LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 31 Dec 2008

1. Introduction

Fellow Investors,

Welcome to the inaugural Lighthouse Advisors newsletter. This marks the first quarter of operations.

First, a word of thanks. Without you, Lighthouse Advisors would not exist. It is never easy to entrust your hard-earned money to someone else, and your manager is grateful to be given this chance. You can rest assured that both your money and your manager's own money will be invested in the same way.

This newsletter follows a simple format. Readers who wish to get an update on investment returns can jump directly to the portfolio review, while those with an interest in the capital markets can read the market commentary first. This issue includes a special section on Madoff Investment Securities, which is turning out to be one of the largest frauds (US$50bn) in history.

Your manager wishes you all a Happy Lunar New Year.

2. Market Commentary

The market turbulence of 2008 has been attributed to myriad factors: artificially cheap credit, incorrect incentives, conflicts of interest, greed and so on. To your manager, it seems to be largely a failure of common sense.

It is human nature for people to maximize their incentives. Therefore, it is vital to structure incentives properly in order to get the desired behaviour. Unfortunately, too many firms used proxies and decided that "close enough" was good enough.

As has become obvious in the last 3 months of 2008, close enough was *not* good enough. In fact, it was way off. Improper incentives, pursued to their logical conclusion, ended in tragedy. Paid on volume, mortgage brokers encouraged people to buy overvalued houses. Paid on volume, investment bankers created toxic securities. Paid on volume, relationship managers sold toxic products. And so on.

For a while, this created a positive feedback cycle, and things went swimmingly for everyone. Easy credit terms helped grease the wheels of commerce further. But you can only build a house of cards so high. As house prices in North America and Europe peaked and finally fell, consumer spending dropped as people realized their homes were no longer a source of easy money.

The resulting knock-on effects spread globally, with corresponding drops in industrial output everywhere. Accordingly, capital markets worldwide were sold down as investors scrambled to exit in the hope of avoiding future losses.

But just as trees grow anew from the ashes of forest fires, in today's losses are sown the seeds of tomorrow's profits.

Has the world changed? No, not really. People still eat, drink and buy goods. Business goes on as usual, albeit at a more sober pace. The only change is that the collective belief that we were in a new Golden Age of prosperity has temporarily passed.

Without doubt, a new mania will eventually descend upon us again, and people will once more believe that prices can only go up, that "this time is different." But to quote German philosopher Georg Hegel, "We learn from history that we do not learn from history."

Charles Mackay's classic 1852 treatise *Extraordinary Popular Delusions and the Madness of Crowds* describes the Mississippi Scheme, the South Sea bubble and the Tulipomania, three financial manias that seem quaint today. And yet, when one substitutes "dotcom", "houses" or "China stock" for the Company of the Indies, the South Sea Company, or even a viceroy tulip, uncomfortable similarities emerge. The more things change, the more they stay the same. Or, as the French might say, *plus ça change, plus c'est la meme chose*.

At that next euphoric point in time, if your manager has not yet taken leave of his senses, you will see him selling stocks that continue to climb higher, and sitting on cash and bonds being eroded by inflation. "Buy, you fool!" You may think. And you may then withdraw money to deposit with another manager who is riding the "new economy" and making great profits from "growth" stocks. Your manager can only counsel that investment risk is greatest when recent returns are highest.

For now, a mood of depression prevails in the stock market, and prices are kept low by the gloomy short-term outlook. This is a cause of great excitement for your manager, who is very optimistic that at today's prices, future investment results are likely to be highly satisfactory. At the very least, with a time horizon of 3 years or more, it appears difficult to lose money if one invests sensibly.

I will write to you again when the report for the quarter ended 31 March 2009 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
3 Feb 2009

3. Portfolio Review

The Reference Account began in mid-November 2008 with Net Asset Value (NAV) set at $100.00 per unit. At the end of 31 December 08, NAV was $101.02 per unit, net of all fees. The highwater mark was $101.02, a new high. Total net return for 2008 was 1.0%. Five securities made up 53%, with the balance 47% in cash. A pie chart is attached in Annex I.

As this is the first portfolio review, all the securities are new and will be briefly described. Subsequent portfolio reviews will focus on new additions and divestments.

ARA Asset Management manages properties for several real estate investment trusts in Singapore, Hong Kong and Malaysia, and a private Asian real estate fund. Assets under management currently total $12bn. If the current poor economic conditions persist, asset value writedowns are inevitable, but a sensible appraisal suggests that impairment will be neither significant nor permanent. The business model requires practically no cash, so almost all the earnings translate into free cash available to shareholders. At purchase, the gearing (debt to equity) was 23%. The price paid was about 7 times 2009 earnings, and dividend yield exceeded 9%.

