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Keeping Your Capital Safe

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Client Newsletter for the period ended 30 June 2010

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2010. We are now in the middle of the second full year of operations.

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

2. Market Commentary

The last few months have been turbulent. Investors have belatedly realized that the problems that led to the financial crisis have not been cured. In particular, the "flight to safety" which pushed up the debt capital markets now seems ill-advised, as investors find out that all sovereign debt is not the same.

Some sovereign bonds are worth less – much less – than others. This should be obvious, since everyone knows that some countries are well-run and others are not. Yet investors priced sovereign bonds for perfection: the yields merely acknowledged the issuers' less-than-stellar names (read: "not Germany") but reflected neither the true state of national finances nor future prospects. Until recently, all sovereign bonds issued by the PIIGS were deemed investment-grade. Recent events suggest that perhaps none of them are.

The old fairytale tells of 3 little pigs. Today's version has 5 PIIGS in a modern tragedy. Portugal, Ireland and Greece (conveniently PIG) might qualify as "little" given the smaller absolute size of their problems, but Italy and Spain are larger and will cause far more damage if they go down.

Worries over the PIIGS continue to plague capital markets. It is known that pigs cannot fly. As it turns out, neither can the PIIGS – or their bonds. The prices of their bonds have dived, and the effective yield on Greek debt is now higher than that of most large companies – which is probably a fairly good reflection of the real level of risk faced by bondholders.

The debt sell-off underscores the fundamental weakness of the Eurozone, where there is monetary union but not political union. The members are *politically* independent, but *economically* interdependent. All of them make their own laws, but none of them can mint their own coin. What this means is that no Eurozone country can physically print its way out of default. Only the European Central Bank can activate the printing press, and neither the French nor the Germans are keen to inflict inflation upon their own citizenry to save their prodigal cousins elsewhere.

On hindsight, the UK and the Scandinavian countries look wise to have kept their own currencies. They retain control over the printing press, the ultimate weapon of purchasing power destruction. This sustains market confidence in their ability to pay their debts and allows them to refinance even if they are technically insolvent. Of course, it helps that the UK and the Scandinavian countries have historically been good credits.

In *theory*, the Eurozone countries' lack of a printing press should result in greater fiscal discipline, since they cannot print money to inflate their way out of trouble. This should make their bonds more valuable to investors.

In *practice*, old habits die hard. Greece had a golden opportunity in the early years of the EU to clean up its finances while interest rates were low. Instead, the government of that time chose to raise more debt and increase spending. Essentially, it borrowed from the distant future to buy votes for the near future.

That distant future is now the present. In the past, the government would have shrugged, devalued the drachma and carried on as usual. But this time is different: there is no drachma to devalue, only a Euro shared with some very angry neighbours.

History yields some hints about how Greece can resolve its financial woes: apart from a "Big Fat Greek Bailout" from the EU and IMF, Greece can default. It has after all been something of a Greek tradition: in the 200-odd years since 1800, Greece has been in a state of default more than 50% of the time[1].

The EU and IMF are trying to lend Greece enough money to avoid default. They are too late: on 9 June 2010, the Ministry of Health & Social Welfare issued a joint press release together with the Ministry of Finance, announcing that the Greek hospital system's debts of 2007-2009, totaling €5.36 bn, would be settled with zero-coupon bonds, at an effective discount of 19%[2]. In layman terms, Greece's state-owned hospital system has defaulted and handed its creditors a 19% loss.

Fortunately for Greece, financial markets seem to have ignored this development entirely and instead focused on the draconian austerity packages imposed by Athens. Greece recently managed to sell 6-month bills at a yield of 4.65%, below the 5% that it currently pays the EU and IMF[3], and the IMF and European Central Bank have endorsed a further €9 bn of aid to reward Greece's progress in fiscal belt-tightening[4].

With Greece apparently pulled back from the brink, capital markets have turned to Spain. The government recently took over CajaSur, a small savings bank, while four other banks decided to merge and apply for government assistance[5]. Not surprisingly, Spain has lost its AAA rating[6]. One wonders if it was ever AAA to begin with, given that Spain has defaulted or restructured its debts *13 times* since 1800, the worst record in Europe.

