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SMALL GIANT

How boutique fund manager Pheim Asset Management and its founder Dr Tan Chong Koay beat the big players

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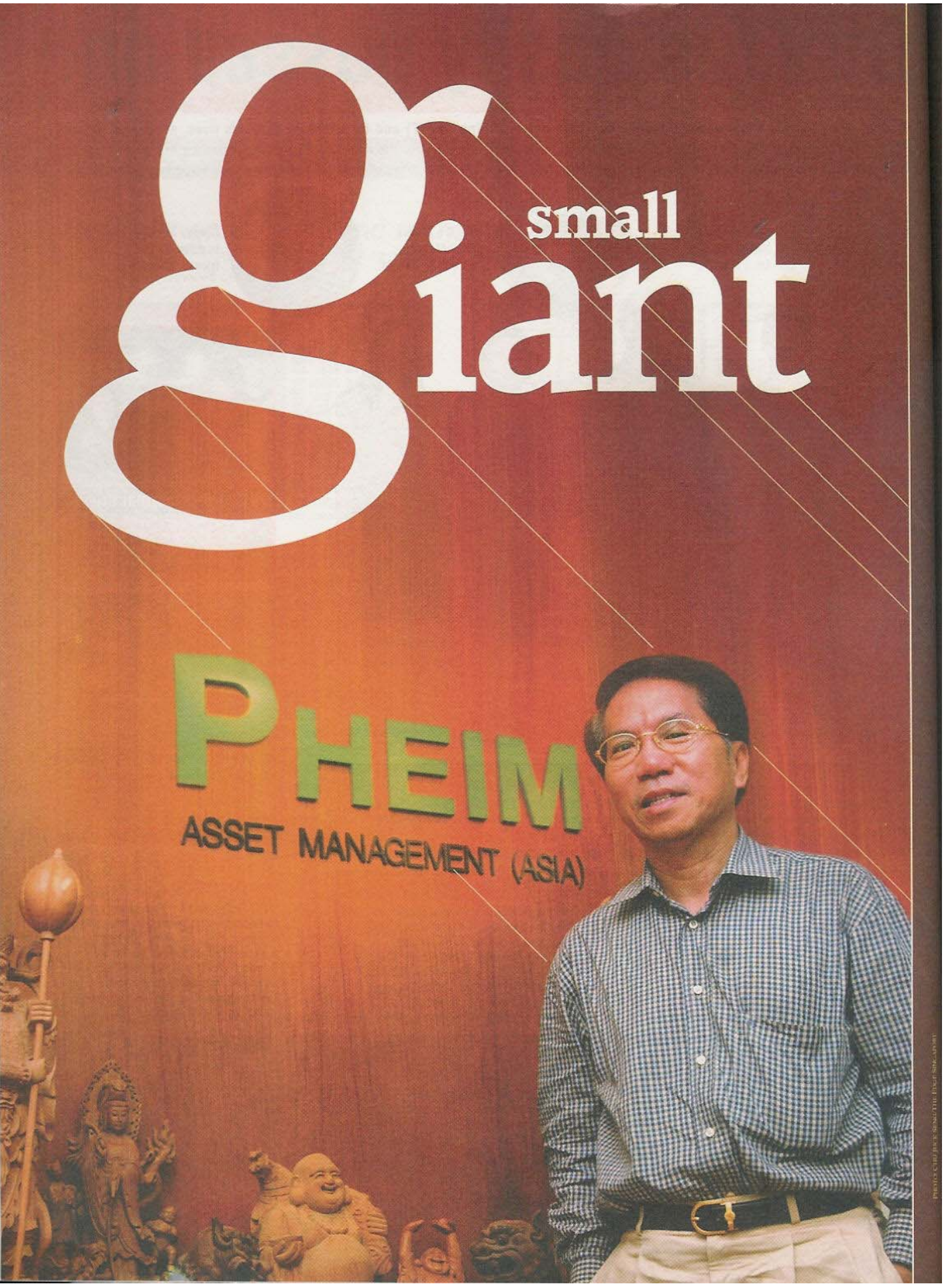
small giant



If you are a small entity in the asset management business, the challenge of competing with larger, bank-backed competitors for business can be daunting. Which is why when you have an exceptional performance track record, you would want to shout about it from the rooftops even more. This is what Dr Tan Chong Koay, founder of boutique fund management company Pheim Asset Management Sdn Bhd, has been doing time and time again. Critics might say that he has a penchant for self-promotion, but with a track record like his, wouldn't you want to tell the world about it? He speaks with Lim Yin Foong.

