LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

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Client Newsletter for the period ended 31 Dec 2009

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for December 2009. This marks the first full year of operations.

Your manager thanks you all for your continued support, and will do his utmost to live up to your expectations. As always, your money and your manager's own money will be invested in the same way.

This newsletter follows the same format as previous issues. The special topic for this issue is **Shipping Trusts**.

2. Market Commentary

What a year it has been! To quote Charles Dickens' classic *A Tale of Two Cities*, it was the best of times, it was the worst of times.

It was the best of times. After a weak first quarter, stock markets worldwide produced amazing returns. In 2009, almost every market did well, from the S&P 500's 23% to the Shanghai Composite Index's 80%. Even Japan's Nikkei 225, long the party-pooper, gained 19%. Closer to home, Hong Kong's Hang Seng Index finished 52% up, while Singapore's Straits Times Index gained 64%. Investors could have hardly wished for more.

And yet, it *was* the worst of times. The world plumbed the depths of the second-worst economic downturn ever recorded. The Great Recession put millions out of work and drastically slowed the wheels of commerce, as even banks became unable to obtain money.

Iceland collapsed. Ireland fell into depression. General Motors filed for bankruptcy. The US government became a major shareholder of Citigroup and AIG, while the UK government took over Lloyds TSB and RBS. The Germans nationalized Hypo Real Estate. The list continues.

In America's housing market, foreclosures continue to mount. Some owners have taken to selling off the house's fixtures for cash before abandoning it[1]. Naturally, this depresses the value of the homes further, compounding the losses the banks will have to take. That is, if the banks still own the loans. As has been well-documented, most of the banks making these loans unloaded them to investment banks, which in turn securitized the loans and sold them to investors. Some, like Goldman Sachs and Deutsche Bank, subsequently made bets that the loans would default[2].

The inside knowledge derived from creating the securities meant that they knew the loans were likely to do badly i.e. their own odds of doing well were good. This is analogous to a construction company who helps build houses with shoddy materials in an earthquake-prone zone, then buys earthquake insurance against the houses and waits for a nice payout.

This practice may not be illegal, but the ethics of such behaviour are difficult to condone, and hardly mesh with Goldman Sachs chairman Lloyd Blankfein's quip that he is just a banker "doing God's work"[3], unless his God happens to be Mammon.

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[1] *Nice Home. Where's the rest of it?* **The New York Times**, 23 December 2009

[2] *Banks Bundled Bad Debt, Bet Against It and Won,* **The New York Times**, 24 December 2009

[3] *I'm doing 'God's work'. Meet Mr Goldman Sachs,* **Times Online**, 8 November 2009

Updated 22 January 2010

But Goldman may have finally met its match: *China*. Li Wei, deputy director of the State-Owned Assets Supervision and Administration Commission (SASAC), has publicly called derivatives "intentionally complex and highly leveraged products that were fraudulently peddled by international investment banks with evil intentions"[4]. He sounds a little upset.

Li noted that so far, 68 state-owned firms under SASAC have incurred combined net losses of RMB 11 billion on derivatives. One of them, Shenzhen Nanshan Power, has now started the ball rolling by refusing to pay up, claiming its contracts were unauthorized[5].

The Chinese government is one customer even Goldman Sachs cannot afford to boss around. If Goldman takes the legal route (and wins), it can forget about doing any meaningful business in China in future. Pragmatism suggests a negotiated settlement, on China's terms of course.

George Soros has called the US banks' recent profits "hidden gifts" from the government[6]. The banks borrow from the government at rock-bottom rates, but instead of lending the money out, they buy government bonds.

This arbitrage results in guaranteed profits. Great for the bank and the bankers, not so great for the country, since the original idea behind giving banks cheap loans to begin with was to spur lending to companies and people in the real economy.

The government is allowing this arbitrage to let banks "earn" their way out of the crisis. It is akin to an outright gift, but looks nicer than simply writing a cheque. Many taxpayers are understandably furious, since the banks got bailed out, but they didn't. It gets worse.

[4] *China blames foreign banks for derivatives losses*, **Reuters**, 4 December 2009

[5] *China firm refuses to pay Goldman on oil hedging losses*, **Agence-France Presse**, 30 December 2009

[6] *Soros calls Wall St profits 'gift' from state*, **Financial Times**, 23 October 2009

Beyond the "free money" they are receiving, the banks have cut deposit rates. Retirees who live off their bank interest are being paid basically nothing. A basic Wells Fargo savings account, for instance, now pays 0.05%, *before* taxes and inflation. These low rates give the banks more guaranteed profits when they use the deposits to buy government bonds again.

