LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 31 Mar 2009

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2009. This marks the second quarter of operations.

This newsletter follows the same format as the inaugural issue. The special topic for this issue is **liquidity**.

2. Market Commentary

The Great Recession continues. While politicians still avoid the "D" word, it is becoming obvious that we are in *a* depression, albeit not a *great* depression. At least, not yet.

While capital markets hang on to the words and plans of the US president, the Federal Reserve and the US Treasury, recent economic data are grimmer than ever.

US unemployment was 8.5% in March, the worst since November 1983. The 20-city Case-Shiller index of US home prices fell 19% in January against the previous year; it has fallen every month since January 2007. 31.8 million Americans – 1 in 10 – were receiving government food stamps in January.

In Germany, business confidence fell to a 26-year low in March, while unemployment rose for the 5th straight month.

Japan's February exports plunged 49% against the previous year, and the Bank of Japan's Tankan index of manufacturer sentiment hit minus 58 in March, the lowest since the survey began in 1974.

Even Australia, the "lucky country", is seeing its stars dim as demand ebbs for coal and iron ore. Unemployment reached 5.7% in March, the worst in 18 years. BHP Billiton and Rio Tinto, big beneficiaries of the commodities boom, have announced capacity reductions and thousands of job cuts.

Clearly, jobless US consumers are not buying, so Chinese factories are not ordering machines from Germany or Japan to produce goods. Nor are they buying iron ore to make steel, or coal to run power plants. Chinese manufacturing capacity[1] fell again in March, the 8th straight monthly decrease. The Japanese are not doing any better; electronics giant Sharp forecasts its first annual loss in 50 years, while automaker Toyota expects its first annual loss in 59 years.

The World Trade Organization estimates global trade will fall 9% in 2009, the worst decline since World War II, while the Organization for Economic Cooperation and Development projects a 13% drop[2]. The OECD expects economic activity among its 30 members to shrink 4.3% in 2009, with global economic activity contracting 2.7%.

Small, highly globalized economies like Singapore and Hong Kong are hurting the most, but no country is immune. Agricultural exporters like New Zealand face weak markets for their produce, while resource-rich countries like Brazil and Indonesia see their bargaining power erode as once-prosperous customers falter. Even oil sheiks' black gold no longer suffices to balance national budgets.

US Treasury Secretary Timothy Geithner has unveiled a US$1 trillion plan to buy up bad

[1] As measured by the **CLSA China Purchasing Managers' Index**.

[2] *OECD Economic Outlook Interim Report*, March 2009.

assets in US banks. At first glance, it solves a big headache: selling off the assets will free banks to lend again and stimulate the economy. The problem is that it substitutes one bubble for another.

The details reveal that the US government will lend 85% of the money on a non-recourse basis to the public-private partnerships bidding for the assets. Of the 15% equity contribution, the US government will put in half. In other words, private investors put up 7.5% of the money but earn half the profits. The US government is likewise entitled to half the profits, but has to put up 92.5% of the money for that privilege. To call this merely "unequal" is a gross understatement.

The investors effectively have a call option with 6.6 times leverage. If the assets do well, the investors make a lot of money. If the assets do poorly, the investors lose only their 7.5%, but US taxpayers incur heavy losses.

Similar payoff structures sank Bear Stearns, Lehman Brothers and Merrill Lynch. Employees made bets with company money. If the bets worked, they got a big bonus. If they failed, shareholders took the loss. Substitute investors for employees, and taxpayers for shareholders, and it is clear this new bubble will end in tears. Again. To re-quote German philosopher Georg Hegel, "we learn from history that we do not learn from history."

Your manager is not alone in his gloomy assessment. Nobel Prize-winning economist Joseph Stiglitz told Reuters in an interview[3] that the plan was "very badly flawed" with "perverse incentives" that amount to "robbery of the American people."

In theory, investors protect themselves by not overbidding. In practice, if investors bid low enough to assure a profit, banks will realize massive losses and need further bailouts. For example, one mortgage-backed bond analyzed by Standard & Poor's was valued by the financial institution owning it at 97 cents on the dollar, yet it recently sold for 38 cents[4]. Backed by 9,000 sub-prime second mortgages, it was once rated AAA, the highest rating. Since the US government wants sales proceeds to yield enough to save the banks, investors will likely be "persuaded" to overpay for this bond and others like it. So the US government, having put up most of the money, is going to lose a lot of it. How will it deal with this? By printing money. This is unlikely to be good for the US dollar.

Meanwhile, derivatives continue to claim new victims. The collapse of many currencies against the US dollar has impacted many companies who thought they had managed to mitigate the impact of currency fluctuations.

