growth in these countries. And also from that side there could come some support for a reasonably decent equity market over the next few years after having been down for the last four, five years.

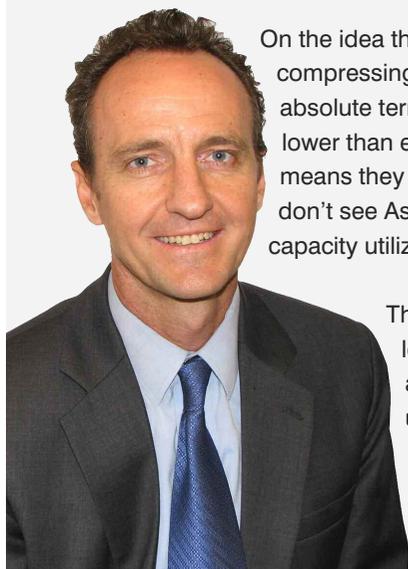


Hugh Dyus: I have a few comments with respect to the macro views that have been expressed. With respect to the idea that global deflationary pressures might be reducing the **overinvestment in China**, I actually believe the way capital is allocated in China, *the issue of overinvestment in China will continue.*

Excess capacity in many Chinese industries is enormous. *One of the reasons why high economic growth has not translated to investment returns in China is because of the high level of competition and the level of excess capacity.* I don't think that's going away in the short-term.

On the idea that Asia's growth versus developed market growth is now increasing rather than compressing, I think the issue is that actual growth in Asia has been less than expected growth. In absolute terms, the growth in Asia has still been very good; but the problem is that growth has been lower than expected, and optimistic entrepreneurs overinvested. And the fact that they overinvested means they overstocked, they had to cut price to move stock, and that caused deflationary pressure. I don't see Asian entrepreneurs suddenly becoming very prudent with factories running at close to 100% capacity utilization.

There are also some macro headwinds. Global interest rates have really been exceptionally low for a very long time. While it is a challenge for anyone to say exactly where interest rates are going, it is hard to see them going lower than they already are. So they are likely to go up, but nobody really knows by how much or how fast. *Rising interest rates in the US could suck capital out of Asia, which would be a headwind.* So from my observations, I am not sure that the environment going forward is necessarily going to be more favorable for equities than it has been.



Richard Warfield: One thing we have seen over the last five plus years is a large divergence between the performance of expensive growth securities and that of cheaper value securities. If you look at what the best performing stocks were – and Howard also alluded to this – in the U.S., basically if you weren't in Amazon and Netflix last year, you underperformed as an asset manager.

And going back further, expensive growth equities have been outperforming value for five plus years, which is historically very unusual. And it isn't only the case in the US, but in Japan and in a lot of other Asian markets as well.

I think we are going to see that reverse. The historical evidence is that, first of all, these cycles tend not to last. Five years is already a very long time for growth to outperform value, historically speaking. There is just a limit to how much more expensive the most expensive securities can get relative to the rest of the market. Also, historically, rising interest rate environments are good for value investors, and it seems quite possible that we are entering such an environment.

The other thing is that if you look at the valuations of the market, like Anuj was saying, the valuations in Asia are quite attractive, especially compared to the US. Our view is that the market is sort of prepared for a very negative case in China, and has been for quite a while now. Now, we certainly believe that the macro concerns about overcapacity, deflation, the debt level, are all very valid. But the likely outcome is not a Lehman kind of financial crisis; I think that's clearly off the table given the structure of national ownership in China and the considerable debt capacity of the government. So from that perspective we think this is actually going to be a very positive environment for cheaply valued securities, particularly those that are not highly geared to GDP growth.



Howard Wong: I totally agree with Hugh that there is extreme overcapacity in a lot of things in China, but let me give you some anecdotal evidence around that. So I go to a number of Chinese conferences every year for the last ten years. Every time I went there for the past ten years, 70% of the people will be bullish. The vast majority of those bulls will be local, and then you have those 10-20% of nay-sayers and foreigners, but nobody listens to them. All the Chinese bulls will say things like “China is fine, China is great, it is growing at 10%, what are you guys talking about? You just want to talk bad things about our communist system,” and such things.