Like Greece, however, capital markets have given Spain a pass: in early August, Spain sold €3.5 bn of 3-year bonds at a yield of 2.276%, a huge 100-basis point improvement over a similar sale in June which yielded 3.317%[7]. Apparently, bond investors think Spain will do just fine, despite a 20% unemployment rate, a 13-year high[8]. Unemployment across the 27-nation EU is "only" 9.6%, which illustrates just how bad Spain's situation really is.

Portugal, too, has had its credit downgraded. Beyond the PIIGS, Hungarian officials recently admitted their country was close to default, with the deputy chairman of the ruling Fidesz party saying Hungary only had a "slim chance to avoid the Greek situation". Clearly, despite the improved confidence, or rather the reduced level of fear, all is not well in Europe.

All five of the PIIGS have recently announced austerity measures in a bid to cut their budget deficits. Unfortunately, since their budgets will *still* be in deficit, their debts will continue to increase. Debts become easier to service only if the economies grow, but the measures essentially guarantee a multi-year recession.

Shrinking economies plus increased debt loads equals a risk of spiraling down into a debt

[1] *This Time Is Different: Eight Centuries of Financial Folly*, **Carmen Reinhart / Kenneth Rogoff**, 2009

[2] *Joint Press Release*, **Ministry of Health & Social Welfare and Ministry of Finance**, 9 June 2010

[3] *Relief over successful €1.6bn Greek debt sale*, **Financial Times**, 13 July 2010

[4] *Greece Passes Key EU/IMF Test but Long Road Ahead*, **ABC News**, 5 August 2010

[5] *CajaSur Takeover Adds to Pressure on Spain's Savings Banks*, **Wall Street Journal**, 25 May 2010

[6] *Fitch downgrade caps miserable week for Spain*, **Gulf Times**, 30 May 2010

[7] *Spanish borrowing cost tumbles at bond sale*, **Reuters**, 5 August 2010

[8] *Spain unemployment rate at 13-year high*, **CNN.com**, 30 July 2010

trap. The experience of Ireland, the first of the PIIGS to adopt austerity measures, has not been promising so far: GDP has fallen 17% in the last two years, and unemployment has reached 14%, while property prices have dropped 34% and are still in decline[9].

Austerity measures are a necessary first step, but will not suffice. The logical next step is a debt restructuring – something so far resisted by all. Yet, it seems inevitable. For the austerity measures alone to work, they would have to be far more severe in order to actually generate a *surplus* for paying down debt.

As it is, the proposed measures are deeply unpopular, with widespread protests and even riots in the case of Greece. If the measures go too far, the governments will probably fall, and their replacements' first act in power will be to roll back the proposed measures.

There looks to be no happy ending. It is a matter of painful reforms now, or even more painful reforms later. Recognizing this, France and Germany have also begun their own austerity measures, in a bid to avoid future trouble[10]. The next 2-3 years look difficult for Europe. Good for visitors taking advantage of lower prices, not so good for residents making do with lower incomes.

An ocean – and apparently a world – away, America is crawling out of its recession. Consistent with the early stages of a recovery, economic indicators are mixed. Although unemployment remains high, housing prices and car sales have stabilized, while overall consumer spending is basically flat. The outlook seems stable, though so far there are no clear signs of a sustainable improvement.

US President Barack Obama has signed yet another federal aid package to stave off unemployment, even as states lay off workers and cut essential services in a bid to balance their budgets[11]. The Federal Reserve, for its part, has decided to maintain a US$2 trillion portfolio of US Treasury bonds in an effort to hold down interest rates and keep the still-weak economy going[12].

Meanwhile, Australia's government has tried to join the fun enjoyed by its resource companies via a "super profits" tax. The plan backfired: protests from affected companies were so loud that Prime Minister Kevin Rudd resigned, and successor Julia Gillard quickly announced a compromise. The Australian mining industry remains divided over the government's deal with the "Big Three" trio of BHP Billiton, Rio Tinto and Xstrata. The talks excluded junior miners, who are understandably angry they were not consulted[13].

China is still trying to avoid overheating. Banks have been told to cut back on lending, at least until after they raise fresh capital. The reduction in loans has hit consumers directly: property sales in the tier-one cities of Beijing, Shanghai and Shenzhen fell 60-70% in May against the previous month[14].

The slower sales and dearth of bank financing have hurt property developers, with several forced to issue bonds paying near-usurious rates of interest[15]. The highest coupon so far is from Fantasia Holdings, whose 5-year bonds carry a 14% coupon. Close behind, Kaisa Group's 5-year notes pay 13.5%. Renhe Commercial is paying 11.75% on its 5-year notes, while Country Garden pays 11.25% on its 7-year notes. Agile Properties is lucky to pay "only" 8.875% on its 7-year notes.