CONSIDER THIS: Funds managed by Pheim have consistently been ranked number one by Lipper Asia Ltd and Standard & Poor's Micropal, the two major fund performance ranking companies in the region.

One of Pheim's proudest achievements to date is the Asean Emerging Companies Growth Fund, an offshore open-ended Asean equity fund managed out of Singapore by Pheim Asset Management (Asia) Pte Ltd. The fund was ranked number one by Standard & Poor's Micropal in the offshore Asean equity category for the one-year period for 1998, 2001 and 2002, and also for the one-, two-, three-, four- and five-year periods ended December 2002.

The fund has outperformed not just the benchmark but also its peers by a wide margin during times of volatile markets. Last year, it registered a return of 17.7 per cent in US dollar terms while the number two fund, Hansard/JF Asean fund, recorded a 5.78 per cent return. The benchmark, the Financial Times Stock Exchange All-World Asean Index (USD), registered -1.97 per cent.

Pheim was recently verified by international investment consulting firm Watson Wyatt Sdn Bhd to have outperformed the Kuala Lumpur Composite Index (KLCI) benchmark for all its Malaysia mandate accounts combined for nine consecutive years from 1994 (when Pheim was first set up).

Watson Wyatt's counterpart in Singapore also verified Pheim Asset Management (Asia) Pte Ltd's outperformance of the relevant benchmarks for all its accounts for eight consecutive years from 1995 to 2002.

This track record is no mean feat for Pheim, which started as a two-man show run by Tan and his business partner Lim Chi Teong. Today, the boutique fund manager with offices in Kuala Lumpur and Singapore manages close to US$400 million (a boutique fund manager is one in which the chief investment officer is also a major shareholder).

Investment Philosophy

TAN'S SOFT-SPOKEN and nondescript nature belies the fact that he is one of the most astute fund managers in town. Speaking with him, though, it is obvious that he is preoccupied with his performance track record. At the same time, he is mindful not to appear too arrogant about his achievements.

As Pheim's chief strategist, Tan is responsible for the group's investment philosophy and process. Two core principles — not being fully invested at all times and taking advantage of market timing — underlie the philosophy, which is credited for the company's successful track record of outperformance and consistency.

Tan believes that the textbook prescription of funds being fully invested at all times cannot be applied to the Malaysian market.

"When you study carefully, between 1987 and 2000, the US only had two sharp corrections, but in Malaysia, the market had seven sharp corrections," he points out.

"So if you fully invest and you happen to go in at the high point, you either don't make money at all, or you may underperform substantially."

Pheim, he says, only fully invests when the market is very depressed, but is always very willing to divest when it thinks that the market has neared the peak.

"We sell when we think the market is overpriced. We always say that — all the time. We pick up stocks at the low end so that when it goes up, you benefit. It works very well because our market is very volatile," he explains.

With this practice comes an emphasis on market timing, not the easiest of tasks to accomplish. In fact, Tan says many fund managers don't believe in market timing because pinning down a market turn is considered an elusive feat.

However, he admits to a strong belief in market timing. "When you have good market timing and your selection of stocks is good, you have a very big advantage."

So how does Tan — and Pheim — achieve success with market timing where others have failed? All Tan says is, "Your success depends on how you sense the valuation of the market. If you are able to sense a major turn, you will have more advantage."

Tan cites two cases where he believes Pheim did the right thing with regard to market timing. The first occurred during the Asian crisis between July and October 1998, when the region's stock markets dropped to their lowest points; during that time, Pheim gradually increased its equity exposure until it was almost fully invested.

"We like a low PER [price earnings ratio], and in 1998, you got plenty of shares like that. When the market was at its lowest point, you could get shares selling at three to four PER; in fact, you could buy shares at one PER," he recalls.

Tan acknowledges, however, that 1997 and 1998 were difficult years for Pheim, though that did not stop the group from outperforming the relevant benchmarks during that period. In fact, Pheim is known to perform better during market downturns.

"We outperform [the market] more during bad months than good months," he notes. In its study, Watson Wyatt found that in the 8½-year period from 1994 to 2002, Pheim outperformed 66 per cent of the time and underperformed the rest of the time. And 72 per cent of the time when Pheim was outperforming the market, the markets were experiencing negative returns, he adds.

Dr Tan's Advice for Retail Investors

1. If you really want to go into equity, your availability of funds must be long term.
2. You are better off buying equity in bad times than in good times, and equity funds are very good long-term instruments. Ideally, the best thing to do is put money into an equity fund through an instalment plan — that will basically sort out the market-timing problem.
3. Get a good fund manager and your chances of winning are quite high. When selecting a fund manager, you want one who can give you a consistent track record, and the fund manager who can do that is one who has a long-term track record.
4. Never gear to buy shares. You can go bankrupt very easily if you gear at the wrong time. If the stock market goes down by 50 per cent, you are finished.

