CFA Society Hong Kong | 30 YEARS ANNIVERSARY

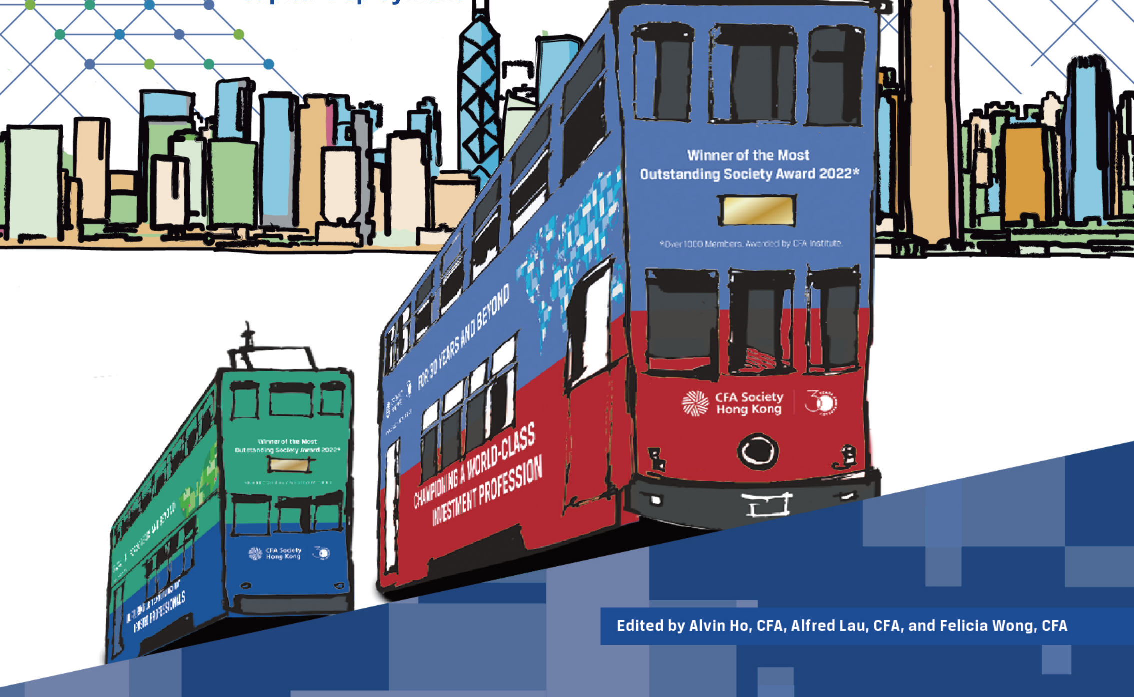
RISE FROM CRISES

- BOOK 3 -

How Hong Kong survived the financial and other crises, and rose to the occasion, over the past 30 years

30 tales from practitioners

Section 4 – Capital Deployment



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This work contains excerpted chapters from *Rise from Crises*. For further content, please consult the other excerpted ebooks, or the complete volume.

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Section 4

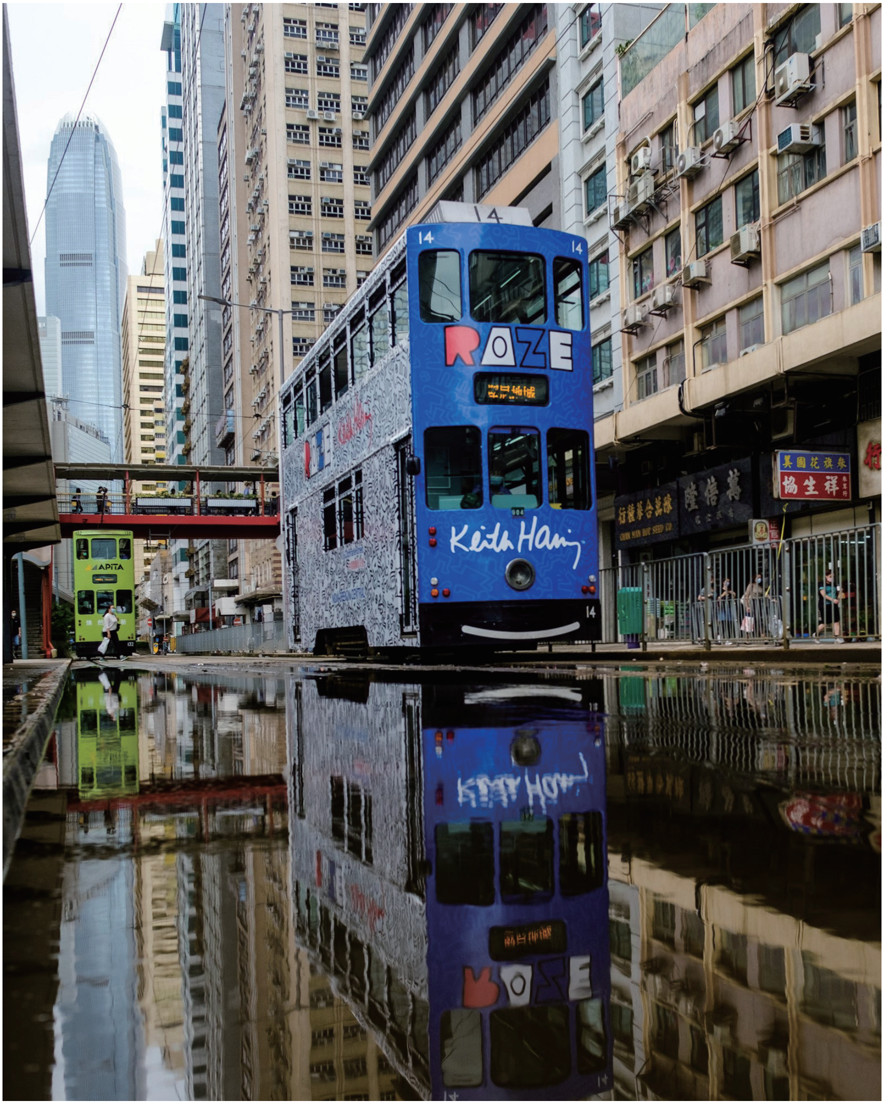
Capital Deployment

Buysides,

Speculations

and Derivatives

Chapter



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4.1

Crises of "Closures": Past and Present

— **James Soutar, CFA**

When investors and market analysts think of the main financial crises in Asia, they look back over a roughly two-decade time horizon. However, Hong Kong faced several crises in the 1980s that most people active in the financial industry today are too young to remember. Six of the top ten quarterly declines in the Hang Seng Index happened before 1990, with the top two occurring in the 1970s. This paper will look at the causes and some of the background to the third worst quarter in the Hang Seng Index's history, the three months ending 31 December 1987, and try to draw some lessons for the present day in Hong Kong, which I will argue is potentially the biggest crisis to hit Hong Kong in its history. This current crisis has already resulted in one of the worst market corrections in recent history (the Hang Seng is down 47.9% from end 2019 to 31 October 2022), and I would argue, using lessons learned from the 1987 debacle, that the damage done to Hong Kong in this crisis will have the longest lasting impact of all the previous crises.

By far the most important asset that Hong Kong possesses in my view is her people. The people of Hong Kong have always been driven, hardworking, risk-taking and resilient. These attributes are due to the kind of people who came to Hong Kong over the years: typically refugees from China, who either escaped the mainland with nothing, or who immigrated legally with few assets to their names. The small minority of non-Chinese who came to Hong Kong from all over the world were drawn to the energy and freedoms in Hong Kong, and generally possessed the same attributes as the local Chinese. I remember being overwhelmed by the pure, raw energy of the city when I arrived in June of 1988. The city literally hummed with activity, and nothing represented that energy more than large Chinese restaurants on Sundays... with large tables of multigenerational families screaming at each other while waiters brought endless succession of dishes... the sound of rapid-fire Cantonese, clanging dishes, the hustle of the waiters... it was an awesome sight and overall sensory experience. Similar experiences could be had as horses rounded into the home strait at Happy Valley or Sha Tin, in hawker markets, construction sites and industrial areas of the city.

All those qualities allowed Hong Kong to rebound from past crises with little to no collateral damage. A quick look at Bloomberg shows that the Hang Seng Index rebounded from bad quarters within a wide range of time frames. A table is shown below.

Quarter End Date	Heng Seng Index Close	Quarter % Change	# of Quarters to recover level
29/6/1973	623.19	-52.10	31
30/9/1974	212.59	-46.77	27
31/12/1987	2,302.75	-41.61	16
31/12/1997	10,722.76	-28.75	9
30/9/1982	927.18	-27.48	11
30/9/1981	1,280.13	-26.19	18
30/6/1998	8,543.10	-25.83	9
30/6/1989	2,273.91	-24.33	6
31/3/1994	9,029.91	-24.04	10

Source: Bloomberg

What we can observe is that the markets regained their previous (pre-crisis) level more quickly in recent times. The two drawdowns in the 1970s were particularly brutal and all part of a difficult time globally for equities, as energy prices soared and geopolitics were challenging. The 1987 crisis by contrast took 16 quarters to get back to the pre-crisis high, which is a long time compared to the S&P 500 index in the U.S., which took only seven quarters to regain its level. The 1987 market collapse was driven by the U.S.: rising rates caused profit taking after a strong bull run and the whole thing snowballed as "portfolio insurance," essentially computer-driven stop-loss selling, kicked in. The Dow Jones Industrial Index fell by 22.6% in one day, at that point the largest drop in history. But what about Hong Kong?