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[9] *Europe Throws A Hail Mary Pass*, **Business Insider**, 15 May 2010

[10] *Keep working: Europe cracks austerity whip*, **Times Online**, 30 May 2010

[11] *President Obama signs $26 billion jobs bill to aid state payrolls*, **Washington Post**, 11 August 2010

[12] *Fed Reverses Exit Plan With $2 Trillion Holding Floor*. **Bloomberg News**, 11 August 2010

[13] *Mining tax rift widens*, **Herald Sun**, 29 July 2010

[14] *China's May Property Sales Drop in Shanghai, Beijing*, **Bloomberg News**, 1 Jun 2010

[15] *China Real Estate Bubble Bursts in Bond Market: Credit Watch*, **Bloomberg News**, 31 May 2010

The Chinese government has now turned its attention to off-balance sheet lending. In the first half of 2010, Chinese banks are estimated to have lent as much as RMB 2.9 trillion via trust products, more than one-third of their entire *annual* lending quota of RMB 7.5 trillion. The credit boom has continued, despite compliance with official rules.

The latest government edict orders banks to put such loans back on their balance sheets, while requiring them to maintain the same capital adequacy ratios as before[16]. This would imply an immediate slowdown in new lending, or a major fund-raising. Unsurprisingly, bank shares sold off following the announcement.

Given the heavy weighting of property and finance stocks in the Hong Kong and Shanghai stock market indices, it is no surprise that both indices have dropped in recent months, with year-to-date declines of 8% for the Hang Seng Index and 27% for the Shanghai SE Composite Index as at 30 June 2010.

Manufacturing in China has also been affected by poor consumer sentiment in Europe, its biggest export market. The National Bureau of Statistics' Purchasing Managers' Index fell in July for the third consecutive month. It is still above 50, indicating continued expansion, but the tone is much more cautious now.

India, like China, continues to do well, albeit with the constant worry of inflation[17]. So far, the government's policies have favoured economic growth against curbing inflation, which should be no surprise given the weak global economy. The government expects full-year growth to reach 8.5%.

As should be clear, the overall outlook for 2010 remains muted. The economy is unlikely to get much worse, and in all probability 2011 should not be any worse than 2010. The bright spots, as usual, are China, the world's factory, and India, the world's back office. Their wage differentials with developed economies are too compelling for large companies to ignore.

In stock market terms, the European financial crisis has sent already-jittery markets tumbling. Most of them have given up their gains for the year, and sentiment remains weak. Some markets staged a rally in July, only to sag again in early August.

If markets continue downward the rest of the year, valuations will become very interesting, and future returns should be exciting. For now, your manager remains cautious, and will write again when the report for the quarter ended 30 September 2010 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
12 August 2010

3. Portfolio Review

As at 30 June 2010, the Reference Account Net Asset Value (NAV) was $180.97 per unit, net of all fees. The highwater mark was $166.03, and the total return to date for 2010, net of all fees, was 9.0%.

14 securities made up 85.6% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

Divestments

Asia Financial was sold after your manager reviewed the investment and concluded that the underlying discount to book value was unlikely to be narrowed in the medium term. The company used to own Asia Commercial Bank, but sold it off in 2006; the bank is now part of Public Financial Group.

Some of the sale proceeds were paid out as a special dividend, but almost HK$2bn remains on the balance sheet, earning essentially nothing. The financial crisis of 2007-2008 was

[16] *China orders end to sales of repackaged bank loans,* **Bloomberg Businessweek**, 11 August 2010

[17] *Bottlenecks to prolong high India inflation,* **The Economic Times**, 9 August 2010

a golden opportunity to put the money to work in the capital markets, but little was done beyond repurchasing some of its own shares.

Given the balance sheet the company was guaranteed to survive a multi-year downturn, so it should have invested significant amounts of money in the markets. The reluctance to do so points to management being conservative to a fault. Money hoarded forever serves no purpose; if the investment hurdle is too high the money will never be used, and it may as well not be there. Your manager decided to reclaim the funds for better use elsewhere. Including dividends, the gain on divestment was not material (under 5%).