The second case that paid off for Pheim followed the first. During the Asian crisis, Pheim restructured its portfolio and by coincidence, selected many technology-related stocks, so much so that by end-1998, it was overweight in tech stocks. Hence, it was in a position to benefit from the tech craze that saw prices soaring in 1999.

However, by April 2000 — when tech stocks crashed — Pheim had already divested more than 90 per cent of its tech stock holdings.

In practising market timing, Tan says, one must have a strong belief that the market will correct sharply or crash because it is overvalued, so that one can get out of the market.

"The tech and Internet stocks were all selling at between 80 and 100 PER — that gave me the impression that they were at the highest point.

"It was a very simple decision because I felt that it was just way overvalued. To some extent, you must be prudent and say 'Look, I am willing to call it a day'," he adds.

Stock-picking decisions also play a crucial part in determining success; Pheim's top three stock picks during the Asian crisis went up close to 15, 10 and 7½ times, says Tan. He bases his stock picks on an investment criteria of low gearing, strong cash flows, focused management and businesses with growth potential. This, he says, serves as a filter.

Managing funds in volatile markets such as Malaysia's certainly has its ups and downs, and for every few successful investment there must be at least one bad decision. Has Tan made any regrettable decisions?

He pauses, then says: "When the market goes up, you tend to worry that you will underperform. So, sometimes you also follow the herd.

"You will always get those one or two bad decisions through that process, especially when the market has a prolonged bull run. We have had one or two of them; luckily not too many, but yes we have."

He stresses, however, that a prudent fund manager would put only a very small percentage of its funds to buy stocks when the market is running up "so that if you get caught, you won't get caught badly".

While Tan advocates buying low and selling high, he admits that it is a challenge to determine what to do when the market is neither at its bottom nor its peak. And hopefully, one's assessment is always right, he says.

When asked if this assessment is also made based on gut feeling, Tan answers with a grimace: "I think the term 'gut feeling' is very bad — I like to use the word 'experience'."

"We are value investors, but at the same time we also have a keen nose on whether the market is overvalued," he reiterates.

Background

TAN'S OWN NOSE for the market has developed over the years, since he began his fund management career with Seacorp in 1976, at the age of 26 (Seacorp launched the first private unit trust company in Malaysia, Asia Unit Trusts Bhd). He was one of the first few fund managers to be licensed by the securities industry.

"I had originally wanted to work with merchant banks but ended up in fund management instead — certainly with no regrets," he says.

His past achievements include helping Arab Malaysian Merchant Bank (now known as AmMerchant Bank) start up its investment services department, being the first executive director of Arab Malaysian Unit Trusts Bhd and being involved in the Malaysia Fund Inc, the first Malaysian close-end country fund managed by Morgan Stanley, which was launched in May 1987.

It was then that Tan established his reputation by outperforming the foreign managers.

"I saw the overvaluation of our market, so I got out and we were 65 per cent in cash when the market crashed in October 1987, following the US' Black Monday.

"In fact, when the market was at its lowest, we actually went in and bought shares and as a result, we did very well in 1987," says Tan. He was rated by William Mercer Zainal Fraser as the top manager for retirement and pension funds in Malaysia in 1987.

In 1988, Tan moved to Singapore because he wanted "to go regional". He joined DG Bank-GZB (Asia) Ltd as the head of investment management, and subsequently in 1990, became the first director of portfolio investment at John Govett (Asia) Pte Ltd.

In 1993 — after 18 years in the industry — Tan decided that it was time to strike out on his own.

"1993 was a prolonged bull run and I thought, if you want to get out, that was the best time. So I thought, if I can get a licence of my own, why don't I do it for myself?"

On Jan 4, 1994 — coincidentally, the highest KLCI day close to date — Pheim opened its doors in KL. A year later, Pheim set up its sister company in Singapore as Tan wanted to compete internationally; he believes that Pheim was the first boutique fund manager to start operations in the island state.

The Retail Market

PRIOR TO JANUARY last year, the only way that retail investors could access Tan's investment philosophy was through the sole retail unit trust fund managed by Pheim: the Alliance First Fund. Incidentally, this fund, managed by Pheim since 1996, is a multiple winner of the annual

PHOTOS BY ABDUL GHANI ISMAIL/THE EDGE

A Case for Boutique Managers

Fund management in Malaysia has long been dominated by bank-backed institutions, but the region is seeing an increasing number of small boutique fund managers such as Pheim Asset Management Sdn Bhd.