On Monday 19 October 1987, in the Asian timezone, the Hang Seng Index fell 11%, as U.S. futures looked weak, and trading on the previous Friday in the U.S. had produced a fall of 5%. The real drama happened during the night of Monday 19 October Hong Kong time. As the U.S. was collapsing, the Hong Kong Stock Exchange, headed by Ronald Li Fook-Shiu (李福兆), decided to close the exchange for four days to limit the panic. It did not work. On the following Monday, when the exchange reopened, the Hang Seng Index fell 33%. Li was later arrested by the Independent Commission Against Corruption (ICAC), and convicted of taking bribes for allowing certain companies to list on the Hong Kong Exchange. He also was known to have a vast portfolio of stocks in Hong Kong, and thus faced considerable conflict of interest in his decision to close the exchange.
It is generally accepted that the closure of the Hong Kong Exchange had long-lasting negative consequences for the reputation of Hong Kong as a financial center. In my view, that is the main reason that the Hong Kong market took so much longer to rebound than the U.S. markets. Many

international investors would not touch Hong Kong, calling it a “Mickey Mouse” market that could be shut without warning. I remember people thinking I was mad to move to Hong Kong as a young graduate in 1988, so soon after that debacle. Thankfully, the Hong Kong government and the Hong Kong Securities and Futures Commission (SFC) took hard lessons from the market closure and decided that the regulatory framework had to be tightened. The SFC has an excellent summary of the events and its findings, published in 1988 (SFC, 1988).

On page 48 of the above-captioned report, the SFC noted that, “We believe that it is wholly inappropriate to attempt to build a system with no fails. Markets will continue to gyrate, sometimes wildly, players will continue to fail and clients will continue to default. No free-market system can, or indeed should attempt to, prevent such events from occurring.” Hong Kong and the Hong Kong Exchange eventually emerged stronger from that crisis, and importantly established its identity as an open and free financial market, with better safeguards. It took time: 16 quarters is four years of hard work to undo one bad decision taken in the early morning of 20 October 1987; four years of the market being below the end September 1987 level. One of the lessons surely was that it is fast and easy to ruin a reputation, but long and difficult to rebuild one.

Fast forward to 2020: 33 years since the events of 1987. What about Hong Kong?

I do not need to go into depth about the COVID-19 outbreak and the upheaval it has caused worldwide. Most readers will be all too familiar with that. But let us consider the action that Hong Kong has taken, and indeed continues to take in the face of this virus. We have instituted some of the toughest restrictions in the world, and at the time of writing, are over two and a half years into these restrictions. While the stock market has not closed, Hong Kong society has been dramatically altered to the point of being virtually closed. First, travel, one of the mainstays of the Hong Kong economy, both through inbound tourism, and outbound business and leisure travel by Hong Kong residents, is down by over 90% from pre-pandemic levels. Second, the spirit of Hong Kong people has all but been smothered to death by draconian measures which have closed schools, businesses, and sporting facilities. Hong Kongers have been made to wallow around the once great city, as masked zombies living in perpetual (but vastly overstated) fear for their lives. All the positive attributes I mentioned above: drive, work ethic, risk-taking spirit and resilience have been crushed by mask mandates, vaccine passports, and unprecedented intrusion by the government into everyday life (in the form of restrictions on bar and restaurant visitations, mandatory quarantining at government facilities, etc.). While the harshest elements of the restrictions have been relaxed recently, Hong Kong remains the only major world city to require vaccine passports, mass masking, including in schools, and controls on activities of people during the first three days that they arrive in Hong Kong. The level of micromanagement in the everyday lives of people remains stifling. We all certainly hope that all measures will be relaxed, but it will take a long time for Hong Kong to retain its former vibrancy. A whole generation of children have had their lives disrupted in an unprecedented manner so we have no idea what the long-term consequences will be.

We could argue that the current crisis is one of identity. The identity of Hong Kong had always been work hard/ play hard, laissez faire, but with a robust, transparent legal system that punished those who did not play fair. To my mind, this identity has been completely crushed in the last two and a half years. As someone who has made Hong Kong his home, married, raised kids, and involved himself in all aspects of Hong Kong life, I am extremely worried about this change because it is a fundamental change in the main driving force of Hong Kong's success.

At the root of the problem is the government's apparent belief that their main task is to ensure that no one falls ill or dies from COVID-19. They want to keep people "safe." Think back to the quote from the SFC paper mentioned above. "We believe that it is wholly inappropriate to attempt to build a system with no fails." While the reference was to financial markets, I believe that it applies equally to healthcare, especially the control of a contagious (yet for the most part very mild) respiratory virus in a densely populated metropolis. While it would certainly be nice to rid the world of disease (and market volatility and bankruptcies, etc.), it is simply not realistic, and as we are finding out now, the costs are astronomical.

Let's examine the costs to Hong Kong. We know all too well what the drag is on the fiscal budget. According to data published by the Hong Kong government, the fiscal reserves of the HKSAR fell from 40.8% to 33.4% of GDP between 31 March 2020 and 31 March 2022. Thousands of businesses closed forever, including Dragon Air, Cathay Pacific's regional carrier. These statistics have been widely reported on.

But what of non-financial costs? Studies from around the world have shown that school closures and forced masking of students have deep and long-lasting negative implications for psychological, development and learning outcomes. Given that the disruption to education has been going on for over two years, we will feel the impact of these costs for decades.

Skilled people, both local and expatriate, are leaving in droves. According to press reports, 78,000 people left in the first two months of 2022, with a further 50,000 leaving in the first two weeks of March 2022. The Hong Kong population is actually shrinking, and it is the educated, skilled professionals who have the means and desire to depart. This exodus will impact Hong Kong's ability to compete in financial services, trade services, education, travel, IT, and many other key industries for years to come.

The frustrating aspect of all this is that it is almost entirely self-inflicted. When one considers the other crises that led to the falls in markets in the table above, almost all were caused by external forces. The strong rises in share prices prior to the crises hitting resulted in sharper falls to be sure, but generally speaking, the key attributes of Hong Kong led it to bounce back quickly and strongly in all cases since the 1980s. This time around, Hong Kong is being hollowed out from the inside, and it will take a very long time to regain the confidence, drive and skillset that has been the hallmark of its success.

Is it possible to regain our former strengths? Yes, I think so. The animal spirits of those remaining have not been completely snuffed out. But the government needs to get out of the way, and quickly. I do not know what will bring the required dose of humility to the government to allow them to realize that every effort they take to "defeat the virus" ends up "defeating Hong Kong." Hong Kong will rise again on the backs of its amazing people, not through closures and government mandates. Those of us that still believe in Hong Kong need to be patient, because, as we saw in the case of the 1987 crisis of confidence in the Hong Kong market, it took four years to regain the pre-crisis level in the markets. Given all the issues I have outlined above, will four years be enough? I leave it as an open question.

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4.2
To Bridge a Funding Gap

— Ronald Chan

It all happened in Singapore. In a spring afternoon under a glistening sunset, I was on my way to the airport to catch a flight home to Hong Kong. My phone suddenly rang. “Ronald, I need you to know something.”

This was the peak of the Sino–American trade war. Talk of a “New Cold War,” Thucydides’ Trap, and the dangers of the world returning to a geopolitical battleground abounded. With escalating trade tariffs, the threat of a technology war, and financial decoupling looming over the horizon, preparing for the worst was one thing, but being hit by the worst was another.

The fateful call brought bad news. A long-time and devoted client from Europe had passed. He had been one of the most loyal and important contributors to my fund, with a quarter of our portfolio stemming from his support. Then it hit me: this wasn’t just financial. This was the departure of a family friend, a mentor, and supporter that I had respected greatly. He seeded me when I first started out in the business.

Now, as a result of all sorts of legal complexities, his children had to redeem his share of the fund. They said this would be temporary. I thought to myself: how temporary?

I had two months to raise the necessary cash. Much of the liquidity we possessed had been committed to pre-existing investments. Putting it all together in time would be a major challenge. I reassured myself that I could get the task done, but my mind quickly drifted to the long-serving colleagues whose interests I had to take care of. “Will Chartwell survive this redemption?” I muttered to myself.

For the first time since I had started the business, I had to hold back tears. I had weathered all sorts of markets for the past 20 years but this redemption could lead to downsizing or even the downfall of the company. In a car racing down the highway to the airport, it felt surreal and ironic. Queen’s Don’t Stop Me Now came on the radio.

