



## Interview with Sid Klein, Japan Asia Investments Canada

*Eurekahedge*

Sid Klein began in the securities industry as a stockbroker in 1982, focusing on large-cap US value stocks and derivatives. Following Brault Guy O'Brien, Sid joined Midland Doherty in 1984 and then Prudential Bache Securities in 1987. By 1989, his focus had shifted to Japan. Actively trading long-term euro-put warrants from the peak, Sid became acquainted with the OTC derivatives business, as a result of which he began structuring long-term warrants on baskets of stocks. The focus was those stocks whose long-term performances he expected to be in-line with equities whose volatilities in the shorter run were much higher, thus causing higher volatility premiums. The life of the warrant covered a period, however, during which there would be a convergence of performance between his selected equities, with those that had had higher volatility premiums, according to his analysis.

The *Sid Klein Comment* has been online since 2001, though reports were continual since the late 1980s, when writing for clients as a retail stockbroker.

Combining a quarter-century of expertise that includes publicly verifiable and repeated precision in major international markets (Japan/Asia-specialised), with a further specialty in derivatives, Sid now seeks to transition from writing ideas for readers, to investing in those long-dated and leveraged structures that are tailor-made to these times, by emulating a high-performance synthetic hedge fund.

### **1. Tell us a little more about your proposed global outperformance warrant fund. What are its salient features? What are the strengths and weaknesses of its investment processes?**

Its salient features are:

- Capacity not constrained, compared to the limitations of listed warrants' issue sizes
- Warrants are originated by the manager, according to strategic needs and forecasts; no need to search for or research product
- Intrinsically a long/short fund
- A long-only product
- Listing after closing (US\$100-200 million)

The single greatest strength is the capacity of the manager to fashion product (ordinarily an investment banking business) for the manager's own investment. The weaknesses would be liquidity (I discuss how to turn this to a positive later on) and the credit rating of the issuer. Whether Chinese or American product, currencies or precious metals, the issuers are the largest multi-nationals in their respective countries and markets of expertise. I disfavour US banks.

### **2. Does the fund's strategy favour specific regional or asset class mandates? Are there any set weights for the fund's geography and asset class allocations?**

Structured outperformance warrants may include any combination of equity, precious metals and currency markets.

My global view is that we are very late in the long economic cycle and have actually rolled over. In terms of financial markets, the bullish equity story is Asia, long term, though we are in a bear cycle led by New York. The clear secular bull market is in Japan, however, and its corrections will be cyclical, such as we had from 2006 until just recently (Japan is ten years ahead of the pack). There are secular bull stories in gold (silver) and the yen now, as well.

There are no set weights so that there is the flexibility to adjust, according to the changing global themes and trends, over the long term.



**3. Synthetic warrant funds are by definition unique; nevertheless, how does your fund propose to differentiate itself from other managers employing a similar strategy (for instance, there are a few synthetic warrant funds listed in the EurekaHedge databases, with exposure to pan-Asian/Japanese markets), in terms of absolute returns and/or minimised risk?**

Outperformance in the markets of this fund's focus is less volatile on a risk-adjusted basis because there is a general similarity of equity and metals trends. I believed and wrote that the warrant I initially structured would go up no matter what, because I believed the bull component (a Japan index) would outperform in an unforeseen continued global up-trend, while certainly doing so in a global downturn, since I related that to a 50% decline (albeit not so quickly) in China.

As for the premium play, it is simple. Suppose the premium of a warrant is the same as for its outperformance versus another index. Then, if I believe that the two markets will go in opposite directions over time, I feel like I got the put on one side or the call on the other side for free. Simply, in such situations, the premiums are cheap according to the extent to which I believe the indices will diverge. (That would be an example of hedge fund efficiency, in synthetic terms.)

The fund may use currencies, precious metals, Japanese indices and baskets of Japanese stocks (which form an "index"). Finally, apart from choosing the expiry date – the fund's warrants will generally issue at 2.5 years – the warrant's long or short side may form any multiple of that index. (I expand on this below.)

In any event, I believe this is all differentiated (again this is further elaborated below).

**4. Would you say that the investment strategy is better suited for volatile markets? Is there any back-tested market data to show how the proposed fund would have handled current market conditions?**

(As I mentioned above) The first recommendation of which I wrote in December was a Japan/China 2-year warrant play. I projected that it could conservatively return 500% and then somewhat better, if managed and/or adjusted well. Either the outperformance warrant's bull or bear components may be in any multiple. For example, instead of a warrant on the outperformance of X versus Y, the denominator may be doubled, suppose. It would be the outperformance of X versus 2Y. In one instance, the accent is on profiting from one index going up, while in the other case, the outperformance warrant's accent is on profiting from the other index's decline. This strategically alters the risk scenario.

In the case of the outperformance warrant I engineered in December, the indices selected from Japan and China was chosen for maximal performance, but there was still the matter of the ratios. For example, at year-end I was convinced that Shanghai was about to collapse. At times in the future I might weight the warrant to do even better when Japan goes up, than when China goes down. Where we are in the respective trends and considerations of timing are obvious determinants.