Essentially, those who were prudent and saved money are now being forced to give the financial institutions a second bailout[7].

In Europe, the fallout from General Motors' bankruptcy continues, as first Opel and then Saab was put up for sale and passed from bidder to bidder. So far, neither has been sold.

The UK is arguably the weakest major European economy, but fortunately, it is outside the Eurozone, so the government can devalue the pound to restore export competitiveness.

Greece, alas, has no such luxury[8]. It will have to implement severe austerity measures if it calls on the EU for help. But if it turns to the IMF, it will merely get a different version of the same bitter medicine. With gross external debt at almost 150 percent of GDP, and a stubbornly strong currency it cannot devalue, 2010 looks like a bad year to be Greek.

Dubai, once hailed as the rising star of the Middle East, is now in trouble. Unlike wealthier UAE rival Abu Dhabi, Dubai's investments were funded with debt. The house of cards came crashing down as the music stopped and the debts came due. State-owned Dubai World only narrowly avoided a default by its Nakheel property unit, and has now asked creditors for a "standstill" on debt repayments[9].

[7] *At Tiny Rates, Saving Money Costs Investors*, **The New York Times**, 26 December 2009

[8] *Greece can expect no gifts from Europe*, **Financial Times**, 29 November 2009

[9] *Dubai World Seeks More Time for Debt 'Standstill' Agreement*, **Bloomberg News**, 21 December 2009

Meanwhile, Dubai's expatriates, who make up 90% of the population, have been fleeing. House prices fell 52% in 2009. Barclays has been the first bank to officially admit the reality that homeowners are not coming back; it recently began foreclosing on abandoned homes[10]. It is likely to be followed soon by Standard Chartered and HSBC, who are the largest foreign lenders in the UAE.

Japan is fairing somewhat better. That is to say, it is not doing much worse than before. Exporters of cars, machinery and consumer electronics are all fighting a soaring yen and weak demand, though trading conditions have been slowly improving[11]. Japan's biggest hope is ironically China, a wartime enemy turned its biggest customer.

Having sidestepped recession, Australia stands alone in the developed world in doing well enough to already be raising interest rates[12]. This is a sign that the central bank is serious enough about inflation to actually do something about it. It also means the Australian central bank has no intention of allowing a US-style bubble to mess up the economy; this is a Good Thing.

Brazil is also moving along, thanks to a largely-domestic economy, aided by exports to countries like China. Its recession lasted just two quarters, a blip compared to the rest of the world, and an amazing achievement given the oil shocks and triple-digit inflation that have wracked its economy over the past 30 years[13].

China has been the strongest economy this past year. Given its large foreign reserves, when the financial crisis came there was little hesitation in putting government money to work. RMB 4 trillion, or over 10% of GDP, was set aside for a stimulus package.

The stimulus package accelerated funding across the board, boosting infrastructure, factory capacity and domestic consumption, pushing Chinese GDP growth back to the magic 8% number.

Still, apart from China, the outlook for the largest economies in 2010 continues to be poor. The IMF expects[14] the US to grow 1.5%, Europe 0.3% and Japan 1.7%. These are not estimates to be cheery about.

Can China save the world? China's 2008 GDP was roughly US$4.3 trillion, 7% of the world economy. In comparison, the EU, US and Japan combined for about US$37.7 trillion, 62% of the world total. China may be almost on par with Japan, but it still trails far behind the US and the EU. Those who believe China is ready to take over as the new locomotive of world economic growth have great expectations indeed.

Fortunately, investors do not *need* China to save the world. Investors only need to invest into companies that can survive the economic downturn. These will naturally benefit from the upturn, as many of their weaker competitors will be gone by then. Such companies are everywhere, not just in China.

However, China *does* present interesting opportunities. The secular growth trend is a powerful tailwind, and well-managed companies in growing industries can be expected to do outstandingly well. Investors who invest at reasonable prices are likely to reap unreasonably high returns. This is a highly desirable outcome, and an area of focus for your manager.

