Khoo injects a new spirit into Sofaer's regional funds

When it comes to managing risk, Terence Khoo leads from the front. Following his return to Sofaer Capital last August, the SC Asia and Pacific funds have taken a turn for the better

Terence Khoo

Terence Lim

An Asian hedge fund house with a 20-plus-year history is a rare find, and its longevity in the region is one of Sofaer Capital's distinguishing features, along with a wide range of funds. Since the launch of the SC Asian and Pacific hedge funds in 1989, which followed on from the launch of Sofaer's first fund, the SC Global Hedge Fund in 1987, a further five funds have been added to the Sofaer stable, covering Europe, Japan, India, natural resources and emerging markets, respectively.

However, a long history does not always protect against the ravages of the market, and the SC Asian and Pacific hedge funds spent the first seven months of 2008 in the performance wilderness, clocking up losses every month. Then in August new blood in the form of Terence Khoo, who returned to Sofaer last summer, having been a director and co-manager (together with Michael Sofaer) of the SC Asia Hedge Fund from 2000 to 2002, turned things around.

The Pacific fund ended the year at a manageable -7.88% while the Asian fund clawed back enough to end the year at -12.72%. Since the handover to Khoo, both funds are up, with gains from mid-August to the end of March of 13.97% for the Asia including Japan Pacific fund and 6.94% for the Asia ex-Japan Asian fund.

"As soon as I took over the fund we went net short and made money without taking a lot of risk," explains Khoo. The other two men behind the management of the funds are ex-Goldman Sachs head of Korean research Terence Lim who works on both funds, and Andrew Graham, a 20-year veteran of the investment industry who joined Sofaer in 2004, who helps to manage the Japan component of the Pacific portfolio as well as managing the SC Japan Hedge Fund.

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Part of Khoo's role is to act as risk manager, a responsibility that he believes cannot be successfully hived off into a separate job because to do so assumes that the models underlying the fund work perfectly. "But the models don't work in markets like these when the basic correlation structure of assets has changed so dramatically. A risk manager can tell you what your value-at-risk is, but VAR is not a useful predictor of risk, you have to react quicker than the models can predict," he says.

"It's all about when to take risk and when to not take it. It's not just about your net exposure because your gross exposure can equally kill you. Most of my wealth is in the fund, so I know you have to manage risk and you also have to preserve capital. Sometimes there's no distinction between managing risk and avoiding it."

The Pacific fund typically has around 50 positions, while the Asian fund has between 30 and 40, combined in both the long and short books. Positions in China/Hong Kong, Japan and Australia are subject to a 60% country limit, whereas Korea, Taiwan and India are classed as tier 2 countries, subject to a 40% limit, and all other markets are considered tier 3, with a 15% limit. There are also fixed limits on sector exposure and net and gross exposure, of -40% to +110%, and 30% to 200%, respectively. However, there are no fixed stop-losses for individual positions.

"I don't believe in fixed stop-losses," says Khoo. "I want to be out earlier rather than later. If a stock's behaviour is counter-intuitive then you don't understand it, and you should cut it, and if you've put too much money into a stock you may need to just sell some," he says.

The fund relies on a blend of macro analysis and bottom-up stock-picking. Both Lim and Graham have particular expertise in bottom-up stock-picking, a skill that Khoo respects as a complement to his more macro stance. "People think I'm totally macro but the money we've made comes from stock picking," he says. "What we try to do is identify themes and then track them at a fairly high frequency. The bottom-up approach tends to assume things are static. In macro everything is a lot more fluid."

SOFAER CAPITAL ASIAN HEDGE FUNDS: AT A GLANCE

Inception Date: April 1989
Managers: Terence Khoo, Terence Lim
Offices: Hong Kong, Central
Strategy: Asia excluding Japan Equity
Assets in strategy: $115 million
Administrator: Citco
Prime broker: Morgan Stanley, Credit Suisse
Minimum Investment: $1,000,000
Open to investment: Yes

TERENCE KHOO: CV

15 years' experience in finance, with 10 years in absolute return.

Current: Fund manager at Sofaer Capital.

Experience: Co-portfolio manager of the FrontPoint Eurasia Opportunites Fund. Portfolio manager at Qi Capital, Kerry Asset Management, Sofaer Capital, Indocam Asset Management.

Expertise: Macro, equity fixed income, commodities and currencies.

