Interview with Marko Ho, Chief Investment Officer of Legends China Fund
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Marko Ho is in charge of all investment decisions of the fund as Legends Asset Management's CIO. Being the general partner he is also responsible for the firm's strategies definition and execution. He has over 10 years of investment experience in HK/China markets. Prior to establishing the firm, he was a portfolio manager of Societe Generale Asset Management (SG Asset Management). During his time at SG Asset Management from 2008 to 2010, his China fund which focused on small-mid caps was consistently ranked at top 3 in Greater China universe. Before joining SG Asset Management, Marko worked at a hedge fund - Quam Asset Management, where he was an Assistant fund manager/Senior research analyst initialising the long/short strategy in HK/China, A and B share markets. Mr. Ho holds a Bachelor of Business Administration (Hons) degree from The University of Hong Kong. Before joining the investment industry, he had many years' experience in running a manufacturing business in China.

1. ***The equity markets in China had a rough time in 2011 and your fund also registered a loss for the year. What were some of the factors that drove your performance last year?***

   Year 2011 was a tough year for the China market and particularly for small mid cap investors like us. In 2011, we were double hit by two factors. Firstly, the China market was in general de-rated by global investors, which marked China as one of the worst performing markets in the region. Secondly, small-mid caps were de-rated massively against big cap regardless of their qualities. Given the fact that most small/mid caps dropped much more than the index in 2011 and our focus was on small/mid caps, our performance was in fact not bad (down <20% for 2011). In addition, we are a contrarian and consistent manager. This means we tend to have higher net exposure amid the weak market and vice versa. During the market crash in Q3 2011, we were increasing net exposure, which effectively meant taking more market risks. While some may view this as increasing our fund volatility, we insist this decision is correct when viewed form a long term perspective. We raised short term fund volatility but this enabled us to buy during the dip when everyone else was selling. In fact, this strategy made us one of the best performers during the subsequent rebound. We want to reiterate, it is only relevant for us to measure returns and risks over the up and down cycle. Performance over a single month or quarter is not our concern. We believe this strategy yields the best outcomes for our investors.

2. ***Your 2010 and 2011 returns were quite close to market returns; both in direction and magnitude, but the returns in 2012 are significantly higher than the market benchmarks. How do you explain this outperformance? Does this represent adjusting your strategy to new market dynamics or is this style drift?***

   Our strategy is simple and straightforward. We invest in counter-cyclical approach and stick to stock picks in alpha generation. According to our attribution analysis, we have been consistently generating substantial alpha from stock pickings every year. Yet in 2011, the negative market performance offset our alpha from stock pickings. As such, we were only able to slightly outperform the market in 2011. Stepping in 2012, once the market returned to a relatively normal rate of performance, our consistent stock picks continue to generate alpha which have contributed to significant outperformance. To be more specific in stock picking, we avoid investing in stocks directly exposed to the European debt crisis as well as the Chinese economic hard landing. For example, our net exposure related directly to the Chinese economic hard landing – financial, property, consumption and raw material sectors are less than 20% - a manageable level. The bulk of our net exposure went on less affected sectors such as TMT, energy, infrastructure. Other than stock picks, our counter-cyclical approach allowed us investing aggressively in Q4 2011 which also contributed positively.

   In short, we just stick to what we have done over the past ten years. 2011 was a big bear market for China. Just like the peak year of 2007, any strategy shift or style drift during a peak or bottom year can be very dangerous and disastrous.

3. ***Your fund profile mentions that you employ various investment themes (market leader, deep value etc.), what is the usual split across the different strategies? Can you give us some examples of any recent winning turnaround plays?***

We do not have a fixed split of the different themes and we do not believe fixing the split would benefit us. Rather we will apply them properly whenever opportunities arise.

JuTeng International (3336.hk) is one of our recent turnaround play winners. It is the largest manufacturer of notebook casings in the world with 30% market share, focusing on plastic notebook casings. At the beginning of 2012, its share price dropped 77% from its peak at early 2010 as profit margin declined rapidly due to competition from tablets and rising costs.

