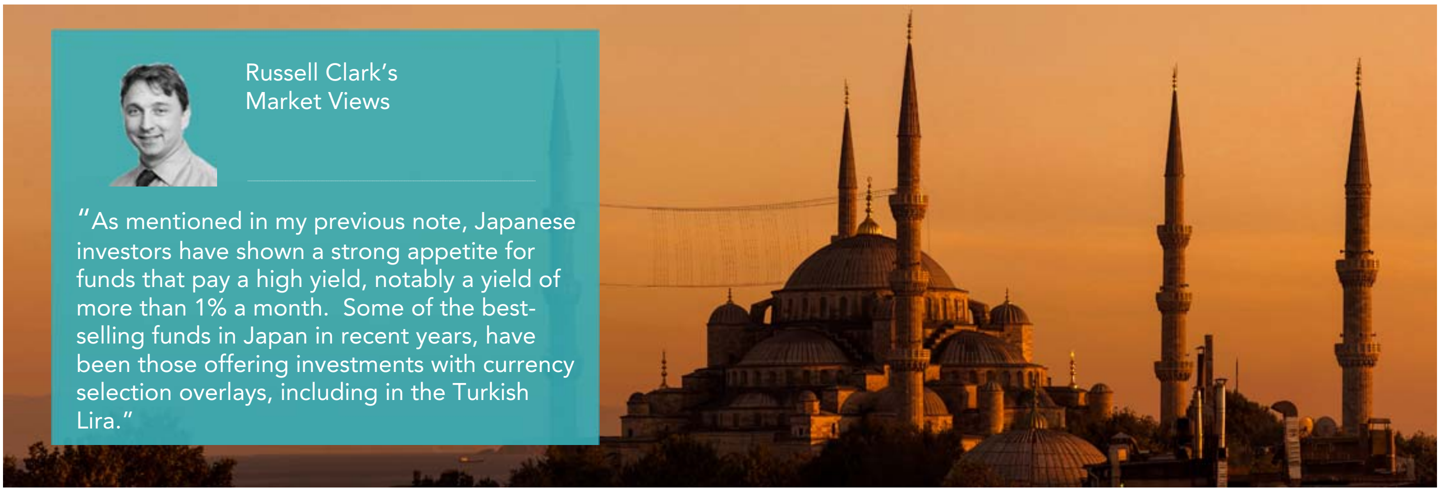
HORSEMAN CAPITAL MANAGEMENT

JAPANESE CURRENCY SELECTION FUNDS AND THE CASE FOR LONG JAPANESE YEN SHORT TURKISH LIRA



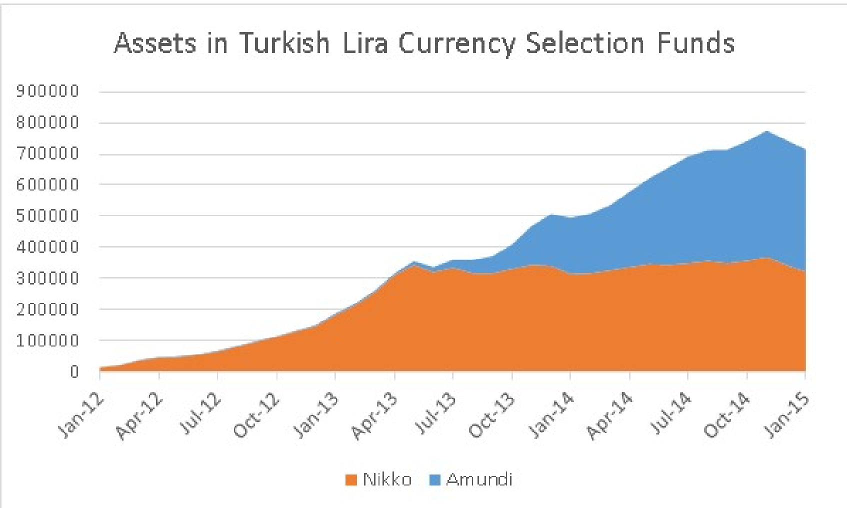
As mentioned in my previous note, Japanese investors have shown a strong appetite for funds that pay a high yield, notably a yield of more than 1% a month. Some of the best-selling funds in Japan in recent years, have been those offering investments with currency selection overlays, including in the Turkish Lira.

