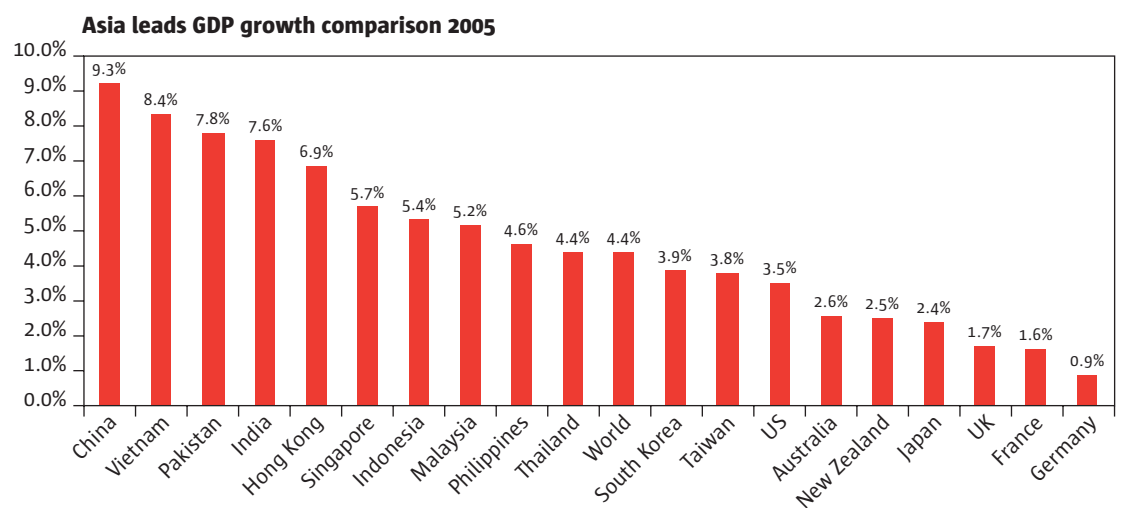


**Strategy** commentary

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Source: The World Factbook. The Data is real GDP information available as of April 7 2006

## Hedge fund investing in Asia (ex-Japan)

Asia offers abundant opportunities for equity-related hedge fund investing. This article will focus on Asia ex-Japan<sup>1</sup> and will be limited to providing a macro view of salient points regarding regional investment prospects.

Astute investors typically evaluate Asian markets by valuations, capital flows, market trends, regulatory environment, politics and fundamental research outlook. Other considerations include liquidity, breadth and depth of the market, political risk, market-making functionality, available instruments and short-selling. As a general observation, the funds with superior long-term performance have had tactical active portfolio management. They understand liquidity is not solely based on trading volume, but is also based on knowledge of counterparties, traders and who will reliably trade a security. In short, these managers know where to find the exit in the event of a fire.

Understanding risk is imperative to success in Asia, and there are two primary sources investors should recognize before investing: operational/business risk and portfolio risk. Many managers are adept traders but are susceptible to operational and controls risks as they lack relevant business experience. Investors must perform extensive due diligence to avoid investing in a manager whose business fails for operational

reasons. This also entails confirming that the manager has a portfolio risk management process and is aware of relevant exposures and leverage.

The burgeoning asset growth in Asia-focused hedge funds stems not only from the attractiveness of the region but also from the increased investor allocations to hedge fund strategies for diversification purposes. Asian hedge fund assets grew by approximately 33% in 2005<sup>2</sup> and can be expected to increase at this pace in 2006.

Capital flows were positive across Asian markets with the exception of the Indonesian bond market which contracted in 2005. India and China saw substantial capital flow increases<sup>3</sup>. Of course, just as capital inflows bid up prices, capital outflows can take them down. Better managers are adept at managing their portfolios through changing capital flows. Valuations based on various metrics look particularly cheap in the young market of Vietnam (9.7xP/E) as well as in China (13.3xP/E) especially in the context of greater than 20% EPS growth rates in 2005<sup>4</sup>. India and Singapore are at the higher end of the valuation spectrum with P/Es of 20.5x and 16.7x in an environment of 17.6% EPS growth and a -4.7% EPS contraction respectively. The consensus of analysts reviewed continues to be positive on China and positive with risk

caveats on Vietnam. Unanimous opinion does not exist and only a sample has been surveyed, but the summary market outlooks in the accompanying table may be useful<sup>5</sup>.