As thinner and lighter notebooks gained popularity, the demand for casing shifted from plastic to metal-plastic hybrids, glass fibre and carbon fibre casings with much better margins and prices. After years of investment in these technologies, JuTeng was well positioned to capture these demands. The company was also able to raise prices for their existing products as competition stabilised with limited global production capacity growth. Although the company's fundamentals had improved significantly, the street was not aware of these factors and the share was still trading at four times 2012 p/e, versus its previous average of eight to twelve times p/e. We built our position in May 2012 when the turnaround catalysts were certain and since then the share price has gained 88.6% as the street started recognising the new fundamentals after the company announced a strong interim result in August - three months after we entered into the position. The best is yet to come as fundamentals will further improve when Windows 8 and the latest notebook models gain traction in 2013, providing further catalysts to re-rate the firm.

4. ***How do you gain your short exposure to Chinese equities? Are there any significant challenges that you must overcome? How has your short portfolio performed over the years?***

We built our short positions via short selling individual stocks, buying/selling index options and futures. With regard to significant challenges, there were certain periods of time when the index outperformed small/mid caps substantially. When that happened, the effectiveness of hedging the desired exposure of the portfolio was lowered due to the basis risk. To deal with this, our short book was comprised mainly of individual stocks, particularly small/mid caps instead of shorting index futures. Thanks to our due diligence studies (conducted as part of a bottom-up research process), we have been doing very well in identifying problematic and potential fraudulent companies, which gives us many short selling ideas. In the past year, our short book contributed around 10.5% in returns for the portfolio.

5. ***How flexible is your fund in terms of its sectoral diversification? Do you have any cap or restrictions in place in terms of your exposure to each sector?***

We are very keen (and to a certain extent a bit rigid) in controlling our market risk and volatility, which is achieved through a rational level of diversification. Our maximum allocation of assets for a single sector is 30%, while our maximum allocation of assets for a single stock is 15%. So far we do not have any single stock exposure reaching 10% of the total fund size, though we set the line at 15% as we always bear in mind concentration risk and liquidity risk when entering into a position.

6. ***What sort of fundamental/technical analysis do you perform on the underlying markets prior to making an investment? Do you also use any electronic models for your analysis?***

Our fundamental analysis is a systematic approach that involves five stages:

1) Event driven catalyst and idea generation
2) Business model analysis
3) Research due diligence

4) Forecast and valuation
5) Portfolio construction and monitoring

For each stage, we have implemented various manual and automatic systems to collect and analyse useful data. Just to pick an example in idea generation, one of our systems is to track and monitor all insiders' transactions disclosed by the stock exchange for stocks under our radar, which gives us ideas to analyse what the drivers of these transactions behind the scene are.

On top of the fundamental analysis, we do a massive amount of quant analysis for market and inter-sector movements, pair trades and intraday futures trading.

7. ***As a stock picker, you are keen to conduct your independent research on listed companies. How does your in-house research add to what is already available? Does your research team offer any special advantages? The CIO's results in SGAM displayed significantly higher outperformance than the track record in Legends China Fund – does this imply dependence on greater institutional resources available at SGAM?***

A successful stock pick involves how accurate the analyst interprets the company, sector, macro environment and - most importantly - the story behind the stock price movement. Instead of just focusing on the business of an individual company, our research team pays extra attention to understand the big picture. That being:

1) the business logic between different upstream and downstream industries
2) the complex relationship of various listed companies
3) their management backgrounds

Our research is not to ask for company guidance for forecasting but more an interpretation of the entire business story and the people. Because of these interpretations, we successfully avoided all the fraudulent companies in the P-chips crisis.

In the world nowadays, the edge never comes from how much information you can get but how you organise and analyse it systematically. Since founding this hedge fund company we have built a lot of systems to track and analyse fundamental, technical and quant data systematically. In terms of research capability, I am very confident in saying that what we have is nothing less than what we had at SGAM. The different performance so far is more due to the different stock market environment we have encountered, instead of research resources.

8. ***Could you shed some light on how you manage risks for your fund's investments during different market conditions? Has your risk management changed over recent times, owing to the high volatility across equity markets?***

In normal market conditions, we tend to lower the market risk through writing options and diversify the portfolio risk through our beta-neutral tradings. In other words, we increase the gross exposure to manage risks. In extreme market conditions, we cut both the gross and net exposure swiftly to avoid sudden changes in asset class correlation. We have not changed this risk management policy over the past year.