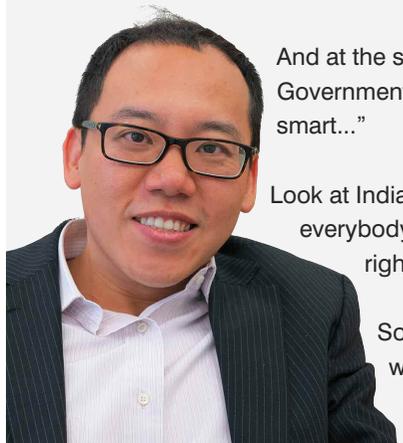
But I think things changed drastically in 2016 when I went to the same two conferences. When I look at all the presentations together with thousands of people, even these Chinese nationals that used to say China has no problem, would say, “Yeah, China is not that great, we are going through a tough time, but it's okay, it could be worse...”, which is their way of indirectly saying China is bad.

So this has been turning. I would say *70% of the people, at least on their tone, have actually become pretty bearish*. I totally agree with Hugh that there is overcapacity, but the mentality has changed. When it comes to the question of investing in another coal mine or in another cement plant, before they said, “Yeah, why not, because I take 5% of every plant they build anyway, so I will build, and I don't need to take care of the tab.” But now, they say “No, nobody allowed me to do it. If I do it, it's like suicidal, in all kind of ways; economically, politically,” so they just don't do it.

And at the same time, the same thoughts travel through to the top. Basically, you can see that Government is very clear from the very top to the bottom, giving messages like “You guys, just be smart...”

Look at India. South India, for example, has had overcapacity with cement for the last 10 years. But then everybody makes very good money, because they collude, and the Chinese are doing exactly that right now.

So all the cement prices went up, not because demand is strong, demand is actually very weak, they even talk about a stimulus or building an underground railway, and all these profit, but when we look, data is actually weak.



But that is what they do basically, which is fine. I mean, before that, because there would be a national or regional plan, they need to show that I am sticking to that plan, so I push 100% of my capacity. But because it's a market economy, if they put 100% of the product out when the demand is only 50, obviously the price collapses and the best corporates within the sector also go bust.

But now basically they say, "Well, we should collude. You guys and us, we consolidate, so maybe we just put out 50% of our capacity, but we sell it at a price so that we all make a good EBITDA."

And then, going down the road the bigger guy will just say, "I will absorb the smallest guy, and I will just further defend having a so-called free market." But at the same time every cement company in the world does just that, and they end up controlling the pricing.

So the most important thing is really the mindset of people. For example, we are benefiting having invested in a company like a coffee shop chain in China. For the last five years it has had a perfect elevator pitch. You are basically buying the Starbucks of China, and they grew 30% a year for the last few years, but then of course other companies entered the same niche, the profit halved while the margin collapsed.

But over the last 18 months we started to put money into this stock, because when we talk to the company again, although we still see slowing growth, we see a lot of other people getting out of their business, because they just don't know how to run it. And therefore, these guys are finally getting same-store-sales growth, they are not growing at 20% or 30%, but it's a good growth, sort of 5% - 10% and the margin is recovering. The margin is up 3 or 4 percentage points and basically profits are doubling this year.

These days we don't see that, for example, a coal miner is going to operate a coffee shop because they think it's a good business. Rather, the leadership has told them that the brand matters and the consumer actually knows the difference between a good chain versus a "me too" player.

So the direction has changed. There is still a lot of overcapacity, but now people have realized and experienced that it doesn't work for business if you just keep investing. Overinvestment is very bad for China, prolonged high growth can be very bad, because, as Hugh said, people compete like hell. Slowing growth is actually very conducive to the equity market.

Hugh Dyus

I just want to add one other macro headwind, and that's the trend towards increasing **global protectionism**. Obviously the whole Asian region benefits massively from growth in global trade, and clearly that has slowed down and nobody yet knows what the outlook will be under a Trump presidency. The recent trend in global trade has been disappointing, and so I think that's another macro headwind for the region.

Brian Pohli

I would like to ask a question. I have a European, maybe North American perspective, but it seems to me like the environment in Asia is maturing. I was wondering about your expectations, hopes or prediction about the rule of law in this part of the world. Will the rule of law strengthen so that, for example, it will become easier for a German insurer to **invest directly into a Chinese asset manager?** Or will the investor always only invest via a Cayman fund into China? Is there any expectation that the rule of law will make investing more globalized here?

Hugh Dyus

I am not optimistic that the rule of law across Asian countries as understood in a Western context will evolve in that direction. I think that many Asian countries are exhibiting increasing national pride, and that pride reflects their own way of doing things. In this context, the spectacle of the recent US election possibly even undermines somewhat the Western model.

In my view it is more likely that each Asian country will retain its own path, together with the sense that their own path is appropriate for them. This then means that the challenge for investors is to adjust to the local conditions in each geography in which they are playing.

