Interview with Shin Kiyoung, CEO at Gen2 Partners

Gen2 Partners (Gen2) is one of the leaders in customised Asian Hedge Funds for Institutional Investors and Family Offices, in addition to being a trusted partner to help manage investors' exposure to Asia across all Asian alternative strategies. For investors wishing to allocate capital to Asia in a well-managed approach, Gen2 believes they are one of the pre-eminent firms with the deepest institutional investment team. Gen2 has a Pan-Asian multi-asset strategy fund with flexibility across capital structures with a niche and focus on Korean corporates and investment grade credits, especially Asian bank capital. The fund is driven by absolute return targets and capital preservation, and aims to provide enhanced risk-adjusted returns by capturing the dynamic growth in Asian markets through superior access, proven investment processes and active management of Asian investments, while managing downside risk.

The fund managers in Gen2 have strong local market experience with an extensive local network allowing access to company executives and decision makers. Gen2 is well positioned to figure out crowded trades through strong relationship with local/foreign investment communities, which enable the company to be better-positioned for short opportunities.

With a team that has extensive geographic and sector experience, the team's appreciation of risk management and their unique investment approach coupled with the help of the company's advanced risk management system gives investors exposure to local markets while limiting the effects of market volatility.

1. **Gen2 Partners offers a suite of hedge fund products tailored to investor needs, covering equity, fixed income and commodities with an Asian mandate. Could you give us a quick introduction about your company and its management team?**

   Gen2 Partners is an independent specialist alternative investment firm in Asia with the deepest team of experienced senior professionals in the Asian financial industry. Our main office is located in Hong Kong's 118-story Landmark building, International Commerce Center (ICC).

   We actively manage the portfolio of investment that uses unique investment strategies, such as benefiting from regulatory and market inefficiencies in the investment grade Asian fixed income market, long and short equities, and derivate positions mainly for hedging purpose in Pan-Asia markets.

   The fund's goal is to deliver double digit returns while keeping the volatility at less than half of market (benchmark is MSCI Asia Equity Index).

2. **As we understand, your firm offers a Korea dedicated fund, focused on credit strategies. What is the reason behind focusing solely on Korea, instead of using a more typical pan-Asia mandate with a higher allocation towards Korea?**

   We think Korean credit offers reasonable risk/rewards especially to Korean investors given the fact that 1) Bank of Korea is expected to cut the benchmark rate further in 2015 and 2) the credit risk is nil especially to Korean investors as the fund only trades investment grade bonds. Korea's credit rating of Aa3 by Moody's is even higher than Japan and some people claim that Korea should be considered as one of the safe havens in Asia.

   More and more Korean institutions will be forced to allocate more capital to offshore Korean bonds, which are denominated mostly in USD, searching for yield. Solid onshore demand toward offshore USD Korean bonds will support offshore Korean bonds in 2015 and beyond.

   One of the key reasons that we launched the fund back in 2010 was due to the investors' reverse inquiry, who just wanted to have Korean exposure. Many Korean institutional investors are more comfortable with Korean banks and corporates' credit risk as they are more familiar with Korean names, despite the fact that Korean bonds' global ratings could be lower than its peers. After the financial crisis, it was not unusual for investors to not blindly trust global credit ratings and preferring not to take other country's risk.

3. **Gen2's flagship hedge fund has received multiple awards and nominations and has not experienced a single down year since its inception in 2010. In your opinion, how did Gen2's unique strengths and its approach towards the market contribute to this illustrious performance?**

Our edges are evaluating where values are fairly quickly and using such opportunities into profit. We keep good relations with diversified counterparties who are helpful to find out such opportunities. We are strict on risk management and use diversified hedges as we acknowledge that there is no perfect hedge in the financial world. In short, we are not a mega hedge fund and thus we can be nimble in making money in Asia.

4. Could you take us through your investment process from end to end? In particular, please elaborate on your combined fundamental and technical stock selection methodology.