9. ***How do you think the increasing number of new products in Asian markets, such as index volatility futures on the Hang Seng and Nikkei, will benefit your investment strategy?***

We welcome new products in the market, since the more products in the market, the higher the liquidity of the underlying securities, which in turn reduces our liquidity risk for both our long and short positions. However, new products usually have lower liquidity at the beginning stage and since they lack data sources for meaningful analysis, we prefer to monitor them initially.

10. ***The few years have been tough for asset-raising for most Asian managers – how has your experience been in this regard? Significant investor flows to emerging markets***

have emerged in the last few months but not that much to hedge funds – in your opinion what would be some of the reasons why investors are not keen to allocate to the regional managers? What do you think hedge fund investors are looking for in a regional/China fund?

We share the view that it has been very tough for Asian managers to raise funds, in particular for equity funds. After conversing with a number of advisors and consultants in Europe and the US to understand how people view the Asian markets, we realised that while investors were aware of the much weaker balance sheets in their countries, their money is still parked there due to the homeland bias for security. With the China fund, many hedge fund investors believe that China's story has stopped and it cannot grow as fast as it has in the last three decades; that it has already reached its peak. We do not believe this is true and we foresee hedge fund investors coming back to China once the signals of continuous growth become more significant.

11. Some investors are sceptical about China's growth story. What is your view as a veteran manager in the region?

There is a proliferation of concern in the markets, especially from the west, that investment in China has been over-done and therefore China can no longer rely on investment to sustain its growth story. Our view is in fact the opposite: China has not received enough investment. Though investment is around 45% of GDP at the moment, China is only halfway through the process of urbanisation. At the end of 2011, the urbanisation rate was only 51.3%. According to the experience of Japan at the same stage of urbanisation, the nation still needs to invest heavily on infrastructure for another 15 years. The content of infrastructure investment might be changed from the traditional road, port and railway to urban infrastructure such as subway systems, aviation facilities, sewage systems, clean energy, urban residential buildings, etcetera, in order to cope with the rising urban demand.

There is also a big concern over weakened exports due to shrinking import demands from the US and Europe. While export has accounted for a significant amount of the economic growth in China (since the reforms of 1978),,if we look closer at demographic changes we can see that a large group of middle class is emerging in China. This group of people is boosting the country's private consumption. By 2020, and within the course of a decade, real consumption will have doubled to US$4.8 trillion and China will then be the world's second-largest consumer market after the United States. We understand that, in some respects, private consumption remains stubbornly low. Chinese consumers still save, on average, over one-third of their incomes, compared with 4.4% in the United States. As a proportion of GDP, private consumption in China, accounted for 33% of GDP in 2010 which is well below that of other countries - 71% in the United States and 65% in the United Kingdom for example. Nevertheless, given wage increases of over 10% per year for most employees and the social safety net improvements in China, we see a large room of growth for private consumption that will be the growth engine for the next ten years.

To summarise, we believe that there are three pillars a country needs in order to sustain its growth:

1) initial capital
2) sufficient labour
3) high savings

For initial capital China's current US$3.2 trillion foreign-exchange reserve is the highest in the world allowing China the luxury of affording any sort of investment it requires. For a sufficient labour force, the urbanisation rate of China is still low at around 52%, which is far below developed nations. Population in the rural area is a huge supply of labour for the country to further develop. China is well known as a nation with a high savings rate. As commented by Zhou Xiaochuan, the governor of China's central bank, China's high savings rate is partly the product of Confucianism, which values thriftiness, self-discipline, moderation and an aversion to extravagance. This is a cultural behaviour that has existed since ancient times and is a tradition that will not change easily. Through the support of these three pillars, our view is that the current downturn is more a cyclical one instead of a structural one. The China story will continue after a cyclical correction.

12. ***In light of the market uncertainties ahead, what investment strategies are likely to be effective this year?***

Quite honestly, this market has never been certain! Right now, most people do not have any confidence in the Chinese market. This is why Chinese market valuations are at such low level. Yet, from the perspective of policy direction and market expectations, it actually indicates a favourable risk/reward scenario. The Chinese economy has been tightened up and the government started to stimulate the economy through fiscal policies in May this year. However, the market is too bearish to ignore these developments.

The Chinese economy is no doubt transforming. Given the low market valuations, the question for us is not whether or not to invest but rather what to invest in. Opportunities will emerge in the industries that will benefit from the economic transformation.

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