“I’m a racing car passing by like Lady Godiva
I’m gonna go, go, go
There’s no stopping me
Don’t stop me now…”

Being an Investment Steward

That plane ride felt like the longest I’d ever taken. Upon my return to Hong Kong, I explained the situation to my team. They were certainly taken aback but we remained unfazed. Without delay, we began to adjust the portfolio to brace for the upcoming redemption. In the first few weeks, selling our liquid positions was easy. However, because we ran a concentrated small and mid-cap portfolio, the task of liquidating some positions became quite daunting in the weeks that followed.

The market was slow and cautious under the heated trade dispute, coupled with the Easter holidays. The bid and ask spreads were wide for many of our holdings, and the overall investment appetite for them was subdued.

A broker called and said that he had found a counterparty willing to take up our shares with a 15% discount. I said no, because that would be unfavorable to our investors. If we took the offer, it also would have sent the wrong signal to the market, which could have affected the good relationships we had built with the owners and managers of our investments.

We were surrounded by sharks and pirates who wanted us dead in the following days. I knew the market had always been cutthroat, and I had seen this happen to my competitors, but I could not have imagined that it would have happened to us.

In a sleepless night, I asked myself, “What should I do?”

“Do what an investment steward would do,” my inner voice replied. “As long as you are honest, sincere, and responsible, you will find a way.”

I subsequently did what I thought was most sensible: I called the majority owners of our investments as well as some of our long-serving clients, explained our situation to them, and asked whether they could buy our shares. They all agreed without even negotiating any sort of price discount.

Six weeks since that fateful call, we were able to return the client’s capital just in time. On the surface, we were sitting on a massive pile of cash, but in reality, we remained heavily invested. Then, in an unexpected turn, two events occurred in parallel.

"We found a solution for the family foundation. We will redeem our shares in your fund and re-subscribe to it on the same day under a different entity," the representative of the deceased client said in a call on a Friday. I was relieved by the serendipitous turn of events.

That same weekend, then-U.S. President Trump tweeted, "...of additional goods sent to us by China remain untaxed, but will be shortly, at a rate of 25%. The Tariffs paid to the USA have had little impact on product cost, mostly borne by China. The Trade Deal with China continues, but too slowly, as they attempt to renegotiate. No!"

The market came crashing down the next day, falling by over 10% over the next few weeks, then by another 10% over the next few months. However, with our cash position, we were immune to the plunge. With an uncertain outlook, investors went into a risk-off mode, either by holding cash or switching to beaten down, value-oriented, and high dividend-yielding stocks. Some of our investments benefited from the turn of events and even recorded positive performances. With our cash position, we subsequently re-entered the market.

The year ended on a high note. The trade disputes softened, and the market regained lost ground and recorded a positive return for the year. As for us, we beat our benchmark by a wide margin.

Clients praised us for having such impeccable foresight to raise cash just before the storm. However, we never shied away from reality: we told them that it was a mixture of unintentional circumstances that led us to our extraordinary performance. "It's better to be lucky than good," they said. Lady Luck was certainly on our side, even though we hadn't seen it at first.

As for me, I only picked up the signs many months later.

“Don’t stop me now
Yes, I’m havin’ a good time
I don’t want to stop at all…”

Thinking of Yourself Less

Over the years, I have treated bull and bear markets as the same. They are part of an economic cycle and an integral part of our business. I firmly believe that as long as we can pick the right businesses, pay the right prices for them, watch and advance their growth, and rebalance their portfolio weightings under different market conditions, we can effectively survive and thrive. These principles are not difficult to implement; that is, until an unexpected situation such as the aforementioned crisis emerges.

Reviewing the ups and downs of that fateful year, I had three takeaways: be humble, hopeful, and flexible.

Humility, to me, is a combination of putting the interests of others first and reflecting carefully upon our responsibilities as stewards in bracing for the unknown. I am reminded of a quote from C.S. Lewis: “True humility is not thinking less of yourself, it’s thinking of yourself less.” In essence, it is really about doing the right thing by being prudent and responsible, and through this we build trust and respect with our clients.

Somebody once told me that the art of investing is to turn unknown unknowns and known unknowns into known knowns. However, not all known unknowns can be quantified, and not all unknown unknowns can be identified, so we must recognize our flaws, embrace our fallibility, and let go of our ego to grow and become a true investment steward.

The second lesson is to be hopeful. In financial analysis, we often construct a series of models for different time horizons, but we must realize that no matter how meticulously we seek to capture every fact and detail, life always has a way of throwing a wrench into the works.

Life is innately unpredictable, so the best way to approach it is to make peace with Mother Nature. Think positively, aim for the best, prepare for the worst, and make room for error. As long as you have a genuine heart and try your utmost, the best will naturally unfold. I am reminded of a quip by Sir Winston Churchill in which he stated that he had a lot of worries and troubles in his life, most of which never happened.

The last point is to be flexible. This doesn't mean that we simply go with the flow or frequently change our principles. In fact, we must keep these consistent as they form the foundation needed to gain trust and respect. However, we can learn to be strategic and tactical in the way we approach the market. As I was told, a strategy is the action plan that brings you to where you wish to go, and tactics are the individual steps that take you there. As long as we keep our principles consistent and set our overall strategy right, we can be as flexible as necessary with our tactics.

We are what we think, which shapes how we feel and act. We must proactively adapt to circumstances, and equip ourselves with hope and a constantly positive attitude, even if a situation seems desperate. Then, with a humble heart, Mother Nature won't stop us but prepare us for the best outcome.

4.3

It Is Always Crisis Season

— **Peter Phillips[1], CFA**

On 19 October 1987, which became known as Black Monday, the Dow Jones Industrial Average declined 22%. Over the next week, the Hang Seng Index fell 45%, including a decline of 33% in one day. This also included four days during which the Hong Kong stock market was closed. The Hong Kong Exchange was criticized for this closure and has minimized closures since then. I arrived in Hong Kong on 11 October 1987, in my new role with Fidelity International as Research Manager. In the previous few years, equity markets had experienced a strong bull market, and Hong Kong had seen a lot of speculative trading in equities. My role at Fidelity included the research of Hong Kong utilities. Within a few weeks after joining, I initiated coverage on CLP and Hong Kong Electric with Buy recommendations as these companies provided stability and growth at a time of high volatility. The stock that excited me the most during this time was Hong Kong and China Gas; this company was achieving amazing growth, with its margin expanding as more customers were being added.

One of the reasons I was appointed to my new role with Fidelity was that I was part way through the CFA course. In 1985 I attended a short course in Rockford, Illinois, where I learned about the CFA program. I enrolled for Level I in Melbourne. The most stressful part of the course was the requirement to find a supervisor for the exam. The CFA people told me to find a Proctor. I contacted my local university, Caulfield Institute, trying to find Mr. Proctor. Only after several calls did I realize that Proctor was a title! In June 1988, I completed Level 3 in Hong Kong; being the only candidate doing this level in Hong Kong. My membership number issued was 11138, which my wife told me was a lucky number!

Greed and Fear

In a usual period in the summer of 1991, I saw greed and fear being displayed in the streets of Central simultaneously. The residential property market was hot, and there were very large queues of people lining up at a developer's Central office to buy flats in a new development in Tin Sui Wai. This greed for property was in contrast to other queues nearby in which customers were lining up to withdraw deposits from banks, including Standard Chartered and Citibank. A banking run had been ignited by the Hong Kong subsidiary of Bank of Credit and Commerce International (BCCI) going bankrupt. This bankruptcy received widespread criticism as the government had assured investors on the Friday before BCCI's collapse of its financial stability. The bank remained open on Saturday, but was declared insolvent the following Monday. Shortly afterward, I remember on a Friday when there were some murmurs in the morning about Standard Chartered Bank going bankrupt. Over the day with people communicating with colleagues and friends during lunchtime (there was a limited number of mobile phones) the rumor spread rapidly, and Standard Chartered had to extend its trading hours that evening to pay out deposits.

HK Economy/Market Merging with the Mainland

I was given the responsibility of managing a Hong Kong equity fund from October 1990. Over the next few years, it was an exciting time to be investing in Hong Kong. The Shenzhen and Shanghai markets allowed B shares to be invested by foreigners. There were some challenges in getting information on Chinese companies, and often prospectuses were not available. Also, for the first Chinese IPO, I encountered some questioning from our U.K. office on how we could invest in China considering that "the Government was unstable." I answered their question simply with the fact that, "China has a stable government, in fact the same since 1949." In July 1993, Tsingtao Beer became the first H share to be listed in Hong Kong. I remember the roadshow lunch at the Marriot Hotel, where Tsingtao executives sat at their table with a massive pile of Tsingtao beer cans arranged in a pyramid structure. The broadening out of the Hong Kong equity market added to the market euphoria—in 1993, the Hang Seng Index soared more than 100%.