In our research we have found two funds that dominate the assets flows into Turkish Lira. They are Amundi's European High Yield Fund and the Nikko Pimco High Income Sovereign Debt Fund. Both funds have the Turkish Lira currency selection as their largest asset class.

While almost all the literature for these funds are in Japanese, Nikko Asset Management provided a useful English description of how they work. http://en.nikkoam.com/files/english_press_releases/2009/release_090701_01_e.pdf

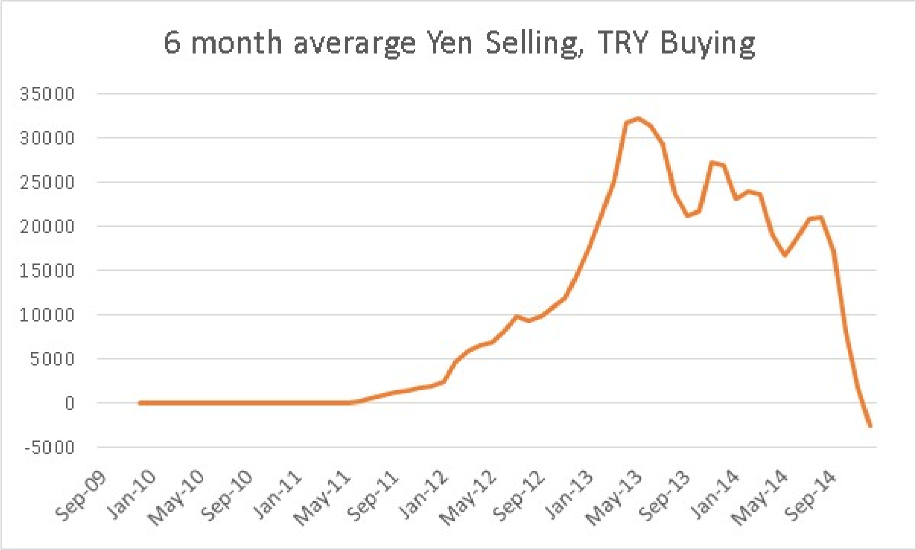
For example, when an investment is made in the Nikko Fund – TRY class, the asset manager will sell Yen, to buy the underlying fund (USD denominated EM bonds). The asset manager will then sell USD and buy Turkish Lira as a forward FX contract. As the bond investment still exists, this can be thought of an additional 100% leverage to the initial investment. The total return to the investors will then come from three parts. First the return on the emerging market bonds. Secondly on the difference between interest rates in Turkey and the US, and finally the exchange rate between the Yen and the Turkish Lira. While I am aware Japanese retail investors are very familiar with foreign exchange products, I spend my days spending most of my time looking at currencies and bonds, and it took me a long time to understand how these funds work. I suspect many investors in the fund are not fully aware of all the risks that are being taken on their behalf.

According to Bloomberg, the total return of the Pimco Emerging Market Bond Fund from the beginning of 2012 is 11.4%, while offering a 0.4% monthly dividend. Interest rates in Turkey have averaged 7% over the period, implying another 7% return to the fund from interest rate differentials. Furthermore, due to QE from Japan, the Yen has actually fallen by around 6% over the period, which again would help the fund returns. The last two years have been very benign for this fund structure. The total return of the Nikko fund – TRY course has been 59%, with an annualised return of 16%. Given the high dividend yield, investors at the beginning of 2012 have had over half their capital returned to them.