In Australia, there is a growing trend of high profile and successful fund managers leaving large organisations to set up their own specialist boutiques.

According to a February 2003 article in *The Sydney Morning Herald,* investors have followed these boutiques enthusiastically, hoping to cash in on the high returns generated by individuals they perceive as being talented.

In the article, research group Assirt said that the main reason investors choose boutiques over institutional managers is the potential for better investment returns.

"Boutique managers are primarily focused on returns... Experience shows the smaller managers tend to be able to capture opportunities in the market place that may be missed by the larger managers without necessarily taking on additional risk – that is, a boutique can take positions in relatively small companies where there are often attractive returns."

In the same article, Mercer Investment Consulting stated that the positives of boutique fund managers include access to some of the most talented people in the industry; ownership of the firm by key staff provides greater incentive to perform; and generally lower funds under management means greater potential to beat the market.

On the minus side, however, there is the risk that the boutique fund manager as a business won't have the resources to do the job properly and that it may go out of business. For instance, a small firm with limited financial resources may not be able to sustain itself should it run into a long period of underperformance.

CPA Australia, an organisation for finance, accounting and business professionals, describes the boutique approach as "almost a return to the grass roots of funds management. It is stripped bare of big brands and marketing campaigns. It lives [and dies] on the strength of performance".

"But perhaps the key factor that makes the boutique funds interesting for individual investors is that the person who owns the store is the one managing the money," it added.

In an article in its newsletter *Contact*, Watson Wyatt Singapore stated that the perception that larger managers always produce strong performance may be questionable, since the quality of their investment skills may be diluted through client and asset growth.

These problems are apparently rare with boutique fund managers as they have yet to reach their critical mass. Furthermore, the best investment processes are those in which decisions are made by small flexible groups operating by a strong set of beliefs and values.

The Edge-Lipper Unit Trust Fund Awards in the Mixed Asset Balanced Income funds category; it has ranked first since 1998 for different time frames ranging from one- to five-year periods.

However, as at June 30, Pheim no longer manages the Alliance First Fund as Alliance Unit Trust Management has decided to manage the fund in-house, says Tan.

Early last year, the Pheim group launched three unit trust funds for the Malaysian retail market, marketed through wholly owned subsidiary Pheim Unit Trusts Bhd (for more on Pheim Unit Trusts, see Page 35).

Going forward, Tan sees the Pheim Group as being well positioned to compete with foreign fund managers once the Malaysian financial market opens up; its track record as a specialist of the Asean and Far East (ex-Japan) markets will serve it well. And competing with the big boys is one thing that Tan is used to as a boutique fund manager.

It's taken a lot of hard work and stamina, he admits. "When I first started in KL, some people said that we would close shop within two years. But if you are in line with the market, you try very hard, and if you have the stamina, you will surely get somewhere," he notes.

He believes that it is his experience and his passion for the job that have carried him this far. "Passion is very important because without it, you would give up your job. And it is your passion that gives you the stamina to work hard."

For Tan, Pheim's performance track record achievement is like a dream come true.

"It's worth a million dollars when you hit something like this. I particularly enjoy it when I get a good ranking; it's a record, and nobody can take it away from you," he states.

Has much of Pheim's success been due to the fact that the company is small?

Tan contends that being small doesn't guarantee success. "People can say that we perform because we are small, because we go to the Second Board. But if you do the wrong thing, even if you are small, you will also get knocked out.

"That's one thing I like about this job -- you really just have to go down and do the best that you can and it doesn't matter if you are big or small," he reflects.

Long-term outlook

Pheim Unit Trust's three retail funds get the same investment strategies from Pheim Asset Management. Jenny Ng finds out if they work.

BANKING ON ITS investment skills, Pheim Asset Management Sdn Bhd set up Pheim Unit Trust Sdn Bhd early last year, offering retail investors the opportunity to ride on the coat-tails of Pheim Asset Management's enviable track record. Pheim Unit Trust launched three funds — Pheim Emerging Companies Balanced fund, Dana Makmur Pheim and Pheim Income Fund. The funds are managed by Pheim Asset Management under its chief executive, Dr Tan Chong Koay.

For the unit trust funds, Tan adopts the same investment strategies that gave him considerable success at Pheim Asset Management: Never be fully invested except when the market is depressed, and relying on its sense of valuation and market turning points. Detractors can say what they like, but Tan's market timing and stock selection strategies have yielded results.