China Construction Bank (CCB) was divested due to concerns that it would be hurt by the Chinese government's measures to slow down the Chinese economy. In particular, the government has begun increasing the reserve ratio requirement for banks. This has 2 effects: first, it curbs lending and thus profits, and second, it increases the chance of a fund-raising.

China Merchants Bank and Bank of Communications recently announced rights issues to boost capital adequacy ratios. CCB's rivals Bank of China and ICBC likewise proposed convertible bond offerings to boost their capital adequacy ratios. CCB's own capital adequacy ratio had also declined after 2009's lending binge, so the writing was on the wall. As the shares were not undervalued, the decision was made to exit. Gains on divestment were just over 20%.

Epilogue: Shortly after your manager sold out, CCB announced a rights issue. Incidentally, Bank of China and ICBC have also decided to conduct rights issues instead of issuing convertible bonds.

Eagle Nice was sold after your manager met the company in Hong Kong and concluded that the strong balance sheet was not enough to offset weaknesses inherent in the business. Specifically, the company depends on 2 key customers, who make up 70% and 20% of sales respectively. Effectively, the company has no pricing power. Most of the products also have a life of only 2 seasons, after which price erosion makes them uneconomic to produce. The company is essentially running on a treadmill, which means that the success of the past is unlikely to be repeated. A small but immaterial gain (under 5%) was realized.

Epilogue: The company recently announced poor results for the 6 months ended 31 March 2010. The share price fell by one-third in two days and has not recovered since. It was most fortunate that your manager visited the company and managed to divest early.

Goodpack W121130 was sold as trading liquidity declined sharply. While sufficient trading liquidity remained in the underlying shares, your manager chose to hew to the maxim to "never convert a convertible" as it would have removed the margin of safety inherent in the warrant. Gains on divestment were not material (under 5%).

Epilogue: Trading liquidity returned soon after your manager sold. On hindsight, it seems divestment may have been a mistake.

HTL was sold as the European financial crisis broke. Over 60% of HTL's sales come from Europe. A multi-year recession is on the cards for the PIIGS countries, and the stronger members of the EU i.e. UK, France, Germany and the Scandinavian countries must bear the cost of the bailout. European consumer demand will likely be weak, and HTL will face significant headwinds.

Another furniture company's conference call transcript indicated that the cost of leather, a key raw material, was rising. Lower forward demand, coupled with higher costs, drove the decision to sell. Including dividends, gains on divestment exceeded 50%.

New Investments

China Minzhong is a supplier of both fresh and processed vegetables. In China, its self-operated farms cover 52,000 *mu* in 6 provinces, and it has 5 processing facilities in 4 provinces. Vegetables are also sourced from contract farmers. By revenue, China Minzhong is the fourth-largest vegetable supplier in China, after Chaoda Modern, COFCO Xinjiang Tunhe and China Green.

The vegetable supplier market in China is highly fragmented. Smallholders account for 99.6% of the supply, so there is huge potential for efficiency gains in consolidation, from bulk purchasing to modern farming methods and improved logistics.

The main barriers seem to be access to land and capital: suitable land in sufficient acreage at a reasonable price has to be found, and sufficient capital must be raised. In particular, land leases have to be paid 5 (usually 10) years in advance, which strains the balance sheet. This is offset by high margins – selling prices reflect smallholders' inefficiencies, while modern, large-scale operations may have far lower per-unit costs.

At investment, the company's shares traded at about 9 times the trailing 12 months' earnings, and about 1.4 times book value. Debt to equity was about 11%, but including the IPO proceeds there is no net debt. As the company was only recently listed, there is no dividend record, so it is possible that no dividends will be paid for 2010. However, competitor China Green pays about 25-30% of profits as dividends, which suggests a yield of 3% for China Minzhong.

Vietnam Export Manufacturing and Processing (VMEP) is a manufacturer of motorcycles in Vietnam. It is controlled by Sanyang, a Taiwanese maker of motorcycles and cars. Sanyang originally acquired its expertise from a 1962 joint venture with Honda Motor to produce motorcycles.

VMEP is Sanyang's vehicle for Vietnam. Sanyang provides technology and some parts; VMEP otherwise operates independently and has its own production facilities in Vietnam.

Motorcycles remain the personal transport of choice in developing countries, and Vietnam is no exception. Cars remain unaffordable for the average person, so motorcycle demand will track overall economic growth for at least several years more.