Alvin Fan: We see certain challenges for US firms that were JV-ing with onshore Chinese asset managers, and a lot of them have pulled out.

But what you will find is over the last six months there has been a lot of progress that have allowed foreign managers to set up a wholly owned shop in China, and this is unprecedented. So from that perspective I am actually quite optimistic in where things are going.

In terms of regulation, China is getting better and better. AMAC started off as an SRO, but for sure it is become an SFC or a SEC, it's just a matter of time.

In fact, they are in dialogue with global regulators from the UK and Hong Kong to see how they can improve. 2015 was a wake-up call and fantastic for the industry, because it weeded out charlatans while the strong survived.

Regulators are paying attention to investors, and capital controls will eventually loosen. We are sitting in the middle of a dam here. Capital controls holding back liquidity from China on one side and low sentiment holding back allocations from the West.

Long term though, our house view is very optimistic. Yes, things have a long way to go compared to regulation in the US and Hong Kong, but you know what, if you look at where they came from, which was from zero regulation, it's phenomenal what they have achieved.

China now requires independent legal opinion for a firm to get an asset management license. All senior management need to pass standardized exams and have experience in asset management.

Eurekahedge has a database of around 10,000 active managers globally, and there in China you have roughly 7,000 managers. The 10,000 offshore hedge fund managers globally trade on 150 exchanges, 50 different currencies, and a countless number of strategies. Now let's *compare that to 7,000 managers in China running one currency, two exchanges, and five strategies.* So the competition is there and it's going to mature, and I believe regulation is definitely acknowledging it.



Brian Pohli: I totally agree with that. You can see it also in the number of connects, like the Shenzhen Connect, the Shanghai Connect. So from that side we see the financial markets and businesses mature.

We have also seen the relaxation of QDII, QDLP and all the other Qs that go with it, which basically is an opening up of the markets as well.

I agree with Alvin that the best thing AMAC could have done was reduce the number of managers. They have increased the quality, reduced the quantity, and now you need to have a stronger capital base together with a stronger business plan to be relevant. This is important because in today's world not only do we need to be a fund manager, you also need to have a business practice, a marketing practice, and a compliance practice. You need to have all those practices in place rather than the two proverbial guys with a Bloomberg. So I think asset management in China is also becoming a more mature and better qualified industry.

Therefore I would think that the rule of law is slowly moving toward a better scenario as opposed to becoming less regulated, and I think that helps everybody.

Alvin Fan

I have a question for the more experienced managers at the table. We have observed over the last few years a growing **trend towards passive management and smart beta on one hand together with an increasing number of quant managers** who are as well challenging active managers.

So the question to the table is what is your view on that? The trend hasn't quite hit Asia yet, but we see that it's about to hit Asia. And how do you compete with that?

Brian Pohli: I think investment management will end up going the other way, I believe *the pendulum will actually go back to active management.*

It's certainly true that we are winding up with a proliferation of ETFs in just about every genre you can think of and that we are looking at the commoditization of a number of products. But as I said, I believe what's going to happen is that we will see a swing back toward active management, so back to say stock picking as opposed to index buying, more toward individual selections versus mass products such as ETFs.

You are right, we are all aware about the recent big move toward passive products. They have been very popular and they serve a purpose. Many people also use them as hedging tools. But I also think that we are getting to a peak in passive management, and what we'll see next is a return to active managing among investors.



Alvin Fan

So what do you think those allocations will start looking like? I mean especially the allocators?

Brian Pohli: Right, I see that, but one of the things I'd like to point out is that ETFs have embedded fees that people don't see. This is one of the issues that always strikes me about ETFs, but, I think if you are going to call a top in passive investing, I think we are getting close to it now. I think we'll see markets **bifurcating**, and that we'll also start seeing the better performing funds receive allocations and poorer ones leave the market. If you can outperform these passive strategies, you will be successful. If you are going to be giving people the same results as passive investments, you are not going to be successful.

So results are going to start mattering more, and I think that you are going to start seeing inflows going toward the funds with better results.



Hugh Dyus: We deploy a combination of quant and fundamental processes. But in general I believe there is a shortcoming using quant processes for the Asian markets. As we discussed, one of the biggest risks in the Asian markets is governance risks, and *it's very hard to assess governance risks just via quantitative measures. So if you have a pure quant strategy, I think that could lead you into some dangerous investments where the governance is questionable.*



Anuj Sehgal: I am not an expert on this topic, similar to Howard's approach, almost three-fourths of our portfolio is in mid to small-sized companies which we think are emerging franchises that can become leaders over the next five, seven, ten years. And I think that opportunity set is something that you can't access via passive investing.