Red Chips

The mid-1990s saw the development of red chips in Hong Kong, i.e., Chinese companies listing in Hong Kong, often by injecting businesses into existing listed companies. Any rumor of an impending injection would send a company's stock price soaring. With the development of red chips, huge speculative gains were achieved by some investors, and some managements gained incredible amounts of money from options being issued very cheaply as part of these transactions. When I questioned one of the red chip companies about these excessive gains, he told me that they would "rebate" these funds back to the company. I pointed out that this would require a disclosure, which did not happen.

Evolving Risk Management

During the 1990s, the markets were relatively buoyant, although this was sometimes interrupted by various events. One of these was the collapse of Barings. In the 1990s, Barings established a strong Asian business with high-quality research, which was well presented in various publications that became reference documents for fund managers. One Sunday afternoon in 1995, I received a phone call from a broker about the disclosure of Barings' derivatives issue. The collapse of Barings highlighted the need to focus on counterparty risk. Several investors experienced this first hand; they were using the Baring Taiwan investment facility to hold their securities in Taiwan.

HK Market Moving from Developing to Developed

There was significant anxiety about the impending handover of 1 July 1997. There were news reports daily giving details of the final negotiations between the British and Chinese governments, which had many points of disagreement. Despite this uncertainty, the market embraced the economic integration —Hong Kong companies were expanding in the mainland, adding new areas of growth. With the development of the Chinese share markets, a larger number of Chinese companies listing in Hong Kong, and with a strong economy, the Hong Kong equity market boomed during this period. For the three years ending in October 1993, the Hang Seng Index was up 252%. Also, the investor base for Hong Kong equities broadened with more international investors attracted to the equity market. With more Chinese companies represented in the Hong Kong market, this became a gateway for investments into the mainland.

In 1993 I visited Shanghai to meet with B-share companies. In those days, many Chinese companies did not have offices but rented rooms in hotels as offices instead. These company visits were very different, as these companies did not have any experience in dealing with international investors. Management at these companies was very enthusiastic and excited to have the opportunity of raising capital from outside of China. The meetings were normally very long, as it took a lot of time to explain the various questions. Interestingly, several companies had some knowledge of investing gained from their exposure to the Peter Lynch book One Up on Wall Street. Today when I look at Chinese companies, I think it is important to remember that they have a pretty short history. As a result, I believe that it is difficult for them to fully embrace some newer areas, such as ESG, in the same manner as companies elsewhere with much longer commercial histories.

Changing Data and Analysis

Being a bottom-up investor, my focus was on stock picking and a key component of this investing process is meeting with companies. Over the years, I observed some changes in this area. Initially I found company meetings very useful. Most company representatives didn't meet with many investors, and answered questions honestly and gave a balanced view. Over the years, the number of investors grew dramatically, and investor conferences became more prevalent. As a result, I found companies very "scripted," presenting their positive story using well-rehearsed presentations. As a result, I became more selective in choosing companies to meet with and spent more time reading annual reports. Regarding IPOs, one thing I found interesting was the reduced emphasis on prospectuses and increased reliance on PowerPoint presentations. On some occasions I had to threaten to cancel an IPO meeting with companies unless I received the prospectus in advance. Our analysts also got caught up in looking for "shortcuts." They often would not read the prospectus but would rely on broker "teach-ins" on the company.

In the late 1980s information was communicated via mail and phone. Each day I received a large stack of broker reports to read. Daily reports were hand-delivered and urgent information communicated with phone calls. During the late 1990s, gradually with the development of the internet and with email, everything became electronic. This change in information availability, together with increasing brokerage coverage of stocks, led to an increase in market efficiency. Broker coverage of companies expanded, with more specialized sector coverage emerging. Over time, we saw investors less likely to react to financial reporting and more focussed on companies' outlook. I remember being disappointed on one occasion when I had correctly anticipated a positive earnings surprise for Cathay Pacific; however, the stock reacted negatively due to a more subdued outlook statement.

With the thought that some type of financial crisis was always on the horizon, I had to learn to adapt in how I analyzed companies. I put more emphasis on balance sheet analysis and became less interested in cyclical companies. I became less interested in dividend yield, as dividends would often be cut during downturns. Companies with a more conservative financial structure became more attractive.

Crises Continue Post the Handover

The bull market ended in 1997 with the Asian Financial Crisis, first seen in Thailand. During this time, we saw some panic selling, and on some occasions, even stable power generation companies such as Tenaga in Malaysia saw their share prices decline by 20% in one day. The move by the Hong Kong government to buy shares during this time was very effective in stabilizing the market. While this downturn was painful for investors, I saw it as a welcome adjustment from the previous excesses.

One of the most visible examples of the end of this bull market in 1997 was the collapse of Peregrine Investments. During the 1990s, Peregrine was a high-flying Asian investment bank and was particularly active in Hong Kong/ Chinese equities. The problem that arose for Peregrine was its debt exposure to an Indonesian taxi company, Steady Safe, that got into financial trouble. Despite raising substantial amounts of money for mainland companies, there wasn't any "rescue" from the mainland, and Peregrine went bankrupt in 1998. This collapse of such a successful investment bank highlighted to the financial community the need to tighten risk management.

Global Financial Crisis, but Only a Ripple in Hong Kong

The Global Financial Crisis of 2008 did have a big impact on the Hong Kong stock market and on investors based in Hong Kong. Over the years, the number and type of institutional investors based in Hong Kong had grown enormously. There were a lot more investors based in Hong Kong investing internationally and, as a result, more exposed to international market movements. However, this crisis did not impact Hong Kong companies as much due to their low gearing. Due to the financial market volatility in the past, most Hong Kong companies that have debt also have significant cash holdings. While this is inefficient from a cost of capital point of view, this approach has helped weather the various crises over the years.

The conservative approach Hong Kong banks took limited the impact on the banking sector. Overall, the experience gained from previous crises cushioned the impact on Hong Kong. I left Fidelity in 2008 and joined my colleague Jeff Kung at Frontier Asia Capital. We relaunched the Frontier Asia Fund on 1 September 2008, just as the Global Financial Crisis commenced. With our start-up, the downturn in markets was very challenging, but the experience of other downturns helped us.

Protest Plus Pandemic Crisis

The most recent crisis in Hong Kong started in 2019 with the protests and continued in 2020-22 with the pandemic. This crisis has had a much more significant social impact—people leaving Hong Kong and a considerable loss of employment and income in the travel and hospitality industries. This year is particularly challenging for asset managers in Hong Kong: not only do they face the industry challenge of very weak markets, but also the social and economic difficulties in Hong Kong. In April 2022 I took on the role of CEO at Stonehorn Global Partners, a newly established long-only equity manager. It is a good opportunity for me to put to work the experience I have gained over the years. Rather than speculating on when and how things will improve, in communicating with my colleagues on our current challenges I am focussing on us improving our organization. Having been exposed to so many crises in Hong Kong I have learned that it is impossible to know what lies ahead. The most practical approach seems to remain calm during any crisis, knowing that things will improve.

Hong Kong as a Financial Center

During the last couple of years, Hong Kong's position as an international financial center has been questioned by various commentators. As I look back on the last few decades, it is remarkable the growth that we have seen in financial services. The investment management and investment banking industries have boomed over the years. In my early years in Hong Kong, most investment managers were in a few buildings in Central. Clearly the economic/ financial integration with the mainland has been an enormous benefit for the financial sector in Hong Kong. Based on my experience, I am confident that Hong Kong will emerge in good shape from this crisis, and there will be a lesson learned that Hong Kong cannot take its position as an international financial center for granted.

Future Crises Are Inevitable, but Also Manageable

What do all these crises in Hong Kong financial markets mean for investing? These crises and the recoveries have been very difficult to predict. Given that markets are forward-looking, the recoveries in markets are particularly hard to predict. I have learned it is better to stay invested and accept the volatility. That is, "time in the market is better than timing the market."

There will always be crises; they may differ in various features, but they are inevitable. It is best that as investors we accept this volatility and manage the emotions that are prevalent during the crisis. An incident that helped me in this area was my first bankruptcy. On 21 September 1990, Northern Star, an Australia media company, went bankrupt. I held shares in the fund that I was managing and one of my colleagues in London had a substantial holding of 10% of this company. In a conversation with my colleague, he remarked "we were too early in the cycle; with an improving economy, media margins will recover strongly." A few months later he bought into another Australian media company and made a gain of ten times over the next 18 months, I did not buy into this other company. From this incident I learned to deal with failure and to continue taking risks.

In Hong Kong, investors have developed a reasonably strong appetite to take risks, a pretty good ability to manage crises, and the optimism that a recovery will come along. I don't think this displays any special skill; it just seems to be a result of us having a lot of experience dealing with significant volatility.

Notes

1 Peter Phillips passed away after submitting this article. His last words to one of us were, "I hope some people get something from it [the article]."