Instead of forward hedging contracts, some companies were pitched "zero cost" Knock-In / Knock-Out (KIKO) contracts by their bankers. These provided hedging if the currencies stayed in a specified range, but beyond it there would be huge losses. Some companies had a speculative net exposure.

We know what happened next. Rapid devaluation sparked by the crisis triggered the KIKO clauses, with expensive and sometimes fatal consequences. Naturally, the bankers all claimed to have forewarned their clients.

The Koreans have been the worst-hit; the Korean government has provided 1.8 trillion won so far to KIKO'd firms to avert bankruptcies[5]. The eight banks selling the most KIKO contracts, on the other hand, have reported 2.6 trillion won of *profits*. Clearly, these derivatives were a zero-sum game with banks holding the upper hand.

Of course, the Koreans do not have a monopoly on foreign currency losses; Chinese conglomerate Citic Pacific recently lost US$1.9 billion on currency derivatives linked

[3] *Geithner plan will rob American taxpayers: Stiglitz,* **Reuters**, 24 March 2009.

[4] *Big Risks for U.S. in Trying to Value Bad Bank Assets,* **The New York Times**, 1 February 2009

[5] *Korean Corporations Court Bankruptcy With Suicidal KIKO Options,* **Bloomberg News**, 25 March 2009.

to the Australian dollar, and over a year ago Singapore shipyard SembCorp Marine lost US$165 million on foreign exchange contracts. Derivatives, like all leveraged products, pose great danger to novice users.

For now, the US$1 trillion rescue plan has temporarily revived the "animal spirits" in the capital markets. Panic buying worldwide followed the announcement, as investors hoped the plan would spark a recovery and ignite a new bull market. Major markets have bounced off their multi-year lows, and many have largely recovered their 2009 losses.

Optimists now point to recent glimmers of hope: in the US, new housing starts climbed 22% in January versus February, while durable goods orders rose 3.9% in February after 6 straight months of decline. In Japan, despite the dismal export figures, February's machinery orders actually rose for the first time in 5 months, albeit by only 1.4%.

However, given the depth of the downturn, your manager is pessimistic about the prospects of a rapid recovery, and fears the recent market rally is but a false dawn. Paul Krugman, a Nobel laureate writing for *The New York Times*, has noted that some US banks' recent positive earnings came from creative accounting and that the profits look "funny" on closer inspection[6]. Goldman Sachs, for example, changed its reporting so that December – an awful month – simply disappeared for comparison purposes.

Help *does* appear to be on the horizon, but it is not coming from the US government. Rather, in an unlikely revival, it is the International Monetary Fund (IMF) that is extending a helping hand. Dismissed as irrelevant in boom times, the IMF suddenly looks like a lifesaver today. In the past 6 months, it has approved loans totaling US$55 billion for the Ukraine, Hungary, Latvia, Belarus, Iceland, Pakistan and Serbia. Turkey is in negotiations, and Romania has signaled interest. Mexico is the latest to announce it will seek IMF aid, about US$47 billion worth.

At the recent G-20 meeting in London, the IMF got a boost. Lending funds will be tripled to US$750 billion, while Special Drawing Rights, no strings-attached loans, have been allotted US$250 billion. US$250 billion more will support trade finance in the next 2 years.

UK Prime Minister Gordon Brown's proclamation of a "New World Order" following the G-20 summit may be a bit too hopeful, but the IMF funds will definitely boost foreign reserves and support trade finance, which *should* speed the global recovery, though it remains to be seen *when* that recovery will actually arrive.

Still, life goes on. Opportunities abound in the stock market, and your manager has been active. High-quality companies continue to sell at prices unjustified by their long-term earning power, while top-grade property and resource assets trade at below private-market valuations. It is a good time to be an investor.

Those who endure short-term fluctuations now will benefit the most when the economy recovers. As per the motto of the British Special Air Service, *Who Dares Wins*. Your manager will write again when the report for the quarter ended 30 June 2009 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
24 Apr 2009

3. Portfolio Review

As at 31 March 2009, the Reference Account Net Asset Value (NAV) was $100.11 per unit, net of all fees. Highwater mark was $101.02. Total return to date for 2009 is minus 0.9%.

Nine securities made up 51%, with the balance 49% in cash. The investment positions appear smaller than as at 31 Dec 08 because your

[6] *Green Shoots and Glimmers*; **The New York Times**, 16 April 2009.

manager has put more money into the Reference Account. A pie chart is in Annex I, while NAV values are tabled in Annex II.