Finally, by tinkering with ratios, I create the "chart" I want. In fundamental terms, this would be akin to creating the semi-fictitious fundamental and economic background against one wants to bet. The investor is molding what *is*, into what is most easy to profit from.

The reason for different ratios at different times can be seen today. I forecast and identified the Shanghai's recent low, and so wouldn't structure a warrant today with China as the bear component, on a one-to-one basis.

So, among the many possibilities when calling a turning point, apart from merely liquidating, is trading or adjusting the warrant's index ratios. In this case (Japan/China), the spike up for the warrant was right from the get-go. So, it was even more so the case that there was a lot of time left for the security. One should sell against, long-term and lower annualised premiums. Remember, the longer the term, the lower the annualised premium. Some want a very long-term structure, simply due to the uncertainty of markets. However, when paying for time, it shouldn't merely be sold away. Time is a right one can trade against, to maximise value, which becomes easy if in a strong profit position.



Therefore, the idea includes capturing low-premium environments, before enjoying expanding volatility. If the investment bank does not pass on the increased volatility premium of the long warrant, it could be asked to purchase a shorter term warrant, shorted by the fund against the long warrant.

Premium expertise is crucial to the maximal success of the investments; this is the crucial complement to integrative global markets analyses. The reason the "house" can be beaten is precisely because the market is open, thereby assuring more standard pricing (or alternative shopping).

In all cases, I have to believe that one component is in a long-term bull trend, while the other is in a long-term bear trend. I have to believe that over the long term, both sides will work and that I'm capturing some premium advantage as well, and precisely partly due to the fact that they are counter-cyclical.

**5. *What potential risks to the fund's performance potential have been identified and how do you propose to mitigate them?***

Cross-charts (which is how one tracks outperformance) are easier to read and, similarly, trend breaks can be much easier to identify. They don't happen so violently as is the case with straight charts, of course.

Given that the warrants are 2-2.5 years at issue, the capital risk after a year is limited. In lieu of a trend-break, the passage of a year with no movement, say, would have to be treated like a break as well, under certain circumstances. So, even heavy losses (for a 1-year period) such as what would occur if the forecasts for markets were just wrong, if somehow the warrant were down 50% after a year, then that is compensated for by the fact that leverage in each case is unlimited.

Of course, diversification is a factor as well, in using the expertise in the areas of importance for this phase of the long cycle. With a combination of forecasting accuracy and premium and timing acumen, the potential is fascinating. And, again, all the financial markets that are crucial in this cycle are available to the fund.

Regarding credit risk, US banks disinterest me. The largest multi-national banks in Europe and Asia provide the necessary expertise in ALL the markets that are of concern to this fund.

**6. *What is the typical holding period for the warrants? How easy/painless is it to exit these positions in the event of an unanticipated counter-trend?***

Regarding the problem of liquidity, it is in capturing expanding volatility premiums, as is easily the case with listed options when volatility increases. Capturing expanding volatility premiums occurs more easily at later stages in the trend. The opportunity to select strike prices and dates provides more than offsetting premium bolstering factors.

In any event, the OTC-warrant market has been around for a long time (I was trading it almost two decades ago) and the well capitalised, highly specialised banks provide the market. Everyone wants to maintain reputations that do not hurt their opportunities in a massive investment banking business. The competition is huge.

Regarding holding period, if a 2-2.5 year warrant runs 500% in two months, I might sell, but one should treat that outcome as the exception, rather than the rule, of course. Otherwise, I proposed above what I would prefer to do to maximise yield (maintain the long-term warrant and trade against it). I also wrote that I would be hard pressed to go beyond a year, holding a position that wasn't working. So, holding periods are long for the investment type, but adjustments may be dynamic (timely).



**7. *What near-term trends do you foresee in the markets that you plan to allocate to? Could you illustrate how your fund might capitalise on such trends?***

Japanese indices and baskets of Japanese stocks as indices, gold or silver and the yen are the global outperformers, coincident with secular bear markets most everywhere else. At the end of the year, I forecasted a hard decline in the first quarter. I felt that it would include Japan's cyclical low (the end of the correction of the secular bull market's first leg up), as well as China and the US' peaks.

At the recent extremes, I wrote that the markets have hit their tops/bottoms for this cycle for the next 3-6 months. This is a wonderful time to plan for what will be even greater opportunities, in terms of depth and speed. The "simplest" money has been made, but that's the nature of the beast.

I continue to look at US equity index concepts priced in gold, playing with the ratios according to timing. Similarly, there are outperformance structures that are best priced in yen or gold. In this case, there is now a third component in the warrant's structure.

What I would be doing in the fund with these 3-6 months of countertrend activity, apart from "planning", would be legging into the outperformance plays of 2008-2010, using ratios that reflect where we are in these ongoing countertrend moves

**Contact Details**

Sid Klein

Japan Asia Investments Canada

+1 514 939 2221

[sid@sidklein.com](mailto:sid@sidklein.com)

[www.sidklein.com](http://www.sidklein.com)