4.4
Three Crises, Infinite Lessons

— **Sean Debow, CFA**

I arrived in Hong Kong in 1994 as an ambitious analyst and chartered accountant who wanted to learn about the financial markets of Asia. Shortly after I joined Merrill Lynch Asset Management in 1994, I came to learn of the CFA Institute and the Chapter in Hong Kong. I enrolled in the CFA Level One exam and started a long path of learning with the CFA Institute. In the three financial crises that I have invested through, each has been unique, bringing with it its own challenges and learning opportunities. Allow me to share with you my memories of investing through these three crises.

The Asian Financial Crisis

Twenty five years ago, when the first rumblings of currency troubles started in 1997, I was working in Hong Kong as a portfolio manager at Merrill Lynch Asset Management (now BlackRock). I managed the company's Indonesia portfolio.

That gave me a front-row seat to one of the region's biggest economic and political crises: the economic collapse, the political overthrow, and ethnic unrest of Indonesia during the Asian Financial Crisis.

A few months after the Thai economy came crashing down in July 1997, the same signs of strain emerged in Indonesia. As with the Thai baht, currency speculators attacked the Indonesian rupiah. The country could no longer defend the currency, forcing it to adopt a floating exchange rate. That sent the rupiah into free fall. Indonesian companies, overloaded with debt, were forced into bankruptcy and in 1998, the country's economy shrank by 13%.

It wasn't just an economic crisis. After more than 30 years in power, Indonesian president Suharto was losing his grip on power. Skyrocketing food and fuel prices led to shortages, plunging the country into chaos, and, combined with mass unemployment, sparking widespread protests and riots.

The crisis in Indonesia taught me some important lessons—about how quickly a seemingly-stable situation can unravel, how a community can come together to help those in danger, and how a crisis can reveal which companies are poorly run.

During Indonesia's crisis, one of the country's minority communities was in harm's way. As far back as when Indonesia was a Dutch colony, the Indonesian Chinese community was a frequent target of violence, especially during economic and political strife. Suharto's New Order also made the suppression of Chinese identity a matter of national policy, closing Chinese schools and banning Chinese symbols and practices from public spaces.

The Chinese community became a convenient target when the economy took a turn for the worse. Indonesian protestors, upset with the state of the economy and the government, took to the streets to loot Chinese-owned stores and Chinese communities. Chinese-owned shops were ransacked, and more than a thousand people died—including the hundreds that perished in a mall set ablaze.

Seeing Indonesia on fire was a shock to all of us in Hong Kong. It was a horrifying time, but also a poignant one. Indonesia, just weeks earlier, had looked reasonably stable. It had tall skyscrapers, five-star hotels, major banks, and all the infrastructure you would expect of a modern metropolis. But just a week after I left Jakarta, people were being pulled out of their cars to be beaten—or worse.

All of us in Hong Kong did what we could to help those at risk in Indonesia. We used all our resources, be it airline contacts, financial resources or logistics know-how, to get our friends out of Indonesia safely. In the end, all of us in finance in Hong Kong and Indonesia—were a community. It didn't matter who it was; people helped one another.

There's a famous saying from Berkshire Hathaway's chairman Warren Buffett, "Only when the tide goes out do you discover who's been swimming naked." In other words, a crisis reveals who's been faking it the whole time.

During my time in Indonesia, a listed taxi company called PT Steady Safe caught investors' attention. The company was led by a charismatic and famous CEO, Jopie Widjaja. Mr. Widjaja summoned all the major fund managers to a party on the roof of the Grand Hyatt Jakarta as the economy was teetering in Indonesia. We'd found it rather strange that such a famous person was inviting us to come to such a party at such a difficult time in Indonesia's economy.

It turned out that Steady Safe was neither steady nor safe. The company's governance was a mess. They were loaded with foreign debt—mainly from a Hong Kong-based bank named Peregrine, led by Philip Tose.

Everyone at the party in Jakarta walked away thinking there was no way that any of them would work with these guys. The party ended up as a general failure: no one was going to invest their capital in the business. Steady Safe eventually collapsed. Peregrine, which had lent a considerable amount of its overall capital to Steady Safe and Mr. Widjaja, fell with it.

Thinking back over the crisis, it was the best companies that not only made it through the crisis but thrived after it. It was those firms that considered shareholder value, instituted ethical practices, and tried to implement best practices that went from good to great during the Asian Financial Crisis. They survived, taking market share from more poorly governed companies.

That crisis sparked important changes to underwriting, deals, and other financial instruments. But it also changed the mindsets of people like me, changing how we vetted companies. Governance. Doing your homework and, work with good people. Those are lessons from the first financial crisis.

The Global Financial Crisis

On 14 September 2008, while trouble was brewing in New York City, I was on the other side of the world, attending a Merrill Lynch investment conference in Tokyo, Japan. This was the day before Lehman Brothers declared bankruptcy and helped kick off the Global Financial Crisis. The subprime crisis dragged down the over-150-year-old bank.

We were days away from when Bank of America agreed to acquire Merrill Lynch to help resolve the investment bank's solvency concerns. By some coincidence, my hotel room looked directly onto the trading floor at the Lehman Brothers Tokyo office. As I was turning in for the night on that fateful Sunday, I looked out my window to see a hive of activity next door. There were people working, none of whom you'd expect to see in the office on a Sunday night.

Judging from their body language, they were stressed. One could understand why. The bank had announced consecutive multi-billion-dollar quarterly losses. It was trying to offload its subsidiaries to other buyers—and other deals to buy the bank outright had fallen through. Layoffs were on the cards.

Lehman's workers were still there the next morning. As I prepared for the conference, I saw them pack up their desks and carry their boxes out the building. I saw them embrace and comfort each other, piecing through the wreckage left in the wake of their company's bankruptcy.

I still think about what I saw that day, almost 15 years later. The sights of people trying to figure out the rest of their lives taught me an enormous amount of humility—especially after things go very, very badly.

Judge James Peck, the federal judge in charge of overseeing Lehman Brothers' bankruptcy hearing, said the investment bank was the victim of "a tsunami that has befallen the credit markets." Sitting in Hong Kong through the Crisis, it sure felt like a tsunami.

In the United States alone, USD 19.2 trillion in household wealth evaporated, according to the U.S. Treasury department. And it didn't stop there. The tsunami dragged down markets in Europe and Asia-Pacific as well.

In 2008, I ran the Asian book of a large hedge fund headquartered in Los Angeles, Ivory Capital, leading a division for the first time. Shorty, a financial crisis was beating at the doors of the globe. The Global Financial Crisis was a horrible time for hedge funds. The average fund lost about 18% of its value in 2008, and funds lost billions as investors tried to pull out their money.

The subprime crisis wiped out USD 19.2 trillion in household wealth in the U.S., according to the U.S. Treasury Department. Over a hundred mortgage companies closed up shop in 2007 as the bubble unwound.

These figures loomed ominously over me, but also provided foreknowledge, helping me to prepare my team for what would end up being a difficult time at Ivory Capital in Asia.

It is worth noting that Ivory performed reasonably well in this time of great strain compared with our peers, as we looked to act in the best interests of our clients. Unfortunately, this ambition was ultimately the firm's undoing at the time.

Several hedge funds, feeling the strain from the Global Financial Crisis, stopped redeeming their customers' requests to withdraw their money ("closed their gates"). Ivory instead chose to honor customer requests for redemptions. That decision to do right by customers ended up working against us. Ivory's customers flocked to have the firm return their money, as one of the few places able and willing to give them their money back.

The redemptions put quite a bit of pressure on Ivory, and it forced leadership to make hard decisions at an unfavorable time. It's more difficult to be a leader when things are bad; I had to let people go on short notice and make tough decisions about where to put our time, energy and money.

Humility is critical, as investors must be mindful that they will not get all investment decisions right. We must work in a fashion where we quickly acknowledge our shortcomings and take corrective actions. This is a humbling task but critical in the investment process.

Ivory Capital eventually closed its Asian branch, which was when I learned how to manage challenges with grace and honor. That's what people remember about our fund, all these years later—that we honored our obligations to our clients, and to our staff.

In my case, the crisis was a great opportunity to meet the person who would eventually become my business partner. The crisis opened doors for me, and I was able to build off those opportunities in the years to come. This came in the form of opening my own fund with a partner, Matchpoint, which was bolstered by the good standing in the financial community afforded to me by the professional way we wound down Ivory's Asia operations.

The Coronavirus Pandemic

As COVID-19 spread around the world in the spring of 2020, I was preparing to assume my current role as chief executive at Eurizon Capital Asia with a mandate to grow the firm's Asia presence. The sharp and sudden effect of the virus had caught markets and investors unaware, and as the crisis unfolded, I drew on lessons from past periods of economic upheaval.

Building a team in this context was a novel experience. While challenging, the circumstances quickly brought us together and deepened bonds of trust that proved indispensable later on as we looked to expand the business.

Watching how good people treat each other in times of great stress and upset is instructional. Like the Lehman employees I had observed from my hotel window more than a decade earlier, the kindness and compassion I saw from my colleagues was a powerful balm against panic.