New Investments

Pan United is one of the 2 largest suppliers of basic building materials in Singapore. It supplies cement, concrete, aggregates and other building materials to most major construction projects in Singapore, including the integrated resorts. Apart from the building materials business, there is a 51% stake in a deepwater port in the Yangtze River Delta in China. Minor assets include a stake in a coal mine, investment properties and quoted securities. Gearing (debt to equity) is 45% but almost all the debt is borrowed by the port, and at below-market rates. At purchase, the price to earnings ratio was 5 times, dividend yield was 10%, and the stock traded below net tangible asset value.

SIA Engineering is the maintenance, repair and overhaul (MRO) arm of Singapore Airlines (SIA), one of the world's largest and most profitable airlines. Non-SIA business is about 30% of reported revenues, but its numerous joint venture and associate companies are equity-accounted. On a group-wide basis, non-SIA revenue is over 60% of total sales. The joint ventures and associates have grown rapidly, and now contribute more than 60% of pretax profits. The company will undoubtedly be hit in this downturn. However, MRO revenue is a function of flight hours, not passenger traffic or cargo volume, so it will suffer much less than its airline customers. The balance sheet is outstanding; there is no debt, and cash alone exceeds all liabilities. At purchase, the price represented 11 times your manager's estimate of FY2010 earnings, with a forward dividend yield of about 7%.

Singapore Land is a major landlord in Singapore. It owns Grade A office assets in the central business district, a prime integrated development, and additional office buildings just outside the business district. Secondary assets comprise office and retail space in suburban areas. There are four residential developments, but their eventual contribution to net asset value will not be material. The company is 72%-owned by SGX-listed UIC, which is itself the subject of a tug-of-war between John Gokongwei and Wee Cho Yaw. Singapore Land will likely be broken up eventually, with the choice assets sold to the highest bidder. Neither tycoon is known to overpay, so patience will be necessary. The stock sells for about one-third of revalued net asset value, and forward yield is about 4-5%. Current gearing is 18%.

Starhill Global REIT is a real estate investment trust focused on retail and office properties. Sponsored by the Malaysian YTL Group conglomerate, its major assets comprise a 74% strata title stake in Wisma Atria and a 27% strata title stake in Ngee Ann City, both prime retail / office complexes side-by-side in Singapore's Orchard Road shopping district. Secondary assets include 7 small properties in Tokyo, Japan and a retail mall in Chengdu, China. The retail tenants feature the usual suspects in fashion, such as Nike, Gap, Levi's, Chanel, Guess and Zara, while office tenants include multinationals like Petrobras, Statoil, Heinz, EADS, Embraer and Tiffany. Gearing is 48%, but no significant refinancing is due until September 2010. At the purchase, the price was below one-third of book value, and dividend yield exceeded 17%.

Wheelock Properties (Singapore) is a property developer based in Singapore. It is 75%-owned by Hong Kong-listed Wheelock Properties Limited. It owns a large Grade A retail / office property, Wheelock Place, and significant stakes in two Singapore-listed property companies (16% of SC Global, 20% of Hotel Properties). It has three developments pending, of which only one, Scotts Square, is significant; it is already 70% sold, and should generate good profits. The other developments will make only minor contributions to net asset value. The balance sheet is very strong; gearing is 21%, but cash on hand exceeds all liabilities. The stock was bought at about half of book value, with a 6% yield.

Divestments

People's Food was divested after a deep-dive review. Your manager previously owned it as a personal investment and was familiar with it. Unfortunately, the review concluded that recent poor profitability was probably the normal state of affairs i.e. previous good profits were inflated and not repeatable. The company started with old plants acquired cheaply; low depreciation charges meant high reported profits. As the company expanded, it paid market prices for its facilities, incurring higher i.e. "normal" depreciation. With more realistic depreciation, profits are no longer attractive. Also, the Chinese government is supporting farmers by propping up hog prices, and helping consumers by importing pork to depress pork prices. This will squeeze processors like People's Food. Thus, the decision was made to exit. Unfortunately, a loss was realized. Your manager also lost money, and feels your pain.

4. The Importance of Being Liquid

With apologies to playwright Oscar Wilde, who wrote *The Importance of Being Earnest*, your manager has decided to focus this issue's special interest section on the importance of being liquid.

Liquidity to an investor has several aspects.

There is liquidity at the *investor* level. An investor with little liquidity may find himself forced to sell assets into a poor market should an emergency situation arise. For example, an investor with heavy margin borrowings has clearly sacrificed liquidity in exchange for the possibility of outsize future gains.