When Pheim Unit Trust was launched, Tan believed it would give retail investors the opportunity to take advantage of Pheim Asset Management's investment expertise. But selling to the general public has not proven to be easy.

Tan says that while the rich can choose their own fund manager, small investors, especially unit trust investors, are not knowledgeable about investing. So, getting this group to part with their money becomes a test of fund houses' marketing abilities.

"When you sell to the retail public, you need a selling machinery. Our big disadvantage is that we're not known to the public, although the well-informed know about us. We're still new: It'll take a while to penetrate the market," he reasons. Investors will be happy to know that Pheim periodically gives walk-in customers discounts.

All three Pheim funds are permitted to invest the lower of 10 per cent of the fund's net asset value (NAV) or RM10 million in securities listed on foreign stock exchanges. Having an affiliate in Singapore — Pheim Asset Management (Asia) Pte Ltd — helps greatly too, especially in terms of research.

"It's a big advantage because we can cover Korea, Hong Kong, China, Taiwan, India, Australia and New Zealand," Tan says. He boasts that Pheim is the only fund house in Malaysia with a sizeable regional fund. Both Singapore and Malaysia offices manage US$400 million in total.

For example, while tech stocks have performed very well in Singapore and Thailand, Malaysia has few tech companies. Having the 10 per cent window allows the funds to dip into areas of growth outside Malaysia. Pheim invests primarily in Hong Kong and Singapore.

Personal Money talks to Tan and his fund management

Pheim Unit Trust: Performance of funds as at Aug 8, 2003

FUND	TYPE	1-YEAR TOTAL RETURN 8/8/02–8/8/03	RANK	FUND SIZE (MIL)
Pheim Income	Bond: Short-term	9.16	1	5.65
Pheim Emerging Companies Balanced	Mixed-asset: Balanced	10.77	3	39.06
Dana Makmur Pheim	Mixed asset: Islamic/Syariah Balanced	10.47	2	1.63

SOURCE: LIPPER ASIA LTD

General fund information

	EQUITY	FIXED INCOME
Sales charge	Not more than 5% of selling price	Nil
Annual management fee per annum	1.5% of NAV	1.0% of NAV
Management expense ratio	1.55	1.37
Minimum initial purchase	RM1,000	
Switching fee	One free switch per calendar year, subsequent switch at the lower of 1.0% of the switch amount or RM100	
Tel	(03) 2142 8888	
Website	www.pheimunittrusts.com	
E-mail	support@pheimunittrusts.com	

team about Pheim Unit Trusts, which is now in its second year of operation.

Pheim Unit Trust was launched to give retail investors the opportunity to participate in Pheim Asset Management's investment skills and remarkable track record. Would you say the objective has been achieved? How have the funds performed and are you satisfied with the performance so far?

In our view, one should not attach too much importance to funds' short-term performance. Longer-term consistency and performance should be emphasised. We focus on outperforming our benchmarks and also to provide positive returns in the longer term. Based on an independent verification done by investment consultants Watson Wyatt, when all our (Pheim Asset Management Malaysian accounts were combined into a composite these accounts collectively outperformed the KLCI (Kuala Lumpur Composite Index) over the last nine years... since we started operations. We are satisfied with the performance of our unit trust funds. If you look at Lipper's fund tables published weekly in *The Edge*, we are ranked among the top few performing funds.

Pheim Asset Management was eight years old and well established in the investment community when Pheim decided to go retail. What prompted you to do so?

After many years of serving the institutional market, we felt that we had built up a credible track record and a good reputation to penetrate the retail market. We also decided not to launch a growth fund, because we believe that the individual investor need not take on too much stock market risk and that is why we launched two balanced funds and one income fund.

Are the funds managed with the same philosophy applied at Pheim Asset Management? For example, you do not believe in staying fully invested at all times. Instead, you aim to be fully invested near the bottom of a market cycle and trim off your position near market peaks. Will you be using the same aggressive contrarian approach when it comes to managing unitholders' funds?

We strive to employ the same investment philosophy and strategy for all our clients, subject to the constraints bound by the respective investment mandates. So our philosophy of not being fully invested at all times applies to the funds managed under Pheim Unit Trusts. Our

Managers Behind the Funds

Chong Chee Fire, CEO, Pheim Unit Trusts

Chong has more than 18 years of experience in the banking and financial services industry. Chong was previously executive director of Hwang-DBS Securities (Johor Bahru) Sdn Bhd, is a fellow of the Association of Chartered Certified Accountants and holds an MBA from Bradford University, UK.