Ascendas India Trust is a real estate investment trust focused on India. It owns office buildings in Bangalore, Chennai and Hyderabad. Its major tenants are multinational companies such as Pfizer, Applied Materials and Invensys, so credit quality is excellent. Office space continues to be in short supply, especially in Bangalore, and the Trust should have little trouble maintaining full occupancy at attractive rentals. At the time of purchase, the gearing was 6%, price to book value was under 50%, and dividend yield exceeded 15%.

CH Offshore is a shipchartering company servicing the oil and gas industry. It owns and charters out anchor-handling tug supply (AHTS) vessels. The world AHTS fleet averages over 25 years in age. Recent newbuildings will not suffice to replace vessels being scrapped, so there is a supply shortage. The company's fleet averages less than 5 years in age and is competitive in the global chartering market. At acquisition, the gearing was just 7%. The price to earnings ratio was under 4 times 2009 earnings, and the dividend yield was 8%. It also traded below book value.

People's Food is a large independent pork processor in China. It operates several abattoirs and sausage plants across China. The company has been battered by a recent pork shortage caused by an outbreak of "blue ear disease" which raised raw pork costs. As the pork supply recovers, raw material prices will decline, and profitability should return to normal. At purchase, gearing was 3%, price to earnings ratio was 6 times today's depressed results, and the dividend yield was about 5%. The stock sold below 75% of book value.

Straits Asia Resources operates 2 coal mines (Sebuku and Jembayan) in Kalimantan, Indonesia with over 110m tons of proven and probable reserves. Output is currently about 9m tons of coal per year, with plans to double this in the medium term. The reported gearing is 78%, but book value is depressed as the Jembayan coal mine was purchased cheaply. After further drilling, recoverable reserves have been significantly upgraded. More upgrades are expected as drilling continues on the remaining unexplored 85% of the Jembayan concession. Most of 2009's output has been sold at comparatively high prices, so 2009 earnings should be more than double those of 2008. Farther out, future operating margins are uncertain, but a conservative appraisal of likely cash flows suggests a bargain. The stock was bought for less than 3 times 2009 earnings, with a prospective dividend yield exceeding 15%. In discounted cash flow terms, it sold below half its estimated net present value, and at a discount to your manager's worst-case estimate.

<u>Note</u>

In your manager's humble opinion, there were too few selections in the Reference Account as at 31 December 08 to provide adequate diversification against mistakes. However, securities are not bought merely for diversification purposes. They are bought solely on their own merits, and only when prices are attractive. Thus, the Reference Account and client portfolios may be very concentrated and/or hold significant cash positions for extended periods of time if opportunities remain scarce.

4. Madoff Investment Securities

The case of Bernard L. Madoff Investment Securities is an interesting one, both for its size and its duration. For readers unacquainted with the case, on 11 December 2008, Bernard L. Madoff was taken into custody on charges of defrauding investors. Madoff confessed to having incurred losses of US$50bn over the past decades. He had paid off early investors with money from new investors in a giant "Ponzi" scheme. It finally collapsed when he received redemption requests for US$7bn which he could not meet.

Most Ponzi schemes collapse quickly, but Madoff was able to attract frequent inflows of money and keep it going for many years. There were 3 key actions. First, he reported realistic rates of return: about 10% per year. Second, these returns were extremely steady: whatever the state of the markets, his results held up. Third, Madoff kept an unassuming demeanor and was active in philanthropy. Being former Chairman of the Nasdaq bolstered his personal reputation, too.

As a result, many people with wealth, but limited financial expertise, entrusted money to him. The firm supposedly managed US$17bn at the point of his arrest. It now seems that most if not all of that money is gone.

The question that investors must then ask is: how did Madoff get away with it for so long, and what can they do to protect themselves from similar schemes? How did investment consultants and fund-of-funds managers end up recommending his fund? In other words, how and why did the due diligence process fail? While the case is still under investigation, some important details are emerging.

First, the structure of the fund. Clients did not invest directly with Madoff Securities. Instead, the money actually went into "feeder" funds that in turn invested money into an account managed by Madoff Securities. The feeder funds were audited by big-name accounting firms, which would have comforted those performing due diligence.

However, as per normal industry practice, the accounting firms merely relied upon the brokerage statements issued by Madoff Securities to issue their opinions. Who, then, audited Madoff Securities?

The answer: Friehling & Horowitz, an accounting firm with just 3 employees, only one of whom, David Friehling, was a CPA. Of the other two staff, one was a secretary. The other, Jerome Horowitz, was 80 years old, retired, and living in Florida, quite a commute from the office in New York!

Hedge fund advisory firm Aksia LLC, which steered clients away from Madoff, pointed out in an interview with Bloomberg News that there was no way an accounting firm that small could audit a firm of Madoff Securities' size. Investors who stopped their checks at the feeder fund level would have missed this red flag entirely. Due credit goes to Aksia LLC for digging deeper.

Second, there was outright fraud. Normally, investors' assets are kept with an independent third party, the custodian. The custodian is the legal owner of the investments, and ensures that assets reported to investors do, indeed, exist. However, in this case Madoff Securities itself was the custodian, so there was no independent third party. Madoff was thus able to create fictitious trading records and forge the brokerage statements.