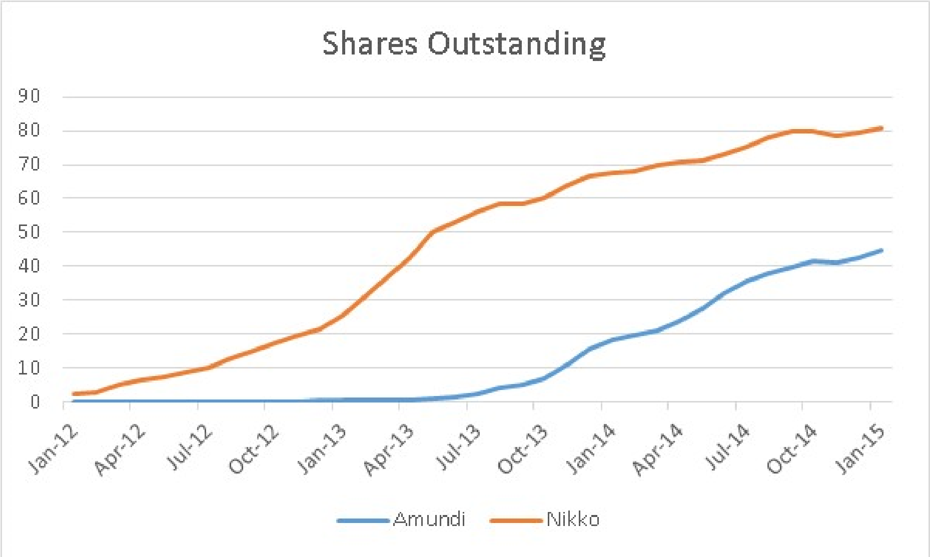
What is interesting to me is that when these funds raise assets, the net effect is to sell Yen to buy foreign bonds and to buy Turkish Lira. When assets start to fall this fund will sell the foreign bonds and sell Turkish Lira versus Japanese Yen. These funds have a source of natural cash flow – that is subscriptions into the fund. We can easily model this by multiplying the NAV by the change in shares over one month. When cash comes in, we should see Yen selling.

There is also a natural outflow from the fund, which is the dividends paid to domestic Japanese investors. In order to pay the dividend the fund will sell Turkish Lira to buy Japanese Yen. We can model this by multiplying shares outstanding by the dividend payable.

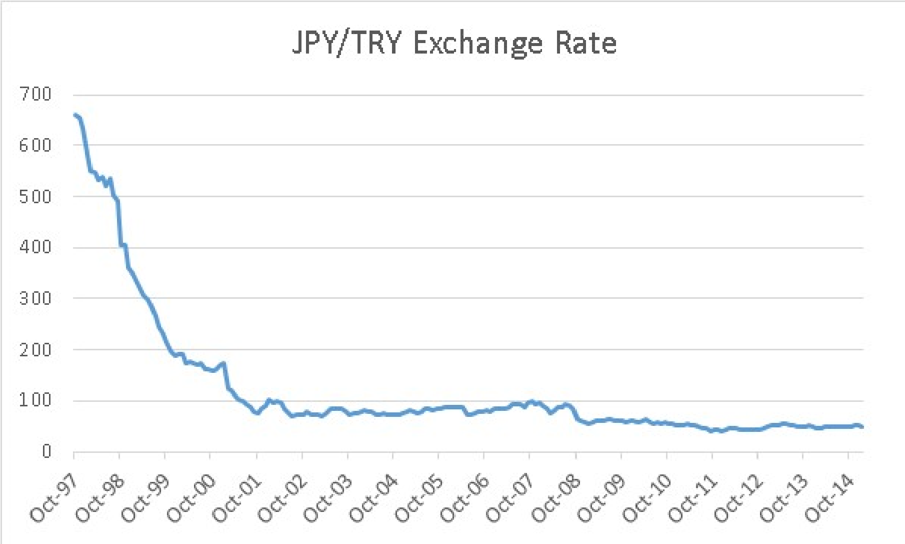


Above we combine the natural cash inflow and cash outflow. We have used a six month average to smooth the numbers, but we can see that the funds have ceased to be net buyers of TRY, and if anything have now become sellers as they need to sell holding in order to fund dividend payouts.

These two funds have assets of roughly 6bn USD. This is substantial in terms of market size. The ishares Turkey ETF in the US has 557m USD market cap. The Vanguard Emerging Market ETF – VWO US – USD47bn of assets - has about USD500m invested in 5 largest Turkish stocks. Even in economic terms, the investment by these funds is substantial. The Turkish current account deficit is roughly 3bn USD a month. Over 2013 and 2014, on average these funds alone were buying around 250m USD of Turkish Lira. Recent data points would suggest that they have stopped buying, and could become net sellers soon.



Intriguingly both funds continue to raise assets, but should they stop raising assets, and have no capital gains, then they would need to sell 173m USD of Turkish Lira a month to just pay dividends. If there was a shock, and both funds saw a sudden 10% redemption, that amount would quickly rise to 800m USD of Turkish Lira.



The long term graph of Yen versus Lira suggests the Lira has a habit of devaluing. I see either Turkish Lira weakness or Yen strength as looking increasingly likely.

INFORMATION

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