Stalled negotiations would not have been a surprise given the massive market shifts taking place due to the pandemic. However, the efforts of honorable and responsible parties prevented this from happening.

Since the height of the first COVID-19 waves in Hong Kong, Eurizon Capital Asia has expanded to cover international funds distribution in Asia as well as investment portfolio management and business development.

And in the midst of one of the largest black swan events in recent memory, we have also grown our team to cover management, sales, risk and compliance as we pursue a primarily stock selection-based allocation strategy.

Fundamental on-the-ground research has been critical to stock selection and in our case, has accounted for the overwhelming majority of our value add in these times of great change and uncertainty. Indeed, policies are evolving, and in China, the constant stream of news about government regulation reached a fever pitch in recent years, especially about the pandemic.

In these times, it pays to have a dedicated and hardworking team with boots on the ground who understand the regional context. Listening to my Asia-based colleagues expounding on their perspectives in the wake of Common Prosperity initiative announcements on the mainland allowed us to get ahead. In doing so, we made the most of sudden market shifts in real estate, among other sectors, to benefit our investors.

A localized market view allowed us to spot emerging trends that, having been shaken loose by COVID-19, now expanded at pace, as consumption, policy, and the economy adapted to the pandemic age. E-commerce, online education and telemedicine bloomed in China. Trapped at home for month-long lockdowns, many Chinese consumers embarked on lifestyle upgrades to complement their socially distanced reality.

Spotting and acting upon these shifts is challenging to do from far away. This reinforces the importance of Hong Kong as a regional hub of financial activity, home to people with a wide range of perspectives, opinions, and experiences about what's happening in North Asia that you cannot find anywhere else in the world.

Today, Hong Kong is more than the gateway to China; it is an important financial center unto itself with competent regulatory standards and an enormous reserve of talent. Watching this city transition from a blot on the map to a skills-based service economy over the last 30 years has been a remarkable sight.

We are spoiled for talent at every level and subset of the financial service industry, be it auditors, lawyers, custodians, intermediaries and more. CFA Society Hong Kong has led this charge towards professionalism. When parsing highly eligible candidates, a CFA charter can be an invaluable equalizer and tool in understanding a person's background.

4.5
12 September 2008

— Lin Ning, CFA

Anyone reading a history of finance would say that 15 September 2008 was the day Lehman Brothers filed for the biggest bankruptcy in history. However, as a long-time employee with them, I remember more 12 September 2008, the last business day of the investment bank's 158-year history.

It was a Friday. That evening, Lehman Europe wired to its New York headquarters some billion dollars of cash as part of normal treasury operations before the New York market opened, without knowing that the firm was about to file for bankruptcy. However, during our Asian working hours, that hadn't happened yet, and we could only grin when hearing about it afterwards. But I knew the firm was going down. It had been going on for a while—everyone could tell from the press and the stock price. There were even murmurs that Bank of America was about to acquire Lehman. What I did remember that kept amusing me was that there were still people coming without knowing the obvious. That day I received a call from one of our senior sales personnel, a managing director who at the time was a rare species, asking me to price a complex derivatives trade at her client's request. I told her to wait for next Monday, as we might all be Bank of America very soon. Anybody in the business would know that for a derivatives trade it made a huge difference who the counterparty was. It was nevertheless unusual for a trader to decline a lucrative trade, especially with a productive salesperson. But I felt I had to tell her. She was calm.

Only a couple of days earlier I executed a trade of similar nature with a European bank in the midst of market turmoil. The bank, considered an important client, simply couldn't find a party to do the trade with (or, to "provide liquidity," using the jargon in market-making business). I saw a good level and was happy to put it on. That was followed by an extremely rare event. I was summoned by the most senior manager of the trading floor into his room, telling me how good the trade was for our franchise. He meant it. We did need new business to help the firm. By the way can you pay some more sales credit for the sales, please? Okay sure, why not?

However, not today, I thought.

I was a trader of derivatives at the Fixed Income Division (FID) in Tokyo, Lehman's Asia headquarters. From the latter half of the 1990s, Tokyo had become a global financial hub, with all the Asian headquarters of global investment banks there. The Japanese version of the "big bang" financial reform helped develop a huge "offshore" financial market with traders from all over the world physically sitting at the heart of Tokyo, but trading largely unregulated financial instruments in their offshore accounts. These included products such as swaps, options, and structured derivatives—on interest rates, forex, commodities and literally any asset you could think of, like real estate, weather (we didn't end up printing one), and derivatives (meaning something made up, of course) themselves. The products just grew more and more complicated. In our eyes, futures of futures and options were not even what we would call "derivatives." They were so-called “cash” products, and sat in the same category as plain stocks or bonds. On the other hand, swaps, like interest rate swaps and cross-currency basis swaps, were taken very seriously as mainstream derivatives, for good reasons—there was constant mispricing of them, even today. Options were duly categorized according to their complexity into “plain vanilla” or simply “vanilla” options, exotic options or simply “exotics,” and hybrids or even hybrid exotics. On top of all these was this hard-to-tame beast called PRDC—Power Reverse Dual Currency!

A typical PRDC was a 30-year maturity swap with one leg paying a structured coupon, usually linked with USD/JPY forex options, and another leg receiving a string of Libor cashflows. The swap can be terminated by the swap provider such as banks (manned basically by traders like myself), by “calling” the trade at par, or by USD/JPY hitting a certain level (knock-out), at some given points of time, i.e. in a “Bermudan” fashion meaning multiple calls or knock-outs in the future. The product, usually offering an optically high coupon, was massively popular in Japan, which at that time had interest rates near zero for the past two decades or so. Japanese yen funding at the same time was attractive to banks from both rates and forex perspectives.

Banks turned PRDCs into hugely successful businesses. Everybody was doing it. It was, however, notorious for the challenges in managing the risks, or simply understanding the risks, or, even worse, seeing the risks themselves. Simply put, there was a multi-dimensional mixture of risks associated with USD rates, JPY rates, forex, volatilities and correlations amongst them, for possibly 30 years. Traders managed their portfolios, PRDC trades and the hedging trades in a trading book with quantitative models and analytical tools. Every bank had engaged in an arms race, pursuing the arguably most complicated models in finance. They hired a troop of physicists, mathematicians and even rocket scientists colloquially named "quants," analytics, and IT specialists to create and implement those models with cutting-edge computational power for traders to manage the "book." Trading PRDCs was really like a pilot maneuvering a state-of-art fighter jet with a swathe of flashing screens and gadgets, yet still constantly dissatisfied at the mechanics and demanding improvements.

I was the trader. The book held the biggest and most complex portfolio in Lehman Asia at the time. It had not only PRDCs but also other exotic trades in forex, interest rates, credit, commodities and stocks (there was even a Nikkei version of the PRDC). I knew, so I thought, how the risks worked, how the market worked, and more importantly at the time, how the firm worked.

So it wasn't totally surprising when our senior sales called me on 12 September 2008 about the trade. Later in the day, I happened to meet another colleague traveling from Hong Kong for a personal trip, quite ignorant of what was going on, and I had to say it looked like we were actually going down.

That happened swiftly after work. As for "after work," we obviously didn't know that was the last time, at least with Lehman. Many people actually wouldn't have much to do except worry. It was however a typical trading day for me; markets, risks, profit-and-loss, etc. After all, I had this fighter to fly. It was a big book and the risks could be all over the place. They were fine that day. Looking at the screens, USD/JPY moved up a bit; so did U.S. rates. The S&P was little changed overnight, Nikkei up a bit in the day. In other words, the market was calm, a bit ironic in retrospect. Definitely no one was expecting Lehman to go under during the coming weekend.

Anyways, after work, a few of us went to The Oak Door, a bar downstairs at the Grand Hyatt, pretty much in the same compound of the office building. I heard of one senior trader being there every night of the whole previous months, knowing that all his savings in Lehman stocks were going to zero. We went there that night, in a sense almost relieved, thinking the bad situation could last no more and, after all, Bank of America was not a bad choice. They were considered a countryside bank, with no sophisticated derivatives knowledge, yet a lot of ambitions in the field, apparently. They needed us.

So I went home pretty late. Then I made the most bizarre decision in my life—silencing my mobile. It had been a long week, after all.

I woke up Saturday morning and saw around 20 missed calls on my mobile. They arrived throughout the night. It was my boss, in the office. “Barclays wants to see the book,” and they were right there in our New York office. My heart sank. It’s not BOA. It’s Barclays Capital. I knew they were big, and aggressive, in the same market. Instead of some countrymen there came the crocodile. By the way, they didn’t come in the weekend as many fictional accounts of the episode later claimed. They already marched in on that Friday New York time. Of course, they wanted to see the book. With the biggest risks in it, that was what mattered to them in the whole of Lehman Asia.

I rushed to the office.

I will keep the rest of the story short and cut off a million words here. I have so far more or less covered the day, 12 September 2008, from Asia to U.S. hours. We all know what happened after. It wasn’t Barclays either, unfortunately.