Risks remain. China still needs low-value, labour-intensive industries to provide jobs,

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[10] *Dubai's First Foreclosure May Open Floodgates in Worst Market*, **Bloomberg News**, 11 January 2010

[11] *Japan Trade Show Signs of Recovery*, **Bloomberg News**, 21 December 2009

[12] *New Australia interest rate rise*, **BBC News**, 3 November 2009

[13] *A special report on business and finance in Brazil: Getting it together at last*, **The Economist**, 12 November 2009

[14] *World Economic Outlook*, **International Monetary Fund**, October 2009

and rapid currency appreciation can force marginal companies out of business faster than the growing economy can absorb their workers.

China must strike a balance between upgrading the economy to compete globally, and keeping unproductive enterprises in business to provide employment. This is not easy even for a small country, but China is the most populous country in the world, and also ranks third-largest by land area. The Chinese Communist Party has its hands full, and this is before considering the soaring prices that have put homes in many cities beyond the reach of the new middle class and created widespread fears of a bubble[15].

Elsewhere, in the small, open economies of Singapore and Hong Kong, there are also opportunities. As trading economies, Singapore and Hong Kong are highly leveraged to the world economy, and should rebound quickly as their trading partners in the West regain their footing. Many companies in Singapore and Hong Kong now operate globally, and can hold their own against competitors anywhere in the world. Your manager is optimistic that they will bounce back. The only problem is that nobody knows *when*.

Looking ahead, the view remains murky. As Yogi Berra supposedly said, “it’s tough to make predictions, especially about the future.” So your manager will refrain from trying to make a prediction. At most, to borrow an over-used term, your manager is “cautiously optimistic”.

Your manager will write again when the report for the quarter ended 31 March 2010 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
21 January 2010

[15] *In China, fear of a real estate bubble*, **The Washington Post**, 11 January 2010

3. Portfolio Review

As at 31 December 2009, the Reference Account Net Asset Value (NAV) was $166.03 per unit, net of all fees. The highwater mark was $101.02, and the total return for 2009, net of all fees, was 64.4%. Your manager considers this highly satisfactory, but cautions that future returns will probably be far more modest.

14 securities made up 86% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

As this is an annual review, in addition to divestments and new investments, mistakes and the lessons learnt will also be discussed.

Divestments

CH Offshore was divested due to a combination of significant price appreciation and a worsening outlook for its businesses. Since initial purchase, the share price has almost tripled. Unfortunately, with the poor economy, the AHTS market is now in oversupply, so charter fees and utilization rates are falling. This eroded the margin of safety, so your manager decided to sell. Total profits recorded exceeded 40%.

Esprit was divested due to continuing poor results in its main European markets. It appears economic recovery in Europe will be slower than your manager anticipated. Also, a decision by the company to pay a compulsory scrip dividend meant that the dividend had in fact been cut. This suggests the managers are not optimistic; in a conference call they admitted that so far, there is “no recovery.” This made the current valuation unattractive.

Your manager decided to sell and put the money to better use. A small but immaterial (less than 5%) gain was recorded. Should the price become attractive again in future, and the European economy recover, Esprit may be welcomed back into the portfolio.

Pan United was also divested due to a combination of significant price appreciation and a worsening business outlook. The building materials business in Singapore is seeing good volumes but poor pricing, while the port in China is handling lower volumes of steel products and containers. Still, your manager remains happy with the management, and may invest again in future should the shares sell for an attractive price once more. Divestment gains exceeded 25%.

Straits Asia Resources was divested on account of significant price appreciation which reduced the margin of safety. Coal remains interesting given the growing energy demands of the world, and your manager will continue to search in this area. The final divestments yielded gains in excess of 200%. Overall gains exceeded 150%.

Wheelock Properties was also divested on account of significant price appreciation which reduced the margin of safety. The quality of the assets remains intact, and should the stock trade at a discount again in future, your manager will likely invest once more. The final divestments were made at gains of over 100%. Overall gains exceeded 80%.

New Investments

Eagle Nice is a manufacturer of sportswear for major brands such as Nike, North Face, Reebok and Kappa. Nike is the single largest customer and has accounted for about half of total sales in recent years.

Founder Chung Yuk Sing started the business in 1993 and began manufacturing in 1995. The group listed in 2003. Shortly after IPO, he partnered with Yue Yuen, the world's largest maker of casual footwear. In exchange for a strategic stake, Yue Yuen would refer business from its shoe clients, and assist with technology implementation. It has been a good partnership: since Yue Yuen's involvement, group sales have increased 137%, while sales per employee have climbed 74%.