Three sub-absolute return strategies are used to navigate market and regulatory risks including:

1. Credit.
   i) The Fund will long investment-grade exposures with tactical duration and sectoral composition
   ii) Steady visible income generation through investment grade coupons
   iii) Atypical relative value strategy, neutralizing bank capital call risk with equity short exposure

2. Equity long/short
   i) Opportunistic long/short strategy focusing on Asian financial and TMT stocks
   ii) Core catalysts and market technical drive allocation decisions
   iii) Fundamentals and valuations provide sanity checks

3. Hedging
   i) Strategies include hedging with index futures/options, US treasury, and currency positions

***5.* Could you provide a rough breakdown of your fund's exposure for our readers? Please describe what your typical portfolio looks like and the exposure limits for a single position/sector?**

We are confident that the top three to four banks in Korea, China, Hong Kong, Japan and Australia would not default and thus have significant exposure to these leading commercial banks. We consider HSBC and Standard Chartered Bank as Hong Kong banks although their headquarters are located in London. We also have a strong view that Korea, Hong Kong, Japan and Australia's leading banks will honour their unofficial promise with the market and call their legacy Basel II compliant callable bonds on the first call date. Accordingly, we have sizable positions in these segments.

If we are to breakdown by region, Australia has the largest share as we have decent positions in investment grade Australian bank bonds, followed by Korea, Hong Kong and Taiwan. By strategy breakdown, we have been mostly credit for the past a few years and little equity long/short. We have back tested which strategy has generated the most profit since the inception in January 2010 and it was credit strategy.

We are considering launching a credit only strategy of KSAARF for investors who just want to have exposure in capturing inefficiencies in Asian fixed income market along with stable coupons from investment grade bonds.

Please see below single position/sector risk limits:

<u>Key exposure limits in general</u>

- Single Position Limit: 10% (most positions will be 1% ~ 5%)
- Sub-Sector Limit: 35% (except Financial and IT Hardware sectors)
- Top 5 Long Positions Limit: 45%.
- Top 5 Short Positions Limit: 40%.
- Portfolio Drawdown Trigger: 5% (reduce gross and net exposure).
- No shorting of options.

6. Gen2 Partners places a strong emphasis on risk management, based on cutting losses quickly to limit adverse portfolio performance as well as hedging positions. How do you ensure that such measures and portfolio drawdown limits help to reduce downside volatility for your investors without sacrificing return?

It is difficult to reduce downside volatility without sacrificing return. If we cut the risk, it will obviously affect the returns although it will help to reduce the downside volatility. We struggle every time we have to cut the risk as it is difficult all the time and there is always no perfect solution. The way we typically lower the risk on specific positions side is to cut the equity long exposures and reduce long duration bonds. On the hedge side, we do dynamic hedge using equity index futures, sell respective currency against USD, purchase sovereign CDS protection etc. The ratio of the above mentioned three instruments depends on our in-house risk model that is tailored to our portfolio.

7. Liquidity is a key concern for your fund, since it eschews investing in products with liquidity risk such as unlisted equities or illiquid credit positions. What is the average turnover of your portfolio like and was your objective reducing transactional cost or eliminating potential squeezes?

We have never invested and do not have any plan to invest in any unlisted equities nor any private equity investment to avoid such liquidity risk. Most of our funds have monthly liquidity with 30 days of notice. All of our credit positions are investment grade; issuance size is also the benchmark size and listed in respective markets. We understand many Asian credit strategy funds invest in Chinese property related high yield bonds which is not the area we have ever invested. Such high yield Chinese property offshore bonds are much less liquid compared to investment grade USD bonds that we have invested.

Our historical turnover is five to seven times and we are actively trading in the market.