Chan Choong Tho, associate director, Pheim Asset Management

A chartered financial analyst, Chan joined Pheim in 2000 with seven years of experience in investment research. Prior to Pheim, he was the vice-president for equity research at Salomon Smith Barney in Kuala Lumpur. Chan has also worked with RHB Research Institute and Hwang-DBS Securities Bhd.

Dr Tan Chong Koay, chief executive officer, Pheim Asset Management

Tan has 26 years of experience in fund management locally and in Singapore. **(See page 36 for his profile)**

Kevin James Padasian, investment analyst

Kevin, who joined Pheim in 2000 has a bachelor's degree in business from Monash University, Melbourne. He was a treasury officer with a local licensed finance company for three years.

Pheim Unit Trust: Top stock holdings as at July 31, 2003

	PHEIM EMERGING COMPANIES BALANCED	DANA MAKMUR PHEIM	PHEIM INCOME FUND
Top 5 stocks	Malaysian Plantations WCT Engineering Sanbumi Holdings Axis Systems Holdings Ltd AMFB Holdings (Foreign)	Hong Seng Lee WCT Engineering PJI Holdings Crest Builder Holdings Tasek Corp	Alliance Bank M'sia – Subordinated bonds Kwantas Corp – Bonds Kenmark Industrial Co – Bonds LBS Bina Group – Bonds WCT Engineering
Foreign stocks	Axis Systems Holdings Ltd GA Holdings Ltd Golding Soft Ltd PT Bank Mandiri Sing Lun Holdings Ltd	Axis Systems Holdings Ltd	Axis Systems Holdings Ltd Devotion Eco-Thermal Ltd

Asset allocation as at July 31, 2003

FUND	EQUITIES (%)	FIXED INCOME & CASH (%)
Pheim Emerging Companies Balanced	58.6	41.4
Dana Makmur Pheim	46	54
Pheim Income	9.4	90.6

market was very volatile between 1987 and 2000; it has crashed seven times compared to the US market, which crashed once or twice in 13 years. It's so volatile that if we fully invest and by coincidence, you're able to raise new money when the market is hot, it'd be difficult to make money from equities. Conversely, if you raise money and go in when the market is low, then your chances of making money is high. Our investment philosophy is working in this part of the world. Having a keen sense of valuation and the market's turning point is important.

Our approach has been described as contrarian but all we are doing is buying when stocks are depressed and selling when stocks are deemed to have run to overextended levels. At times, people think this is a risky strategy; we think otherwise. Our aim is to provide consistently good returns to our clients and unitholders at a reasonable level of risk, as opposed to the idea of achieving maximum returns while taking maximum risk. Again, that is why we have so far launched only balanced and fixed income funds and not high-growth aggressive equity funds.

When Pheim Unit Trust was first launched, you were reported as saying that you aimed to attract RM50 million to RM100 million to be invested via the three funds by end-2002. Today, almost 18 months later, the funds' total asset under management is RM46.34 million (as at Aug 8). What is the reason for the shortfall? Has the fact that Pheim is not bank-backed made it a challenge getting the investing public to put their money with it?

Our strength is our track record. A strong record, however, is only one-dimensioned when competing for a share of funds from individual investors. We need to strengthen our brand equity and distribution. Also, following the launch of our funds in January last year, the stock market peaked in April, only to be followed by a 13-month period of weakness. With many investors wary of the stock market during this period to May this year, we have met some resistance when approaching potential clients. Of course, during that period, having a bank's brand name attached to the fund would have helped, but in the long run we are confident of achieving our targets even without a bank behind us. At present, with the upturn in the stock market, our funds have started to perform strongly and we look forward to delivering stronger returns to our clients, should the market continue to move up. We stick to our belief that with a good track record, we should be able to expand. We have many awards in Malaysia and the region; we will continue to follow our investment philosophy.

Are you concerned that the size of the fund may be perceived as disadvantageous in any way? Some say small funds are easier to manage while others assert that a fund house needs a large fund size to stay in business. Can you remain small yet profitable?

Smaller equity portfolios are generally nimbler and when managed well, can provide highly rewarding returns. However, not all small portfolios are managed well. On the contrary, there are many small equity portfolios that are poorly managed. So, picking a good fund manager that is managing a small fund can also be tricky for the individual investor.

We are not unduly concerned about our short-term profitability, as we strongly believe that we will eventually be profitable. There is no doubt about that. Unit trust

CONTINUES ON PAGE 44

Whither bond funds?

Bond fund investors can say goodbye to double-digit returns as the bond bubble has finally burst. With expectations of rising interest rates further down the road, what can investors do now? **Jenny Ng** explores.