Market trends are relevant. Currently, the weakest trends are Hong Kong (losing share to mainland China) and Taiwan, both of which look fairly flat. India, Pakistan, Indonesia and Korea have enjoyed multi-year bull markets, the sustainability of which is a persistent question. Indonesia remains volatile as the recent string of bombings has demonstrated. China, Malaysia and Vietnam look most compelling with trends which appear relatively early in the up cycle.

Making the correct macro call can be the determining variable for success in Asian investing. Analyzing the above-mentioned fundamentals, the standout opportunities appear to be in China, Malaysia and Vietnam (although Vietnam is a relatively small opportunity set). China demonstrates robust GDP growth and attractive valuations despite the fact that many companies lack operating history and knowledge of competitors. China recently announced its landmark implementation of stock options as a form of compensation for executives. Malaysia is characterized by attractive valuations and growth, and the government has recently lifted its eight year ban on short selling. In India, the market >>

## Emerging Asia data summary

Country	Capital Flows (USD Mill)			Equity Market Information								Research
	Equity Market Size 2006 <sup>1</sup>	Equity Capital Flows 2005 <sup>1</sup>	Bond Market Growth 2005 <sup>2</sup>	PE(x) 2005 (y/e) <sup>3</sup>	EPS Growth 2005 <sup>3</sup>	Market Performance <sup>4</sup>					Consensus Forecast	
						YTD 2006	2005	2004	2003	2002	2001	
China	445,038	3,973	106,000	13.3	25.3%	21.4%	15.9%	-0.8%	81.1%	-16.2%	-26.0%	POS
Hong Kong	1,184,720	37,667	6,850	13.5	17.2%	-0.7%	0.1%	13.2%	34.9%	-18.2%	-24.5%	NEU+
India	1,177,530	19,058	13,310	20.5	17.6%	21.1%	35.4%	16.5%	73.9%	5.9%	-21.2%	NEU
Indonesia	92,646	963	(10,440)	14.6	20.3%	25.5%	12.6%	44.5%	70.0%	38.1%	-10.9%	NEU
Malaysia	192,566	1,996	11,090	12.4	19.3%	7.9%	-1.5%	11.8%	23.1%	-2.7%	2.3%	POS
Pakistan	96,534	501	N/A	11.3	10.4%	21.5%	56.5%	8.6%	31.1%	122.4%	-35.0%	POS
Philippines	43,459	752	5,780	11.4	14.9%	3.0%	19.9%	24.1%	39.0%	-30.5%	-19.7%	NEU
Singapore	282,007	5,436	4,040	16.7	-4.7%	11.0%	10.8%	18.8%	34.2%	-13.1%	-25.0%	NEU+
South Korea	758,716	4,811	70,160	10.2	13.2%	2.4%	58.9%	24.3%	29.7%	-9.5%	37.5%	POS
Taiwan	484,660	2,213	2	13.5	-8.9%	2.6%	3.3%	6.5%	40.0%	-25.4%	8.8%	NEU
Thailand	137,243	433	12,320	10.1	3.4%	6.0%	4.9%	-4.0%	134.3%	24.3%	2.9%	POS
Vietnam	10	N/A	1,420	9.7	20.2%	63.7%	27.4%	42.2%	-10.3%	-23.8%	9.5%	POS