8. **Gen2 Partners has broadened its product line-up, providing multiple selections which are customised to fit the needs of your investment clientele. Could you tell us what the fastest growing sectors in Asia are? How do you accommodate the different needs of your investors without being stretched too thin?**

We try to customise the portfolio to fit the needs of our investors as long as we have confidence that we can deliver appropriate risk/return to our investors. Many of our investors do not want to be commingled with other investors due to various reasons and require higher level of transparency, which we are happy to provide. The difficulty is the economy of scale as clients' initial investment may not be economical for many hedge funds. Also some investors change their mind after they committed due to many reasons. All fund's setup related costs were then born by Gen2 Partners. We have already closed down four funds that investors were unable to invest in although they had committed. We consider this is an investment to build the relationship with the investor. We hope they may come back in the future and invest with Gen2 Partners.

Korean onshore hedge funds' assets under management (AUM) were near zero a few years ago, and have now grown to US$2.5 billion. But compared to the Korean gross domestic product of US$1.1 trillion, onshore hedge funds remain very small. This is just the beginning.

9. How much of your assets under management come from Asian family offices as compared to institutional investors? What are the main differences in the investor demands of the two groups?

Most of our assets under management come from institutional investors. Institutional investors are looking for low risk and low-medium returns for the investment horizon of one to five years. Many of our institutional investors are fine with 4% to 6% returns with one to five years investment period if they have conviction that there is little downside risk.

10. Please explain how your firm divides different key roles between in-house and outsourcing services. How do they work together towards achieving synergy and what would you say are the primary benefits of outsourcing fund administration?

I understand all of proper hedge funds are outsourcing fund administration, otherwise it would be impossible to attract institutional investors these days. We outsource many other key functions, such as 1) risk management through an independent third party, 2) middle and back office for all of Gen2 Partners' funds' operations, 3) Gen2 Partners' Human Resources including payroll, internal accounting and audit support, 4) SFC quarterly FRR reporting and SFC's required liquid capital calculation etc, and 5) back-up execution trading desk etc.

Our investors are happy with our outsourcing policy and this gives good impression to our investors and strengthens Gen2 Partner's credibility. Some clients think that if there are any fraudulent/material issues, the investment manager/advisor will never use any outsourcing services to keep/hide such fraudulent/material matters in-house.

There is growing regulatory requirement and it would be getting difficult to cope with upcoming regulatory related operational burdens going forward. There are less employees that I need to deal with for many HR related matters, which is time consuming and difficult for most hedge fund managers. If we can outsource the key functions properly, we can reduce much of the burden and focus on making money for our investors. Besides, it is cheaper compared to keeping all the functions in-house.

11. Lastly, could you share with our readers about your experience investing in Korea – particularly about the opportunities in that sector and outlook for the future?

While we expect Korean bonds market will continue to be interesting, the Korean equity market seems to be going nowhere for the time being. KOSPI has been driven by Samsung and Hyundai Motor. However, the outlook for both of them is not promising near term. Samsung Electronics' key smartphone business has been sandwiched between Apple on high-end market and Chinese players on mid/low-end market, which is the key reason why its 4Q 2014 operation profit is down ~37% year-on-year. Sharp yen depreciation is not helping Hyundai Motor as well as they compete with Japanese rivals. Local investors have been redeeming from equity funds for years and there is no meaningful signal yet that the trend could be reversed. If tKOSPI rallies above 2000, they could be aggressive sellers again as they used to be.

Koreans will be a significant source of hedge fund capital given the size of institutional investors' AUMs. For example, NPS (National Pension Services) has US$450 billion AUM in Korea and is expected to grow US$770 billion AUM by 2020 and US$2,328 billion AUM by 2043, but are not yet allowed to invest in any hedge funds globally. Although they are encouraged by the government; they've been blocked by the investment community. We believe NPS should be able to get the approval from their investment committee given their size and expectations for higher returns. If they start making allocations to hedge funds, the size would be substantial as they should start from zero to proper allocation targets. Even a few percent of US$770 billion AUM allocation in six years is substantial.

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