The stock was bought at about 9 times the trailing 12 months' earnings, and at about 1.6 times net tangible assets. Trailing dividend yield was over 7%. Debt to net tangible assets was 5%. Cash on hand exceeded all liabilities.

Samson Holding is a manufacturer of furniture such as dining tables, chairs and cabinets, or "casegoods" in industry parlance. It is currently among the top 10 casegoods wholesalers in the US and UK. Taiwanese husband-and-wife duo Samuel Kuo and Grace Liu started Lacquer Craft (Dongguan) in 1995, and built the business into today's Samson. They continue to run the company as executive directors.

The company's largest market is the US. The moribund housing market in the US is slowly recovering, and furniture sales are likewise making a comeback.

The recent history of the US furniture industry is not pleasant. 2005-2006 marked the peak for most major US furniture companies. Your manager surveyed 11 major home furnishings companies selling into the US. Across the 11 companies, total sales in 2009 were less than two-thirds of that achieved in 2006, and profits fell drastically in 2007-2009. 4 companies reported operating losses in 2008, while 6 did so in 2009.

Samson took a beating too: 2009 profits fell 60% from the 2006 peak. However, the management quickly cut capital spending, and free cash flow in 2009 was actually higher than in 2006. Throughout the crisis, inventory remained under control, bad debts were minimal, and bank debt was paid down.

During the downturn, Samson also took the opportunity to acquire additional brands from cash-strapped competitors and bankruptcy administrators; these will allow it to offer products at more price points in the market.

The ongoing consolidation in the US furniture industry is likely to continue, with accelerated outsourcing to Asia. With its main manufacturing base in China, Samson has a structural cost advantage against US-based competitors, and will probably gain market share. The imminent recovery of the US housing market should also provide a helpful boost over the next few years.

Additionally, two years ago the company decided to open a new plant in Bangladesh; it is slated to begin production in July. Although the infrastructure in Bangladesh is inferior to that of China, labour is 60% cheaper. Total production capacity will increase by less than 10%, but a successful implementation can be scaled up, and in the long term it will bring down overall production costs, further enhancing cost-competitiveness.

The stock was purchased at about 11 times forward earnings, and just below net tangible asset value. Dividend yield was 4%. Debt to net tangible assets was 3%, and cash on hand exceeded all liabilities.

Sarin Technologies is a manufacturer of metrological equipment used to map rough diamonds. Imperfections, or “inclusions” in industry parlance, reduce a diamond’s value. The equipment helps manufacturers plan how to cut and polish rough diamonds to minimize or avoid inclusions in the final stones.

Sarin is the market leader, and its products are used by most major diamond manufacturers and all the major gemological institutes worldwide.

However, its business model has a major weakness: as the equipment is electro-optical in nature, there are few moving parts. The useful life is very long, and replacement sales are thus virtually nil; the company makes money only from the initial sale.

It took the recent recession and the consequent downturn in the diamond market, manifested in 3 straight quarters of losses, for the management to finally address this issue. The company’s newest product, the *Galaxy 1000*, is now also offered as a service, on a pay-per-use basis. This ensures a recurring income stream which will greatly improve cash flow.

Mining giant BHP Billiton has been among the first big-name customers to use the *Galaxy 1000* for rough diamond auctions. Commercial use of the service will likely expand dramatically. Nine months after its debut, *Galaxy 1000* accounts for 10% of revenues, and will likely grow in importance over time.

Meanwhile, the diamond equipment market has come back to life as the world economy slowly gets back on its feet. Sales for the last three quarters are now back to pre-crisis levels, and Sarin’s June 2010 quarter actually recorded the highest sales since its 2005 IPO.

Still, the company remains dependent on equipment sales. Until service income becomes a major contributor to revenue, the company will be badly affected if the diamond market turns south again. Your manager remains mindful of this risk and thus considers Sarin a “special situation” investment – a turnaround, rather than a long-term holding.

The stock was purchased at about 7 times forward earnings, at a projected dividend yield of 5%. There is no debt, and cash exceeds all liabilities.

4. Guarantees

A guarantee is a promise, an obligation to make good a commitment or to repay a liability. In the world of finance it usually pertains to performance of a contract such as future profits, or future repayment of debt.

It is common sense that the word of an honourable man is worth more than the contract of a crook. Yet professional investors continue to fall prey to con artists in their greed to make money.