(1) Source: World Federation of Exchanges ([www.world-exchanges.org](http://www.world-exchanges.org)). Capital Flows represent the total of IPOs and Secondary Offerings. NOTE: Vietnam Market Size is an estimate calculated from data from Merrill Lynch, "Asian Insights" and The World Factbook ([www.cia.gov/cia/publications/factbook/geos/pk.html](http://www.cia.gov/cia/publications/factbook/geos/pk.html)). Pakistan Market Size data obtained from the Karachi Stock Exchange ([www.kse.com.pk](http://www.kse.com.pk)) and the Lahore Stock Exchange ([www.lahorestock.com](http://www.lahorestock.com)) and converted to USD. Pakistan Capital Flow data obtained from the Karachi Stock Exchange and converted to USD. Thailand Capital Flow data obtained from The Stock Exchange of Thailand ([www.set.or.th](http://www.set.or.th)) and converted to USD and pertains to newly listed companies. 2006 data is as of February 28, 2006. (2) Source: Asian Development Bank, "Asian Bond Monitor 2006" ([www.asianbondsonline.adb.org](http://www.asianbondsonline.adb.org)). NOTE: India data from Bank for International Settlements, "The corporate debt market in India" and data is a 2004 estimate converted to USD. Taiwan data is corporate bond data only from Financial Supervisory Commission ([www.sfb.gov.tw](http://www.sfb.gov.tw)) and converted to USD. (3) Source: Merrill Lynch, "The Asian Market Economist" and "Asian Insights." NOTE: Pakistan and Vietnam PE and EPS stats are 2006 forecasts. (4) Source: MSCI - Price Indices in USD. NOTE: Vietnam Market performance data obtained from Bloomberg in USD. Hong Kong performance taken from The Hang Seng Index in USD. South Korea performance taken from the KOSPI Composite Index in USD.

«run-up has increased P/Es significantly and the economy is somewhat narrowly focused on service and high tech industries.

Other Asian countries exhibit generally encouraging fundamentals but with some caveats. Korea has had a strong equity market and valuations appear reasonable, although corporate debt levels are high and overall EPS growth is relatively moderate. Given the debt levels, many Korean companies are vulnerable to any economic hiccup. Pakistan presents some cheap valuations and excellent opportunities even after the market gains of recent years. Thailand would benefit from a more positive government approach and lacks earnings growth; however, low valuations exist. Indonesia has growth and reasonable valuations, but the equity market upward trend is somewhat mature and government reforms are needed. Taiwan and Singapore lack fundamentals and earnings growth. Singapore, however, has excellent governmental oversight and presents selected opportunities through synergies with China. Conversely, the Philippines suffers from government instability having just thwarted a coup d'état in February. Such political risk must be assessed when investing in Asia. In the past, this risk has manifested itself through currency devaluations, nationalization of private assets and outright corruption-driven appropriation of funds.

Each market has significant differences in opportunities, risks and costs. The importance of thorough due diligence cannot be over-emphasized on the other side of the globe where in several cases laws protect citizens to a greater degree than foreign investors (e.g. Korea). Moreover, many of the countries are trading partners, and while certain economists argue that their economies have decoupled, regional convergence risk persists. The so-called "Asian Contagion" (Economic Flu) of the late 1990s and the performance of Asian markets<sup>6</sup> in 2001-2002 are indelible reminders.

The historical volatility of emerging markets is undeniable. In the last twelve years, emerging market hedge funds have been among the top two performing strategies in six years and the worst strategy in three years<sup>7</sup>. This diametrically opposed performance is typical, and the cyclical, volatile nature of these markets persists. Whether triggered by a global credit crunch, liquidity crisis, the Economic Flu, or disease, Asia has been subject to dramatic event driven sell-offs. In such defining events, positions, sectors and/or markets tend to move together, and correlations can increase without regard for fundamentals.

Today, the economies, markets, capital flows and research outlook are generally positive

on Asia. Asia is the primary engine of global economic growth and offers tremendous investment opportunity. Nine Asian countries exhibited higher GDP growth than the World in 2005<sup>8</sup>. Asia is also a region historically characterized by volatility. The management talent exemplified by the better hedge funds has demonstrated an ability to mitigate volatility while providing regional exposure, proving that there is no substitute for skill-based, alpha-generating managers, especially in Asia. A rigorous due diligence process, careful selection, attention to risk factors and access to manager talent are some of the elements required for successful hedge fund investing in Asia.

1. Japan was the subject of the feature in the January 2006 issue of The Hedge Fund Journal.
2. EurekaHedge estimates.
3. See table.
4. See table.
5. These take into account most fundamental top-down macro and bottom-up micro analyses as well as government and civil stability, accounting quality, currency outlook, regulatory controls among other factors.
6. See table.
7. Based on the nine strategies in the CSFB Tremont Index.
8. See Bar Chart.