Let's say you invest in India, sure you can mimic the NIFTY or the BSE SENSEX, but beyond that, how do access to those opportunities? And right, the risk is the governance side part and making sure you are investing in the right names, but then that itself is the opportunity, because you don't want to invest in all the large 30 top index stocks. If you want to do that, you will have a different return profile and then the competition with the passive investments will be tough.



Going back to what Brian said, returns are ultimately differentiated, so I think it's a function of what your aspirations and return expectations are, and then what you invest in. So if you just want the index return, then very good and good for you, but if you are really wanting to capitalize on the underlying growth in this part of the world, which as we have discussed is still way far behind the Western world in terms of maturity, in terms of penetration for more services, then the passive style is not going to give you full access to that opportunity.

Alvin Fan

It's a widely accepted opinion that Asia is tremendously strong in stock picking and research, but weak in portfolio construction. So I guess the message I am getting is that portfolio construction and absolute returns still has a shot in Asia.

Anuj Sehgal

True, and allow me to add more thing. Everybody claims they are differentiated, their edge is finding new under researched companies. I think our biggest edge is just being very diligent, patient and disciplined and genuinely taking a long term view, because markets are volatile in the near term, they go up, they go down, you can easily get carried away with them, but if you are just patient and disciplined with the right temperament, that takes care of a lot of things.

Richard Warfield: I think that this trend towards passive is going to last for a while. Largely this is coming at the expense of two kinds of types of asset managers. One of them is not really found that much in the hedge fund space, but more in the sort of traditional asset manager space, and I am referring there to the so-called closet indexers. I think that the world is kind of finally starting to catch on to the fact that if your tracking error to an index is 1%, it's probably not worth paying you a high management fee.

And the other is the very large asset managers, the sort of multi-tens of billions of shops, including the alternatives. There was a report, I can't recall from where, that looked at the cause of the underperformance over the last few years of the hedge fund industry, and a lot of that was concentrated in the largest managers who obviously have an outsized weight in the indices. Those fund have a hard time outperforming. Of course they are extremely skilled, but your opportunity set is just far more limited if you have to deploy \$20 billion.

Therefore I believe that going forward investors will start looking more towards smaller and emerging managers and managers coming out of those largest shops. Ultimately I believe this will prove a healthy trend for the industry as a whole

On the topic of quant, we are not a quant shop, but as it happens all of our principals are from computer science or electrical engineering backgrounds, so this field is



something we look at and think about a lot.

Now, obviously the quant trend is partly driven by new technologies around **machine learning**. If you look in detail of what those technologies can do, one of the big weaknesses of them is that *they are often not very good at telling you why they make decisions, and I think this is going to be a major issue at some point*. If a fund is down, particularly if it's down significantly or for longer periods, investors want to know ex post why the fund is down, why a decision was made, and why you expect performance to turn around, or otherwise the inclination is to redeem. It can be very difficult to give a convincing explanation if you are dealing with some of these technologies.

Matthias Knab

Any other comment about important developments in our industry?

Steffen Gnutzmann: I have one last remark that could be relevant for those of you trying to diversify your investor base and to raise more assets. Should a German investor come your way and say, "I like your fund," then it may be interesting for you to know that right now German investors are difficult to have, because overseas fund managers need to deliver a lot of German tax compliance to serve them. But from the first of January 2018, this will become much, much easier. People like us at WTS will lose a lot of our tax advice business, but for you it's good, because most funds will have to solve much less tax compliance for your German investors. So from Jan 1st 2018, life will be much easier for you if you **onboard German investors**.



The background is that right now these funds need to disclose great detail and show what they are doing in their portfolio, the income streams that they are generating as well as their expenses, all of these items have to be sliced and diced under certain German rules. And a Cayman fund or a Hong Kong fund, they often do not know how to apply the German tax rules.

But from the 1st of January 2018, all the German investor has to consider is the NAV increase or decrease and German investor tax base will be derived from the fund's NAV. So, the concept of tax transparency of a fund will no longer apply, it is all done from the outside, if your funds will qualify for this regime. Therefore, life becomes a lot easier for you and your potential German investors in the future.

Matthias Knab

What I can add here is that over the ten years or so, German investors have studied alternatives, they came to understand them, and now more and more, because we are living in this yieldless world and negative interest rates, they have started to pull the trigger and go into alternatives. This is a very positive development.

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