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Harsh environment hurts alternative managers.

Alternative investment managers often boasted that return of their portfolio comes from managers' skills in stock selection, market timing or proprietary statistical models. So, it has a very low correlation with traditional asset classes e.g. stocks, bonds and makes very good diversification vehicle.

However, alternative investment managers as a group, was just going down with general market in 2008. According to HFRX, the general hedge fund index went down by 22.18% in the first 10 months of the year. Why the diversifications did not work well this time?

We think that it was largely related to the changes in market environment. In fact, there were many unusual changes in the market. Some of them were very obstructive to alternative investment strategies. Below are some the changes and their impact on alternative investment strategies.

1. Credit crunch – Capital base of banks was destroyed. They need to tighten lending standard and call back loans to avoid further losses. As a result, alternative investment manager who borrows for leverage could not find enough financing.
2. Ban on short sale of individual stocks – Many countries including US, UK, Germany had banned the short sell of financial stocks previously. It deprived equity long/short and arbitrage strategies managers of the chance to profit from the short leg.
3. Frozen credit market – Managers with corporate and high yield bonds in hand found no buyers for these assets and had their capital locked up.
4. Extreme risk aversion – Redemption request rose significantly while liquidity of assets in hand was impaired. Investment managers could only sell their assets at low prices to meet redemption demand.

As the environment turned very hostile, most of the managers in the group incurred a loss. Some of them even went bankrupt due to severe loss and capital flight. But, managed futures, as a strategy, had stood out from the crowd. Some managed futures managers could still deliver double-digit return so far in 2008. Why managed futures is still doing well in such a difficult environment?

The advantage of managed futures came from the common practice listed below, which made them immune to the hostile changes.

1. No borrowing – Futures and forwards has built-in leverage, managers need not borrow to gear up the portfolio.
2. Short positions in futures market were not prohibited.
3. Market liquidity – Managed futures managers often restrict their investment to markets with sufficient liquidity for establishment and settlement of positions. It helps to reduce liquidity risk.

Here we must stress that the features listed above is the usual but not mandatory practice. Some managed futures manager also borrow for leverage and trade in less liquidity market, so investors should always evaluate the risk of individual portfolio base on its own strategy.

Credit crunch, massive redemption and extremely low risk appetite is expected to last for months at least, they shall continue to pressure on alternative managers performance. More managers shall exit the market. We suggest investors to stick with those managers who have a long track record and experience in handling financial crisis. Besides, we think that the advantage of managed futures over other strategies will continue for some time.

US: Negative

In October, DJIA fell hard by 14.06%, S&P 500 lost 20.15% and NASDAQ plunged down by 17.35%. Government capital injected gave a pause to bankruptcy crisis for financials. But, the problem spread out to other sectors. Many large corporations outside financial and housing sectors are in trouble. Examples included "The Big Three" automobile manufacturers, General Motor, Chrysler and Ford who's fate hinged on government bail out, bankruptcy of the 2nd largest electronics retailer Circuit City, and termination of US operation by freight carrier, DHL. The problem had already spread to consumption through job and credit market. It suggested that the economy should have further downside. For equities market, it may have a rebound after the panic selling. However, it is too early to call if the bottom had been reached.

EU: Negative

DAX slumped by 14.46%, CAC dropped by 13.52% and FTSE100 fell by 10.71%. Euro zone and Germany fell into economic recession in 3Q2008, it seemed to be the start of global economic recession. Again, we are still waiting to see the bottom for the European equities markets.

Japan: Negative

NIKKEI went down by 23.83%. Besides Europe, economic recession had also started in Japan. Japanese GDP declined by 0.1% in 3Q2008, following a 0.9% contraction in 2Q2008. The driver for Japanese economy, exports, had also declined quickly on weakening global demand and stronger Yen. Japanese equities market shall continue to struggle as its economy fell into recession and external environment weakened.

China: Negative

HSCEI had a nosedive and dropped 27.12% last month. The Chinese government announced plans to boost infrastructure investment and domestic consumption to alleviate the impact of slowing exports demand. Estimated capital input in the next 2 years amounts to RMB 4,000 billion, it is equivalent to 17.5% of 2007 GDP. Huge government expenditure would be helpful in protecting economic growth. A share markets rebound on the news. But, for Chinese enterprises listed in Hong Kong, they were shadowed by poor global market performance.

Hong Kong: Negative

HSI followed the US market and dropped 22.47% last month. Hong Kong economy and equities market was just following the trends in global markets and it is expected to remain in this way.

Emerging Markets: Negative

Last month, we wrote about worries about the financial stability of emerging markets government and the capital flight in their stock market and currencies. The situation improved after that as several countries had obtained international aids. The IMF had approved loans to Hungary, Ukraine, Slovenia and Pakistan. Besides, US had signed currency swap agreement with South Korea, Mexico, Indonesia and Singapore. Under the agreement each of them can get US 30 billion to meet their short term needs. The aids had strengthened their government balance sheet and eased the risk of collapse of government finance. However, it did not help in maintaining economic growth and corporate profits. So, their equities markets shall remain under pressure.

Bonds: Neutral

Threat of economic recession and rapidly waning inflation made good reasons for major central banks to slash policy interest rates. In October, Bank of England cut interest rate by 1% and ECB lowered it by 0.75%. But, the rate cut did not pass through to corporate bond yield. The reason was that investors were concerned about higher risk of bankruptcy and default as global economic conditions deteriorated. For us, high -grade government bonds is still the choice for conservation of capital despite the yield have been driven down to

unattractive level.

Commodities: Slightly positive

Commodity prices continued to struggle on de-leveraging and strength of USD. As the de-leveraging and low risk appetite may last the several months longer, USD shall benefit from it and stay firm. Commodities prices are expected to struggle further.

Hedge funds: Slightly negative

As discussed in the market commentary this month, hedge fund performance was disappointing. In October, HFRX Global Hedge Fund Index lost another 9.35%. Several of the strategy sub-indices even had double digit lost. HFRX Convertible Arbitrage Index dropped 34.68%, HFRX Relative Value Arbitrage Index fell 14.11% and HFRX Distressed Securities Index slumped by 11.69%.

Advices for investors

Threatened by global economic recession, investment markets is still very volatile. Bad news is all we can get whether it is about the economy or companies. Still, we must reiterate that equities market have already gone through very significant declines, 50% drop for developed markets and 70% decline for developing markets is common. It have already priced in very substantial deterioration in fundamental factors. Although we do not expect a quick turnaround in fundamental conditions, we maintain that investors should start accumulating assets at current low price.

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