There is liquidity at the *security* level. Some securities trade frequently and at tight spreads, so they can readily be converted to cash within a few days. Index component stocks fall into such a category; the realizable value closely approximates their reported market value. But some securities, such as small-capitalization stocks or convertible bonds, do not trade frequently. The reported market value can only be realized by selling slowly, and over a long period of time. Such illiquid securities pose additional risk to the investor: if he needs money urgently, he may have to accept a large discount to the last traded price to close the trade. As such, investments in this area can damage net worth if there is pressure to sell.

Finally, there is liquidity at the *company* level. Companies who keep debt low and cash levels high are well prepared for business downturns, and use them to acquire assets, people, or entire businesses. Others use "other people's money" and hope benign conditions last long enough to pay off the debt and come out ahead. Of course, paying off debt becomes a pipe dream when debt-fueled returns prove addictive. Like youngsters who have trouble spelling "banana", few companies know when to stop once they start borrowing heavily.

The current crisis makes clear that liquidity at all three levels is important. An investor strapped for cash would be unable to seize the opportunities in today's market. Margin calls could even wipe him out. Some illiquid securities have stopped trading entirely, or now trade so infrequently that investors have no hope of realizing their cash in a reasonable amount of time. And heavily-indebted companies are going bust as formerly accommodating bankers turn hostile.

Your manager remains safely liquid, with no borrowings and a high level of cash. The securities chosen all have at least reasonable levels of liquidity, and the companies themselves do not carry worrying levels of debt. Clients should rest assured that they can sleep well. Your manager certainly does.

End

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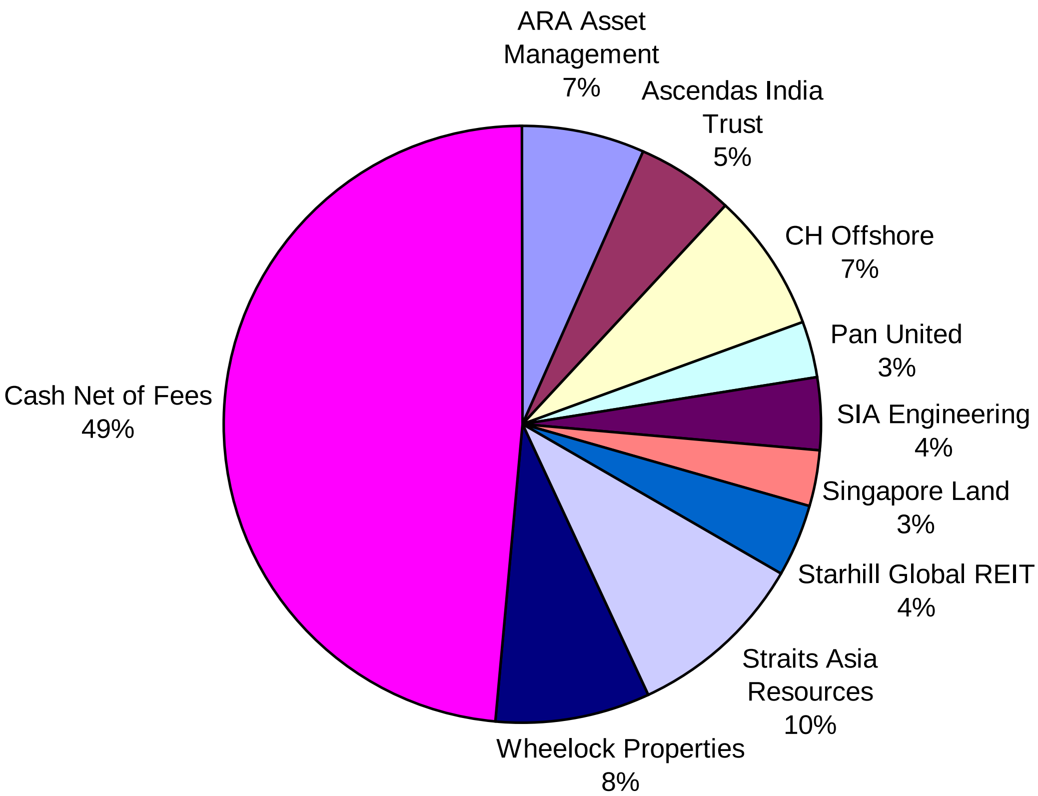
Keeping Your Capital Safe

Annex I

Reference Account as of 31 March 2009



Annex II

Monthly NAV Values

Date	Net Asset Value per Unit
30 Nov 2008	$100.00
31 Dec 2008	$100.02
31 Jan 2009	$103.03
28 Feb 2009	$102.42
31 Mar 2009	$100.11