Why was this absence of an independent custodian not flagged? Apparently, in at least one case, HSBC was the independent custodian, but it appointed Madoff Securities as the *sub-custodian*, thereby extinguishing all independence from the custodian role. Whether this action constituted a breach of the independent custodian's duty is for the courts to decide, but at minimum it looks like a case of appointing the fox to guard the henhouse.

Investors who looked for an independent custodian apparently found one. It is not clear whether investors could have uncovered this aspect of the fraud by themselves.

Third, returns did not match the strategies being used. In the same interview, Aksia LLC stated that testing Madoff's "split-strike" strategy yielded results that were much more volatile than actually reported. Additionally, Madoff's strategies relied upon options on the S&P 100 (not S&P 500) index. This market was small compared to the money Madoff managed. In other words, the returns were too steady, and the market space too small. Ergo, the results were unlikely to be real.

Finally, some fund consultants and fund-of-funds managers simply dropped the ball: a few actually placed all their clients' money with Madoff. From the risk management point of view, this is absolutely insane. And for this work to find "The Chosen One" they charged a variety of fees that reads like a bad joke: upfront commissions that reached 5%, management fees that exceeded 2%, *plus* performance fees of as much as 20%.

Such fees might not be excessive for a fund manager. But they *are* high for a fund-of-funds manager. In a fund-of-funds structure, only the fund manager allocated the money is doing the actual investment work. The fund-of-funds manager's work is solely to (i) identify fund managers who are honest and competent; and (ii) send them money. Investors pay 2 layers of fees: one to the fund manager, and one to the fund-of-funds manager. In other words, investors pay extra fees in exchange for **proper due diligence**.

More than a few fund-of-funds managers were caught sleeping on the job. Here are two offenders. Fairfield Sentry, a US$7.3bn fund-of-funds, put all its assets with Madoff. In exchange, each year it charged 1% of assets, plus 20% of gains. At Madoff's purported 10% average returns, the manager, Fairfield Greenwich, drew fees of US$200m a year while not doing the required due diligence, the *only* thing it was paid to do.

Bank Medici did a similarly "fantastic" job; its Herald funds invested all their US$2.1bn with Madoff. Bank Medici charged 5% upfront, plus a 2% annual fee on assets *and* 10% of profits. Upfront fees totaled US$100m, and given a reported 10% return, annual fees were US$60m. In return, clients were defrauded. The chutzpah displayed by the likes of Fairfield Greenwich and Bank Medici is incredible. Charging high fees is one thing; charging high fees and *not* doing the job...

Something else should have alerted the fund-of-funds managers: <u>Madoff charged no fees</u>, living off only the brokerage commissions. With his superior long-term record, Madoff should have charged *something*. He was literally giving up hundreds of millions of dollars a year in fees. As the saying goes, if something's too good to be true, it probably is.

Furthermore, banks have revealed losses from *loans* to funds that invested with Madoff. Borrowing money to operate a business may be an unpleasant necessity. Borrowing money for an investment product is an unnecessary risk. Greed makes fools of men, indeed.

Based on the public information released to date, it seems that the only ways for prospective clients to protect themselves against similar frauds in future are to either be paranoid, or apply common sense.

Paranoia: Check all the way up and down the chain. Who audits whom, do they have the resources, and how deep is the audit? Can each party verify that it is indeed acting in the stated capacity? In effect, this is the private investigator's domain. Ultimately, it pits the fraudster against the investigator: just because no damning evidence has been found, doesn't mean that no crime has been committed.

Common Sense: Can investors understand the fund manager's strategy? Madoff claimed to use a "black box" and was deliberately vague. The arcane strategies he described were beyond most clients' interest or ability to comprehend; only savvy investors would have uncovered the mismatch between strategy and results. Clients typically hire money managers precisely *because* of their own lack of investing acumen, so few of them would have caught this. But if the strategy was so complicated that it couldn't be explained in layman terms, did the fund manager himself fully understand what he was doing?

Neither paranoia nor common sense are foolproof. But simplicity has its virtues. At the very least, investors can satisfy themselves that the results make sense when considering the risks being taken.

The common-sense approach rules out secretive, computer-driven "quant" funds, some of which have admittedly reported outstanding long-term results. However, it also ensures that investors avoid most sophisticated frauds. Someone who claims to be an expert, but can't explain clearly what he does in layman terms, should set off alarm bells as to who he really is.

Who might he be? He might be an honest idiot who's going to lose your money by making poor choices. He might be a con artist out to steal your money. Or, he might truly be that rare genius who makes money without being able or willing to explain how or why. Other possibilities exist, but clearly, a sensible reading of the odds does not suggest a favourable outcome. *Caveat Investor.*

End

Annex I

Reference Account as of 31 Dec 08