There was NO ONE!

I later relocated to Hong Kong, arriving at dawn on 30 December 2008. Journey completed, the immigration stamp said.

It was, by all means, a dramatic time for me, even with the benefit of hindsight. There were people around me telling me not to worry, citing the fact I was the trader and considered important. I had people kindly offering help as well. I had nine solid years of experience. I spoke three languages. But still, the prospect of an otherwise fantastic career being ruined was devastating. I was used to running this fighter jet, with the entire crew and supporting staff. It was a good feeling, though I was under stress from time to time. We actually had had a very good year thus far in 2008, with the book well-hedged and cash reserved. We were never more comfortable with the risk numbers we saw on the screens, after years of improvements in our models and systems. We were proud of the jet we built together, traders, quants, analytics and IT staff. The machine was just immaculate. Even though we kind of knew none of those would matter anymore with the firm fading out of existence, it was a strong feeling of belongingness.

So I decided that my job was not done. I wanted my seat back. I hadn't got enough. I still had things to figure out. I could still improve. My destiny was to find the trade. I hadn't found it yet I reckoned.

It proved to be hard. The market landscape changed a lot, with tougher restrictions like the Volker Rule, the Dodd-Frank Act, and all sorts of Wall Street reforms and derivatives regulations. I also found it culturally hard to fit the Lehman way, the good way I thought, into another Western bank.

Basically the same fighter jet was never there. I simply couldn't really find one. It's hard to build one too—there needed to be a huge mandate. I guess it's fair from another perspective. Who would be able to tell between top gun and old gun? Why would they, after all? And along the way, the crew inevitably disbanded.

It really took me a while. I was stubborn, I guess. I was obsessed with the idea that I had to carry on fighting the war I was in.

That's all I've got to say. Let me just report the outcome here. I finally got to what I wanted to do, eventually overseeing the entire fixed-income operations across the Asia-Pacific region at a major global bank. I commanded a squad. We built and flew fighter jets with a team of brilliant fellow traders, quants, analytics and IT people across Hong Kong, Tokyo, Sydney, Singapore, and London. We flew well. We fought well.

So back to the topic. A crisis may happen in just one day, but rising back up from it would take much longer. It takes perseverance to rise too. Is there a right way to rise? I don't think so. I could have chosen another way. I could have done something else. In the years following the GFC, there was no shortage of opportunities. I indeed chose the hard way. Was I aware of another way? Oh yes. However, I was completely with Billy Beane, who at the end of that one spectacular Money Ball's run was still looking for his first Major League title with the Oakland A's. The same way I felt for the 300 Spartans at Thermopylae. I kind of knew they would be there, no matter what.

Because they decided there wasn't another way.

And to me, that's quite enough.

Notes

1 My desk did the first ever property swap with Goldman Sachs, and interestingly, a few years later, I worked with the GS trader on the other side of the trade.

4.6

Can Hong Kong Fly Again?

— Alex Au, CFA

First of all, Congratulations to CFA Society Hong Kong for its 30th Anniversary! While there may be a lot of different professional qualification titles in finance and investment, CFA designation remains the gold standard.

Evolving Landscape Through the Crisis

I have witnessed the ups and downs of Hong Kong's financial market over the past 30 years. In the early 1990s, Hong Kong's securities market was dominated by mighty European houses like Barings, Fleming, CLSA, Warburg and James Capel. As China started to allow its state-owned enterprises to list in Hong Kong in 1992, more international firms joined the gold rush to set up offices in Hong Kong. In those heydays, each investment bank had at least one yacht for entertaining clients and staff, while cleaning ladies could expect a bonus equivalent to a few times their annual salary. During that time, Hong Kong attracted a lot of international talents and capital. Its stock market was at the mercy of foreign investment funds and banks. "Gweilo" were the real bosses of the Hong Kong capital markets, while English was the only language used in investment banks.

After a few years of pain and desperation following the Asian Financial Crisis, Hong Kong's stock market recovered its liveliness in 2003, with the capital market picking up after China's accession to the World Trade Organization and the local economy revived with the help of a new tourism scheme from China. In the few years following 2003, mega-cap mainland firms like ICBC, China Life, Ping An and Tencent came to Hong Kong for listing. Hong Kong's stock market started to be regarded as the center for China investment. When the BRIC investment theme became fashionable in the global investment community, Hong Kong benefited hugely from the influx of capital. During that time, investment banks started to employ more Hong Kong people for their Chinese language skills and local knowledge. Cantonese could be heard everywhere in the office in addition to English.

The Global Financial Crisis from 2007 to 2011 was another turning point for the capital markets in Hong Kong. As China emerged as the first country to recover from the crisis, money started to flow from the mainland into Hong Kong as a first step for them to allocate capital into the international market. Mainland fund houses and brokerage firms rushed to set up offices in Hong Kong. Mainland students in Hong Kong's universities provided a big talent pool for these firms to recruit new blood. Mandarin has become the most commonly used language in Central. Hong Kong has consistently ranked top three in IPO fundraising globally for years. Chinese firms were gaining market share in both brokerage and IBD businesses. Foreign houses would find it hard to challenge their coverage in the A-share market. Those few years before COVID-19 was the prime time for Hong Kong as a global financial powerhouse.

In Stock Trading, the Only Constant Is Change

In terms of trading opportunities, Hong Kong was virgin territory in the 1990s. Back then, opportunities were abundant as foreign money started to enter the Asia-ex-Japan market. Given that most markets like Korea, India and Taiwan had very restrictive foreign investor policies, international capital mostly flowed into Hong Kong. Every trader wanted to know the flow of foreign firms in order to capture trading opportunities. Proprietary trading desks of foreign brokers dominated the market when hedge funds were not as popular as today.

That period was heaven for traders, and there was no restriction on short selling. You did not need to locate the stock loan ahead or comply with the uptick rule. Thus, if you wanted to bet on the downside when you did not own the stock, you could simply call up your broker and place a sell order to hit the bid straight away. That was exactly how international hedge funds (a.k.a., "big crocodiles") had been able to destroy the Hong Kong stock market during the Asian Financial Crisis in 1997-98. They just kept on dumping index heavyweights like HSBC, Sun Hung Kai and Hutchison in order to push down the index and made money in the futures market without caring about having enough stock to settle. Eventually, short selling restrictions were imposed in late 1998 to fence off the attack. The crisis eventually led to the introduction of the Securities and Futures Ordinance in 2002, which made the market better regulated.

There were tremendous trading opportunities for professional traders before the market was dominated by hedge funds. Index rebalancing was a popular trading opportunity where traders pre-positioned by buying the new index constituents ahead of the actual effective date, since benchmark funds needed to follow the index change. However, as more hedge funds and traders learned about this strategy, all of them traded ahead in a similar fashion and squeezed out all the juice, sometimes even resulting in the opposite move. This is a classic example of "crowded trade," meaning too many people doing the same trade. Another strategy ending up in a similar situation was merger arbitrage. I can still remember the wide profit margin for the arbitrage trade between PCCW and Hong Kong Telecom during the internet bubble era. However, with the mushrooming of hedge funds and the influx of cheap capital, a lot of these trades have become crowded and are no longer attractive enough.

Stamp Duty Hike Is Detrimental to Hong Kong

Another hot topic in recent years is the dual listing of Chinese ADRs. There has been the expectation that trading volume in Hong Kong will overtake that in the U.S. for those ADRs as interest from mainland investors in Hong Kong is growing. However, if we take a deeper look, it may not be the case. Taking Alibaba as an example, for July 2022, the average daily number of ADRs traded in the U.S. and Hong Kong were 25 million shares and 6 million shares (or 50 million local shares) respectively. Even though Alibaba is one of the most popular and liquid stocks here, its turnover is only a fraction of the U.S. standard. The single most important reason is the hefty transaction cost. While commission is based on commercial considerations like competition and bargaining power, the most rigid and dominant cost of trading in Hong Kong is the stamp duty levied by the government. To trade a U.S. stock, investors only need to pay a tiny fee of 0.002% (the SEC fee), while for Hong Kong stocks, the total fee is 0.14% (including 0.13% of stamp and 0.01% of other fees). One can easily see why short-term traders and scalpers prefer trading in the U.S. market and why the so-called high-frequency trading strategy does not exist in Hong Kong.

Some people may think that high transaction costs are common in Asia. However, the fact is that there is no stamp duty for Japanese stocks. Even for the mainland A-share market, there is no stamp on all buy trades. As a result, the round-trip stamp duty (buy and sell) is only 0.1% in China compared to 0.26% in Hong Kong. The relatively reasonable trading cost in China has already attracted some high-frequency funds there. Thus, the hike of stamp duty from 0.1% to 0.13% in 2021 may earn more tax revenue in the short run but has significantly damaged the Hong Kong market's competitiveness in the longer term. As China's onshore market opens more, investors will certainly prefer the more liquid and cheaper market to trade. In fact, by looking into the data of the actual trading volume of all equities in Hong Kong for the 12-month period after the stamp duty hike, total trading value has dropped 22% compared to the previous 12-month period. As a result, the government has not marginally collected much more tax revenue.