For stock picking there is a heavy emphasis on due diligence, not just on the firms but on the management behind them. "We invest like Asians, and it's especially important as we go through a crisis in Asia every three to five years, to know the people you are investing with – it's not only the horse, it's the jockey," says Khoo.

Despite the current economic gloom, Khoo and his colleagues have begun to shift away from the short bias they had last year. The funds have been long China since October, and have been building up exposure since mid-March, to the point where China/Hong Kong is the portfolios' biggest overweight at the moment. The economic indicators have already begun to bottom out, says Khoo, citing US housing stocks, existing home sales and purchasing manager indices as key examples.

"The China stimulus programme has turned things around. For example, two months ago at its earnings meeting Vanke, China's largest residential real estate developer, was very cautious. Now they are expecting better sales. Things have changed dramatically quickly and I think the markets are way too bearish. We would have to go back to the 1930s to get bond spreads comparable with today's. Unfortunately those who said the market has no upside limit in 2007 are saying there's no limit on the downside now."

When there is an abundance of stocks priced at half cash, there are opportunities to double or triple your money once the economy returns to normal. And now is the time to start investing rather than fearing that things are going to get worse, says Khoo.

"We've probably seen the worst in the stock markets and we are likely to see the worst in the economy in the second quarter and third quarter 2009, if we haven't seen it already," says Khoo. "People criticised Bernanke's 'green shoots' comments because unemployment is still rising, but it is well known that unemployment is a lagging indicator and you can't expect it to show the bottoming point.

"Unemployment will probably go to 9% to 10% in the US, everyone expects that, and in the process of bottoming, growth in developed markets is not going to be exciting. Government balance sheets will be bloated and there will be growth off the trend line of the last 30 years. But 1% to 2% growth is the trade-off you make to get out of the mess quickly."

Economic expansion in Asia will be moderate with significant variations around the region, says Khoo, who expects China's GDP growth to go back to its historical level of 8%. The fact that analysts have probably priced in growth of 4% to 5% and may be beginning to price in only a little more, is further evidence of their unwarranted pessimism about macro-economic indicators, Khoo adds.

"In Asia not all countries are the same; some countries will do better than others. China will do better because it has a clean balance sheet, and started the process of cleaning it two years ahead of other countries. Hong Kong is part of China and will do okay, while more constructive economic and political leadership in Korea and Taiwan mean they are in better shape than a lot of places. Both Koreans and Taiwanese are highly adaptive and they, particularly Taiwan, have more economically constructive governments in place today," says Khoo.

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Both India and Korea did the right thing to re-liquefy their economies but India still faces the challenge of the large amount of non-performing loans still in the system. In India there are signs of a lack of political will to address this problem and others affecting its fiscal and current account deficits, according to Khoo. "Over time these issues will be resolved but in the short- to medium-term they will restrict India's ability to grow much," he says.

On a sector basis, Khoo sees some interesting opportunities for cross-country trades. He and his team are keeping a close eye on industries like TFT-LCD panels in Japan, Korea and Taiwan and the steel industry in Korea, Japan, Taiwan and China. These show potential for pair trades and other cross-border plays.

TERENCE LIM: CV

15 years' experience in finance.

Current: Fund manager at Sofaer Capital.

Experience: MD, strategist, head of research and co-branch manager at Goldman Sachs. Strategist, bank analyst and head of research at Merrill Lynch.

Expertise: Macro, market, equity valuation analysis.

The two funds are long commodities and mining companies, but Khoo keeps a close eye on the sector through price indices, industrial production and talking to traders. As well as equities, the fund also has some bond exposure, which in addition to its intrinsic value as a source of performance, also helps him to understand the equities environment more deeply, Khoo says.

"In October we started buying convertible bonds and straight bonds which helps us to understand what credit conditions are available. One of the problems of most analysts is that they think that the cost of capital is static when it's not static at all, but is a function of the credit markets and as such can drop or skyrocket. By being in the bond markets and observing the cost of capital we truly understand its cost and that helps on the equities side."

In recent weeks the funds have been taken from net short in early March to a long position in April, with heavy investment in banks and properties. The fund was up 5.46% month-to-date by April 13 on the back of this shift, Khoo explains.

"What separates us from the average bottom-up hedge fund manager is that they say nothing has fundamentally changed, but if you look at the macro picture you can see it has. One of the most difficult things for a hedge fund manager is asset allocation, how to get from -40% net to 100% long," says Khoo. "If you believe in timing for beta, which I believe is critical, then the macro path is the most consistent approach in order to capture the bottom as well as the peak."

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