The balance sheet is strong: there is no debt, and cash alone exceeds all liabilities. The stock was bought at about 8 times earnings, with a dividend yield exceeding 7.5%.

HTL is a manufacturer of leather sofas. It was founded by the Phua family in 1976, and went public in 1993. Today, its production facilities are in China, and it sells on an OEM basis to customers worldwide. Two-thirds of sales come from Europe, with the balance coming from North America, Asia and Australasia.

The company's fortunes have closely tracked the housing markets in the US and Europe. Unsurprisingly, it reported much lower profits for 2007, and a significant loss in 2008.

Beneath the accounting losses however is a solid cash-generating engine. Despite the ongoing financial tsunami, the company has already turned around: 30 September 2009 marked the 6th consecutive quarter of positive cash flow, and the 3rd consecutive quarter of profits. This points to a sustainable recovery in the business; the company is out of the abyss.

The company has been buying back its own shares; this suggests that the Phuas, as owner-managers, believe (a) business has recovered, and (b) the stock is undervalued.

The stock was purchased at about 5 times forward earnings, and about 10% below net tangible asset value. Dividend yield was 6%. Debt to net tangible assets is 68%, but cash on hand exceeds short-term bank debt.

Natural Beauty is a Taiwanese manufacturer of skincare, cosmetics and supplements under the "Natural Beauty" and "Fonperi" brand names. Its key markets are China and Taiwan, with respective sales contributions of 75% and 23%. The balance comes from other markets like Hong Kong, Macau and Malaysia. The products are sold to retail outlets and spas.

As at 30 June 2009, the products were sold in 441 spas and 3,351 retail points in Taiwan, and in 1,392 spas in China. 18 spas and 46 retail counters were self-owned/operated as "model stores" to promote the products. Given that the company started out in 1972 with just a single beautician chair in Taipei, this is a considerable achievement. Founder Tsai Yen Yu continues to run the business as its chairman, with help from her family.

The company has a solid record of generating and paying out cash. Since IPO in 2002, reported profits converted into free cash flow at an average rate of 91%, and the dividend payout ratio averaged 88%. During this period, despite paying out most of the profits and issuing virtually no new shares, sales grew 11% per year, while profits compounded at 23% per year. These results are indicative of a great business being run by great managers.

The balance sheet is outstanding: there is no debt, and cash alone is more than 3 times total liabilities. The stock was bought at 12 times depressed earnings, at a yield of 5%.

Importantly, <u>Natural Beauty is in the process of being taken private</u>. The Tsai family teamed up with private equity firm **CVC Asia Pacific** in November 2008 to make a bid, but failed. The Tsai family is trying again, this time with **Carlyle Group**, another private equity firm.

This second attempt makes it almost certain that Natural Beauty will be successfully privatized. Your manager believes that a significant premium will be paid to push the deal through. This makes Natural Beauty a <u>low-risk, high-return</u> investment. Accordingly, it is the single largest position in the portfolio, and is near the maximum 20% exposure limit.

Given the merits of the underlying business, your manager would prefer to own Natural Beauty over a multi-year period, but the outcome of the buyout attempt depends on other minority shareholders, specifically two funds who currently own 20% of the company and must be bought out for the bid to succeed.

<u>Mistakes and Lessons Learnt</u>

People's Food was the biggest mistake this year. It was divested at a loss of about 25%. As discussed previously, a thorough review of the business concluded that the good returns of the past were not sustainable due to unrealistically low depreciation charges, and that future results would continue to be affected by factors beyond the management's control e.g. weather, disease and inflation. The lesson learned here: **pay more attention to factors that affect the business, but are beyond management control**.

CH Offshore was the second significant mistake. This investment actually had a positive outcome, but premature divestment by your manager reduced the ultimate profits. When the company reported good results for the quarter ended 31 March 2009, the share price increased significantly.

Unfortunately, your manager had already divested 2/3 of the initial stake due to low trading liquidity – on some days, the stock did not trade at all. Divestment was initiated to reduce the amount of capital that might be trapped. However, as the stock appreciated, trading liquidity improved rapidly. Fortunately, enough stock was kept that meaningful profits were still realized. The final divestments were made at gains of over 150% on cost.

Overall gains still exceeded 40%, but would have exceeded 150% if your manager had held on through the period of low liquidity for divestment later. The lesson: **liquidity is worst when prices are lowest.**

4. Shipping Trusts

Shipping Trusts are "alternative" methods of ship financing. Ships are usually financed by owner-operators via a combination of debt and equity. The creation of shipping trusts has allowed the separation of ownership from operation, and financial investors have since become significant owners of ships.