With the onset of the Asian financial crisis, bonds became investors' darling. Fixed income investment vehicles were the reigning kings as investors took shelter in the stability offered by these instruments as equities tumbled. There was no let-up in the volatility of the equity markets as geopolitical flare-ups continued to send shock waves across markets the world over.

Equity bulls are breathing easier now. In Malaysia, the economy is picking up slowly but gradually. The Kuala Lumpur Composite Index has gone up by 12 per cent since the May stimulus package was announced. And for bonds, the party appears to be winding down.

A turning point for bonds

"The recent moves in bond prices post-stimulus package at the end of May did cause bond prices to move up sharply to overdone levels, which were not sustainable. Following some price correction in the US, the local bonds prices and yields have since adjusted to more acceptable levels in the last few weeks," says Connie Ong, executive director of KLCS Asset Management Sdn Bhd.

Beginning in mid-July, Malaysian Government Securities (MGS) have been hit by a sell-down, pushing yields up by 50 to 70 basis points. There were several reasons investors were selling.

Edward Iskandar Toh, portfolio manager of Avenue Asset Management Services Sdn Bhd, explains that the local market — like the rest of the world — was taking its cue from the US bond market.

"Firstly, the small Fed [Federal Reserve] fund rate cut in June of a quarter basis point meant that interest rates had bottomed. Greenspan has said that deflation is not a threat and we're seeing positive numbers from the US market. Starting from there, the yields for the US 10-year Treasury notes have shot up from the end of June," he says.

The US government's plan to issue US$60 billion in Treasury notes in August – part of its plan to borrow US$104 billion in the third quarter — further compounded the fall in prices and surge in yields. As more positive data emerged from the US, bonds continued to slide. Toh notes that the yield curve for the 10-year Treasury notes has gone up 125 basis points compared to early July.

The spike in MGS yields is also attributable to Bank Negara's announcement of new bond issues towards the end of July, which indicated an increase in the supply of bonds coming into market. Indications from the authorities that there would not be further rate cuts contributed further to the bearish sentiment in bonds.

"But one of the main signals is that the economic outlook definitely appears more positive now, which means growth is expected to pick up," Toh adds.

Ringgit sovereign bond prices fell and by July 28, yields were up to a seven-month high. Abdul Razak Ahmad, senior vice-president for investment at SBB

Yeah: Go for papers with shorter horizons as well as those with floating rates

Abdul Razak believes the orrection in the bond market is a healthy one

PHOTOS (YEAH) KENNY YAP/THE EDGE; (RAZAK) MOHD IZWAN MOHD NAZAM/THE EDGE

Asset Management Sdn Bhd, says local bond players took the opportunity to take profit on their holdings. Dr Yeah Kim Leng, chief operating officer and economist at RAM Consultancy Services Sdn Bhd, says there has been selective sell-down in bonds by those taking positions with a belief that improvement in external economic conditions would lead to better economic performance locally, which might then lead to tightening in monetary policies, putting upward pressure on interest rates.

Razak believes the correction in the bond market is a healthy one but he emphasises the need to differentiate between the US and Malaysian markets by examining the fundamental issues. He believes the local short-term rate provides sufficient cushion against any drastic rate hike in the US where the federal fund rate of 1.0 per cent is at a 45-year low. He does not think interest rates will be raised in the near future given this buffer, high liquidity and mild inflation the Malaysian economy is experiencing. There is no pressure to raise short-term rates as inflation is not an issue now giventhe excess capacity in the economy.

Saying goodbye to double-digit returns

As the markets shift, bond fund investors need to manage their expectations.

"From hereon, investors need to lower their expectations of 8.0 to 12.0 per cent returns per annum from the last few years to the more down-to-earth 5.0 to 6.0 per cent. Even at these levels, yields are still higher than FD returns," says Ong of KLCS Asset Management.

Double-digit returns from bond funds were to be expected in the two years following the 1998 crisis. When interest rates came tumbling down, bond prices soared as reflected in robust bond fund returns. But double-digit returns today, despite a prolonged period of low interest rates, have raised some eyebrows.

Toh: Invest in shorter-term bonds to reduce the risk of rising interest rates eating into returns

Yeoh: Have a diversified portfolio, spread out in equities and bonds with a good mix of short-term and long-term bonds

"Some funds are giving returns of 8.0 per cent, and some double-digit. A year ago, that was possible but in today's market it's not possible. Even the EPF has lowered its dividend rate," says Thomas Yeoh of Rating Agency Malaysia Bhd.

How do some funds manage to present double-digit returns even today?

"It depends on the manager's ability to manage the portfolio and its policies. Some diversify into triple-Bs and if luck is on your side and it doesn't fail you, then it's possible," he explains.