The Importance of a Level Playing Field

One thing I have realized from trading this market for years is that there is no long-term winning formula, as the market is always evolving. Only the fittest can survive. However, having a level playing field is important for all the participants to compete fairly. The biggest challenge faced by a fund manager today is insider trading. In the current landscape, most of the companies listed in Hong Kong are ultimately owned by the Chinese government or mainland individuals. The introduction of Mutual Market Access has also facilitated southbound fund flow into Hong Kong. There is a general perception that the Hong Kong stock market is becoming more "A-Share like," meaning that volatility is higher, trading becomes more speculative, with groups of investors acting in concert, reacting to or "preempting" policy news. As a result, major indices share higher correlations with the A-share market. The Efficient Market Hypothesis tells us that stock prices will react only to new information. However, it is increasingly common to see abnormal stock price movements before earning announcements, major news, or corporate events like M&A and share placements.

What's more, even the whole market can move before a major policy is publicly announced. Thus, it may suggest that people with inside knowledge of certain information have acted ahead of the game. The "A-Share like" nature is a double-edged sword, bringing opportunities and challenges. The situation is becoming more alarming. The regulators need to combat this before frustrated investors completely move away from Hong Kong.

With all the policy uncertainty, hefty trading costs, insider trading, and geopolitical risks, the Chinese stock markets (HK/A-Shares/ADRs) are occasionally but increasingly being questioned as "un-investable." The Hang Seng Index is still trading at roughly the same level as 16 years ago.

Can Hong Kong fly again? It will take a lot of wisdom from our leaders.

4.7

Crises and Opportunities: We Can Go Further Together

— Song Shuang, CFA

Introduction

As one reflects upon the last three decades, three major challenges-turned-opportunities stand out as Hong Kong and its resilient people's significant testing times. These "epic" periods include the Asian Financial Crisis in 1997-98, the Global Financial Crisis in 2008, and the recent COVID-19 global pandemic in 2020. In each of these crises, Hong Kong emerged stronger. This article offers perspectives on the past, present, and future challenges of Hong Kong, as well as how it rose from the crises.

Three Crises and Opportunities

Accelerated reforms after the 1997-98 Asian Financial Crisis

In 1997, the Thai bhat significantly depreciated as the currency was unpegged to the U.S. dollar and caused massive flights of capital. This currency crisis was the start of a regional Asia Financial Crisis; it spread to neighboring countries with high current account deficits and high levels of external debt, as well as lendings from Japanese banks as hedge funds shorted emerging markets currencies such as the Malaysia ringgit, the Philippines peso, the Korean won, and the Indonesia rupiah.

The Hong Kong dollar was not spared either, as the Hong Kong economy was overheating with a property bubble and overly leveraged corporates, especially the property developers.[1] In August 1997, some market participants speculated on the Hong Kong dollar and made an attempt to attack the currency. Under a pegged currency regime, when the exchange rate was close to 7.75, the Hong Kong Monetary Authority intervened to stabilize the currency market. In October, the short-selling intensified; the Hong Kong Monetary Authority reacted by buying the Hong Kong dollar sold by the shorts and increasing the borrowing costs of the currency through the lending banks. However, such a measure was not sustainable and would harm the real economy if it lasted for a prolonged period of time. One year later, in 1998, another round of attacks resumed. This time around, the local equity market was also under the radar as Hibor soared. The Hong Kong Monetary Authority overcame the selling pressure from speculators in the end through intervention as the main buyer in the market for ten trading days by utilizing a massive amount of foreign reserves supported by the Chinese government at all costs. On 28 August 1998, the trading volume was at a historic high.

After the turmoil, Hong Kong responded to the crisis by reforming the securities and futures markets in three main respects[2]—embracing state-of-the-art technology, strengthening supervisory and investigative powers, and demutualizing exchanges and their associated clearing houses through consolidation. In 1999, Hong Kong shares stabilized and the Hang Seng Index rose to an all-time high as Hong Kong recovered from the Asian Financial Crisis.

Global Financial Crisis in 2008

There are several interlinked causes of the Global Financial Crisis. The initial damage caused by U.S. sub-prime loans and securitized products such as residential mortgage-backed securities, as market participants sought higher yields without exercising proper due diligence, led to a full-blown financial crisis. In addition, the declaration of the G20 Summit on Financial Markets and the World Economy in 2008 states that the root causes of the crisis also include a lack of prudent risk management practices. Moreover, policymakers and regulators in some developed economies failed to adequately appreciate and address the risks in financial markets and keep up with financial innovation. More complex and non-transparent financial products combined with excessive leverage also added vulnerabilities to the system. As an international financial center, Hong Kong was impacted as a result. The global stock market declined and the Hang Seng Index almost fell by 50%, with the real estate sector being impacted significantly. The increasing uncertainty and fear causing panic among banks led to risk aversion in global markets.

As the global economy entered into a recession, Hong Kong's trading was impacted, as seen in the decline of exports. This led to negative GDP growth in Q1 2009 and a higher unemployment rate. However, compared to ten years ago, the impact of the Global Financial Crisis on Hong Kong was less, thanks to the financial system having little exposure to U.S. sub-prime loans and securitized products. In addition, banks in Hong Kong had higher capital adequacy compared to their U.S. counterparts. Another dimension of support came from China's stimulus and easing of financial conditions.

According to the Council of Foreign Relations, in 2008, the U.S. government announced it would seize control of federal mortgage insurers

Fannie Mae and Freddie Mac. One day after Lehman Brothers filed for bankruptcy, the Fed stepped in to bail out AIG. Next, Treasury Secretary Henry Paulson unveiled a rescue plan, the Troubled Asset Relief Program, which aimed to use USD 700 billion of U.S. taxpayer money to stabilize markets. It also proposed buying troubled assets from the country's largest financial firms to restore confidence in credit markets. The Fed also used quantitative easing to lower long-term interest rates and purchase assets to expand its balance sheet. The SEC announced a temporary emergency ban on short-selling in the stocks of all companies in the financial sector. In 2009, President Barack Obama signed a stimulus package; the Dodd-Frank Wall Street Reform and Consumer Protection Act was also passed to regulate Wall Street. On the international level, the Financial Stability Board (FSB) was established in 2009 after the G20 London summit to oversee reforms to address the vulnerabilities in the financial system.

In 2009, Hong Kong became the largest offshore RMB center worldwide and recovered from the Global Financial Crisis with the unemployment rate lowered to a historical low.

Pandemic-led Crisis 2020 - Now

One decade after the Great Financial Crisis, the unprecedented COVID-19 pandemic hit China in 2020 and shortly afterwards the rest of the world. Borders were closed and air fleets grounded. Those who could work remotely started to work from home with the help of technology which accelerated digital transformation. To support Hong Kong, the Chinese government and corporations donated medical supplies, assisted with the construction of the temporary hospitals, and offered donations to individuals as well as small-to-medium enterprises in difficulty. Financial markets were volatile and major central banks carried out quantitative easing. While the situation was under control initially, the mutation of the virus from Delta to Omicron led to a surging number of cases in the fifth wave in 2022, posing challenges together with the zero-COVID policy due to quarantine requirements which are still present at the time of writing. This not only affected local tourism and the hospitality industry but also led to the relocation of professionals and an exodus of talents from Hong Kong due to the travel restrictions.

In April 2022, Hong Kong opened its border to non-residents for the first time in over two years and the situation is now under control. It is getting closer to when we can see the light at the end of the tunnel, and the latest example of overcoming yet another challenge.

On a personal level, this is the year I became a CFA charterholder. I will continue to contribute to the local Society on different fronts, such as involving in the University Ethics Challenge.

The future

Past crises often offer valuable lessons for the future. The crises in this article are three examples among many others. With every crisis, there is always a silver lining. From 1997 to 2021, Hong Kong's GDP has doubled and GDP per capita has grown by over 80% according to the International Monetary Fund. In terms of foreign exchange, Hong Kong is the fourth largest center globally behind London, New York, and Singapore. Compared to cities such as Shanghai, Shenzhen, and Singapore, how can Hong Kong maintain its edge in the international arena and continue to enable Asia's economic development? Embracing diversity and inclusion is definitely key.

The CFA community in Hong Kong has grown from less than 100 members in the 1990s to well over 6,000 currently. The Society is the fourth-largest member society globally and the largest member society in Asia, which is no mean feat. On a personal level, the author has witnessed how interconnected the world has become over the past 30 years, and reading the anecdotes of the previous generations helped me understand past crises. Looking ahead, Hong Kong needs to continue to capitalize on its close proximity to the mainland, and free trade, as well as integration with the Greater Bay area to attract foreign investments with its open capital market and business environment against stiff competition. At the same time, it is also critical to diversify the economic drivers through technology innovation and encourage the development of emerging industries in future decades to prepare for potential headwinds.

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