Shipping trusts have traditionally been private investment vehicles. Popular structures include the Norwegian *kommandittselskap*

(KS) and the German *Kommanditgesellschaft* (KG) partnerships. In recent years, some shipping trusts have been publicly listed. Are these trusts valid investments?

The answer: it depends. As usual, the devil is in the details. The biggest question is whether the trust is structured as a going concern or a self-liquidating vehicle.

As a going concern, cash must be set aside for fleet renewal. **It is a reality that ships age and must eventually be scrapped.** Therefore the cash generated from depreciation cannot be returned to investors, but must be retained to finance replacement ships.

As a self-liquidating vehicle, there is no need to retain cash to renew the fleet, and therefore all the cash can be paid out. KS and KG vehicles fall into this category – at the end of the charters, the ships are sold or scrapped.

As long as investors understand the intent of the trust, *and* the trust managers behave accordingly, there is no problem.

The problem arises when the trust managers market the trust as a going concern, but then pay out cash as if the trust were self-liquidating i.e. 100% cash payout. This misleads investors who think that the high payouts are sustainable and do not realize that part of the cash received is a return of capital.

What happens eventually? The ships are scrapped, and the trust is wound up. Can the trust managers extend the life of the trust? Yes – by raising fresh funds. In other words, the ability of such a shipping trust to survive as a going concern depends on the whims of the capital markets. If capital markets are strong, funds can be raised to renew or even expand the fleet. But if capital markets are poor, no money can be raised, and the trust liquidates.

This is clearly a defective business model because survival as a going concern depends not on operations, but on public sentiment. For a shipping trust to operate as a *bona fide* going concern, it must retain cash generated from depreciation to renew the fleet. If there is debt, the debt must also be paid down. Otherwise, eventually the debt will exceed the value of the ships. Long before that, the bank would have seized and sold the ships.

A shipping trust that claims to be a going concern, but returns capital to investors as "income", can only survive by regularly selling new units to raise fresh capital. Comparisons to Ponzi schemes, such as the one operated by Bernard Madoff, would not be unfair.

There are 3 shipping trusts actively traded on the Singapore Exchange. A comparative study yields some interesting insights.

Case 1: Pacific Shipping Trust (PST) is an owner of container ships. 70% of its revenue comes from Pacific International Lines (PIL), PST's listing sponsor. The rest comes from CSAV, a South American ship operator.

PST's payouts are based on cash available *after* repaying debt. So as the ships depreciate, the debt is paid down. Also, PST currently pays out only 70% of the cash left after repaying debt, which effectively results in the cash from depreciation being retained. Thus, PST currently appears to be operating as a going concern, and it should be able to renew its fleet on its own when the time comes.

Still, PST has its challenges: it is negotiating with CSAV over the latter's desire for reduced charter rates due to the poor freight rate environment. Should PST acquiesce to CSAV's demands for fear of losing the charter entirely, PIL may demand the same treatment. Obviously, this would not be a pleasant turn of events for PST unitholders. Counterparty risk is clearly a problem for PST.

Case 2: First Ship Lease Trust (FSLT) is an owner of a diversified fleet, comprising container vessels, oil tankers, chemical tankers, product tankers and dry bulk carriers. Until recently, FSLT paid out 100% of cash generated and did not pay down its debt. This essentially made the trust behave like a self-liquidating vehicle, regardless of any management claims to the contrary.

The current downturn has caused the value of FSLT's ships to plummet, and it has been forced to renegotiate its loans with the banks to waive loan-to-value covenants. FSLT has placed out new units to raise cash, and it has also finally begun to pay down debt, albeit very slowly. This has of course impacted cash distributions, and investors who invested on the basis of the high yield are now stuck with much lower yields.

Also, there is significant debt due in 2012, which FSLT has no chance of repaying on its own. If the banks do not refinance the debt, FSLT must sell ships, raise equity or do both – but the shipping or capital markets may not be strong when FSLT needs to sell.

To make things worse, when the shipping market recovers, FSLT may lose ships: it agreed to buyout clauses in several of its charters, in order to raise the charter rates.

Should the shipping market be strong at renewal time, the customers will buy the ships cheaply, forcing FSLT to replace the ships at a high price. But if the market is weak, FSLT will have to renew the charters at a low price. So heads the customers win, tails FSLT loses.