Yeah of RAM Consultancy Services adds that in a recovering economy, the probability of default is lower, bringing down the debt's credit risk. The problem is, as the economy inches towards recovery, interest rates edge up too, which leads to capital depreciation for bond funds.

"The funds' performance will depend on the manager's active portfolio management capabilities in managing credit risk, liquidity risk and market risk," he says.

According to Yeah, in a young economy, there are opportunities to invest in high-yielding bonds because while the economy is still booming, the likelihood of default is low, giving rise to opportunities for credit arbitrage. If the manager's research proves to be right, the company pays up and the fund earns good returns.

SBB Mutual Bhd's SBB Bond Fund registered a one-year return of 18.07 per cent as at Aug 3, 2003, according to the Lipper fund performance tables. Abdul Razak Ahmad of SBB Asset Management, which manages SBB funds, responds that the fund takes a proactive trading stance and had shifted a significant portion of its portfolio to A-rated bonds from triple- and double-As papers.

"We feel that the MGS, triple-As and double-As have come down a lot while A-rated papers have not. Most of these

PHOTO: KENNY YAP/THE EDGE

A-rated companies were given that rating because they are cyclical in nature and when you expect the economy to recover, then those companies should do well," he explains.

While some may deride the move as risky, Razak points out that risk is relative. For example, the fund does not hold any MGS as they reflect the risk-free rate and are constantly subject to market volatility.

"Even though, credit-wise, it is very safe in terms of movement in prices, it can move violently and we don't think our investors can stomach that," he explains.

What next for bond investors?

Before dumping fixed income for equities, consider the characteristics of the two instruments. Bonds will always supply a steady stream of income while equities will always be subject to market volatility.

Toh believes that for long-term holders of investments in bonds, it is advisable to invest in shorter-term bonds to reduce the risk of rising interest rates eating into returns. Rising interest rates will lead to depreciation in bond prices, which will then be reflected in bond funds' returns. The only way to reduce this risk is to go into papers with shorter duration that are less sensitive to interest rate movements.

Yeah of RAM Consultancy Services agrees that shorter-term papers will be favoured. "Go for papers with shorter horizons as well as those with floating rates. Don't lock into long-term instruments with fixed rates."

But Toh of Avenue Asset reminds investors that it is not gloom and doom all the way for bonds. The country's monetary policy would still favour a low interest rate in support of economic recovery and will only edge upwards when signs of inflation become visible.

Yeoh of Rating Agency Malaysia advises investors to have a diversified portfolio at all times, spread out in equities and bonds with a good mix of short- and long-term bonds. Most importantly, they should have their own set of objectives and plan. Also, investors should examine their fund managers' performance and policies.

As fund managers always say, there will always be a place for fixed income instruments in one's portfolio. However, investors in bond funds must now lower their expectations of the double-digit returns seen in the last few years.

FROM PAGE 41

investing is about the long term and we are definitely here to stay and will continue to focus on striving to provide our unitholders with consistent long-term outperformance. At the moment, we believe that there are not many investment houses that have been able to secure strong long-term performances.

How do you plan to bring in more money? How are the funds distributed now? Are there plans to promote Dr Tan and Pheim Asset Management's record of outperformance among retail investors?

We will continue with our marketing efforts to obtain a visible share of voice in the unit trust market. We will continue to push for more IUTAs [institutional unit trust agents] to carry our funds and recruit more agents. It is only a matter of time. Some IUTAs want to see a good long-term record, which we should secure with the passage of time. Our funds are carried by Standard Chartered Bank, AmBank and our distribution force.

How do you view the current bullish sentiment in the market? What position are Pheim Unit Trust's equity funds taking?

We expect the Malaysian stock market to remain firm and the uptrend, which started in late May, should continue. Factors like strong regional markets, attractive valuations, and accommodative fiscal and monetary policies are already in place and will continue to provide the foundations of the uptrend. A key shift in asset allocation is expected to benefit Asian equities — an asset class that remains attractively valued, based on global comparisons. Increasingly, there is anecdotal evidence that more investors are keen to move away from fixed income instruments towards equities. With interest rates at record lows in many countries, fixed income instruments may preserve capital but are increasingly unable to provide an attractive rate of return. Second, among regional markets, Malaysia clearly stands out as a market that has not moved significantly and valuations remain compelling. Although many large capitalisation stocks are trading at higher PER [price-earnings ratio] multiples, many strong medium-sized companies are trading at discount valuations of less than 10 times forward PERs. Against this background, we continue to seek companies that have attractive valuations, strong cash flows, healthy balance sheets and good management.