Profit guarantees are sometimes used in acquisitions to put the acquirer's mind at ease. The buyer believes it is buying the business at *X* times earnings. If earnings decline, the excess paid is refunded. The buying party may think it has bought free insurance: heads they win, tails the seller loses.

Of course, in business nothing is truly free. The seller knows more about his business than the buyer. Why should he give a profit guarantee, and expose himself to a future liability? The logical answer is that he has already budgeted for the shortfall out of the sales proceeds. In his mind, he holds the upper hand: the true sales price is the price net of the shortfall. Achieving the profit guarantee would simply be a bonus.

Sensible buyers who want to buy based on future profits should escrow the money beforehand and release it only when the profits are realized. Better still, instead of a profit guarantee, the purchase can be based on the known results, with an "earn-out" clause that attracts additional payment should future profits prove as high as expected.

Sadly, not all buyers are so prudent. One example of a buyer who appears to have been too hasty is SGX-listed **Aussino Group**.

Aussino is a wholesaler and retailer of home furnishings such as pillow cases, quilts, blankets and towels. It operates stores in Singapore and licenses franchisees overseas. It also distributes ladies' fashion apparel under the *SINO LONDON* and *Hardy Amies* brands.

It was disclosed on 24 August 2007 that a 60:20:20 joint venture, Doppio Fashion Group Pty Ltd, had been set up to acquire Nuovo Uno Pty Ltd and Leo Fashion Pty Ltd. Nuovo was a wholesaler and retailer of ladies' fashion apparel, while Leo was a wholesaler and retailer of Hardy Amies shirts. At first glance, these were good fits as "bolt-on" acquisitions.

Aussino's stake was 60%, and it contributed AUD 2m towards the purchases via a shareholders' loan. The minority owners, Allen Dong and Harvey Boots, were apparently the respective original owners of Nuovo and Leo. Essentially, they sold their businesses to Doppio in exchange for a collective 40% stake in Doppio, plus cash of up to AUD 2m.

Allen and Harvey jointly and severally guaranteed that Doppio and its subsidiaries i.e. Nuovo and Leo would have pretax profits of AUD 911,943 for the year ending 30 June 2008, and AUD 1,559,300 for 2009. Shortfalls would be settled in cash.

The profit guarantee implied an amazing deal for Aussino. Assuming all the cash was paid to Allen and Harvey, with none used for working capital, Aussino was paying AUD 2m for a 60% stake in a company that was guaranteed to earn AUD 2.4m pretax in the next 2 years. Aussino's implied share of the pretax profits was AUD 1.4m, so it would get 70% of its money back in 24 months.

If 2010 was as good as 2009, then on a pretax basis Aussino would get all its money back – and more – in just 3 years. This would be an incredible – and *totally unbelievable* – internal rate of return.

Not surprisingly, Doppio could not fulfill such great expectations. One year later, on 29 August 2008, Aussino announced the restructuring of Doppio. The reason was sobering: instead of pretax profits of AUD 911,943, the actual pretax profits were just AUD 45,891, a shortfall of 95%.

Harvey left. In what appears to be a sweetheart deal, besides selling back his 20% stake back to Doppio for AUD 50,000, he was discharged from his profit guarantee. This left Aussino with a 75% stake, and Allen with a 25% stake.

Importantly, Allen was now the sole guarantor for Doppio's profits. Instead of asking Allen to make up the shortfall, Aussino rolled the profit guarantees one year forward i.e. the goals were now for 2009 and 2010.

Fast forward one year: more bad news. For the fiscal year ended 30 June 2009, instead of AUD 911,943 in pretax profits, Doppio had a pretax *loss* of AUD 1,525,503.

Aussino finally decided enough was enough, and began legal proceedings to claim on the guarantee. Allen chose to declare bankruptcy. The legal proceedings are still ongoing.

It looks like Allen and Harvey sold Aussino lemons, whether deliberately or otherwise. Harvey somehow got a graceful exit, while Allen was stuck with a guarantee that he could not, or would not, honour.

What can we learn from this episode?

First, the obvious: **if something is too good to be true, it probably is**. If Aussino was getting a fantastic deal, then Allen and Harvey were getting a bad deal: they were selling their businesses too cheap. No sensible owner willingly and knowingly sells out cheaply. Among many possible explanations are two simple ones: Allen and Harvey were stupid; or they knew Aussino was in fact overpaying.

Were Allen and Harvey stupid? Probably not – each had built up a business, after all. Aussino clearly believed in Allen and Harvey, since they were retained to manage Nuovo and Leo.