In short, FSLT did not make provisions for renewing its fleet, borrowed money it could not repay, and gave up the possible upside from a strong shipping market. Investors can draw their own conclusions about whether FSLT management has truly been acting in the interest of unitholders.

Case 3: Rickmers Maritime Trust (RMT) owns a fleet of container ships. It originally paid out 75% of cash generated, but did not pay down debt.

RMT has significant debt, with some of it due in April 2010. RMT cannot generate enough cash to repay this debt. If refinancing is not secured, RMT will have to sell ships and / or raise equity. Cash distributions have been drastically reduced, but it may be too little, too late – the cash retained won't make a dent in the debt that needs to be repaid. Those who invested for the high yield have received a rude shock.

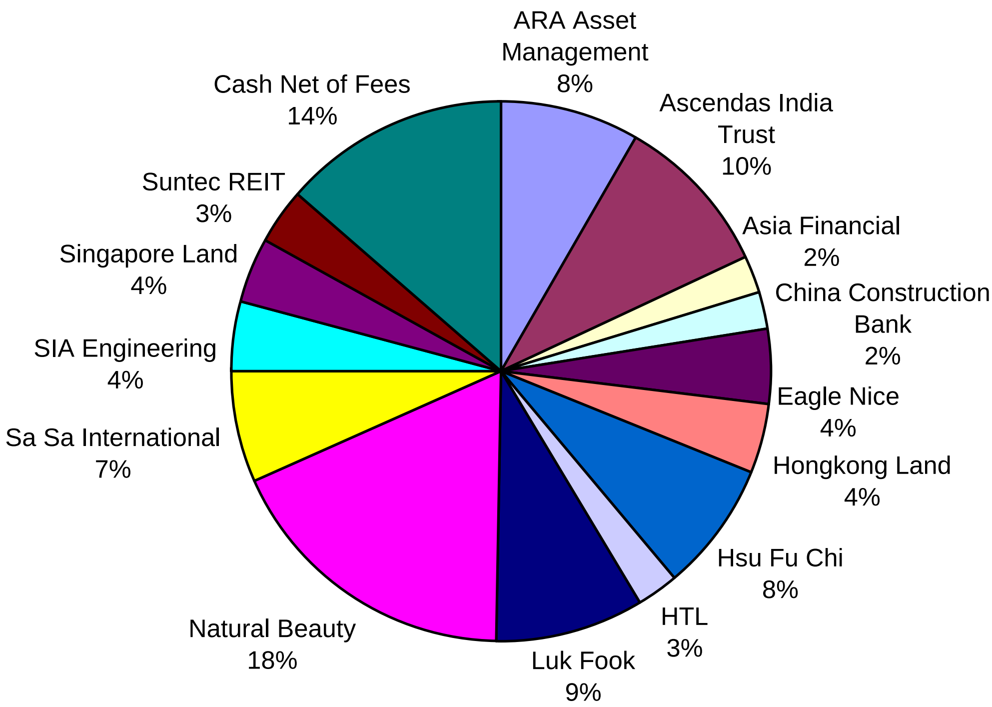
Unlike FSLT, RMT also has huge future commitments: four 13,100 TEU ships were ordered without having arranged the financing. Apparently, the management assumed RMT units would soon trade at a price high enough to allow equity fundraising. The downturn has put paid to those fantasies. RMT has not paid the deposits yet, but it remains to be seen how long it can stall.

To put it bluntly, RMT management borrowed money without any plans for repayment, and ordered ships without any arrangements for financing. Little more needs to be said about this type of decision-making process.

End

Annex I

Reference Account as of 31 December 2009



Annex II

Monthly NAV Values

Date	Net Asset Value per Unit	% Invested
30 Nov 2008	$100.00	16.20%
31 Dec 2008	$101.02	52.67%
31 Jan 2009	$103.03	52.65%
28 Feb 2009	$102.42	69.37%
31 Mar 2009	$100.11	51.35%
30 Apr 2009	$106.95	68.24%
31 May 2009	$131.61	77.07%
30 Jun 2009	$131.39	82.95%
31 Jul 2009	$142.18	85.58%
31 Aug 2009	$141.28	91.92%
30 Sep 2009	$146.38	94.84%
31 Oct 2009	$149.29	97.56%
30 Nov 2009	$154.88	94.34%
31 Dec 2009	$166.03	86.44%