Did Allen and Harvey know they were misleading Aussino into overpaying? That question can only be definitively answered by Allen and Harvey themselves. Certainly, each man was in the best position to know what his own business was really worth. In the end, perhaps the terms were so attractive to Aussino that greed trumped good judgment.

One mystery for aspiring sleuths to solve: why, after Doppio's poor first year, was Harvey allowed to walk away from the profit guarantee, with a farewell bonus no less, while Allen got no such kindness, and had to shoulder the profit guarantee burden alone?

The second lesson to be learnt from Aussino's misadventure is that **a guarantee is only worth what the guarantor will pay**. Allen's AUD 2.4m profit guarantee turned out to be worth a lot less than that.

Let us now look at **third-party guarantees**. The most common form of these is insurance.

Many companies imagine that they can remove risk from their business by simply buying insurance against a particular event. But the truth is, they have merely exchanged one type of risk for another. The new risk they have taken on is *counterparty* risk.

The insurer is supposed to stand ready to make good any claims. But many policyholders have learnt the hard way that not all insurers are able and willing to pay claims.

In 2005, when Hurricane Katrina struck the south coast of the United States, many insurers went bust. After several years of mild hurricane seasons, many insurers had lowered their premiums, and did not set aside enough reserves to pay claims. Thus, when the inevitable happened, these insurers – and their policyholders – went under.

More recently, in the US sub-prime mortgage debacle, mortgage insurers were also badly hit. Because the US had never had a nationwide decline in housing prices, insurers assumed it would never happen, and priced their policies accordingly. When it did happen, the insurers did not have enough reserves to pay their claims. The most infamous casualty is perhaps AIG, which was effectively taken over by the US government in a 2008 bailout.

Even as the US exits the Great Recession, municipal governments are defaulting in record numbers. Because US municipal bond default rates were miniscule in the past, bond insurers underwrote on a "no-loss" basis and set aside almost nothing for claims.

Ambac, MBIA and Assured Guaranty, the 3 largest bond insurers, have collectively set aside in reserves just 0.04% of the total public debt they have insured[18]. In other words, if the actual default rate exceeds 0.04%, which is not unlikely, one or more of them will go bust.

The takeaway is that the mere *act* of buying insurance is not enough. The insurer must be able and willing to pay claims as and when they are made. Otherwise, it is equivalent to buying a parachute that doesn't work when you do jump from the plane.

We now turn to debt, in particular, **sovereign debt**. Debt, after all, depends on a promise – a *guarantee* – of future repayment.

In a conventional loan, the creditor has power over the borrower. On pain of demanding immediate repayment, the creditor can impose covenants with regards to further borrowing, principal repayment, and so on. The creditor also has priority when the borrower is insolvent, and can seize collateral or even outright control of a company.

This seniority makes debt inherently safer than equity, so lenders generally accept a lower return in exchange for perceived safety.

However, sovereign debt presents a clear exception to the "debt is safer than equity" aphorism. Investors in *corporate* bonds can take over a company or liquidate its assets in the event of a default. Indeed, such activity is commonplace in the distressed corporate debt arena. But we have yet to see an investor in *sovereign* bonds invade a country or seize a country's gold reserves upon default.

No investor today is known to maintain a private army capable of enforcing the repayment of a sovereign debt. The size and capabilities of a modern sovereign army prevent creditors from taking any action beyond issuing polite requests for repayment.

[18] *Buffett's 'Dangerous Business' Grips Bond Insurers,* **Bloomberg News**, 19 Feb 2010

That is to say, a sovereign borrower is the proverbial 800-pound gorilla that can sit anywhere it wants; a sovereign pays its debts when it pleases, not when its creditors wish.

Clearly, the poor bargaining position of the private lender makes sovereign debt an *inferior* investment in normal circumstances. This is contrary to conventional wisdom, which deems sovereign debt a "risk-free" instrument against which other investments are compared.

Because repayment is in fact voluntary and not compulsory, sovereign debt carries a *higher* risk than corporate debt. Yet almost all bond investors accept *lower* coupons on their sovereign bonds than on their corporate bonds.

Higher risk, and lower return. This apparent insanity is in fact the market norm. Accordingly, some wags have dubbed sovereign debt "return-free risk".

In *theory*, a country can print paper money to meet its obligations. In *practice*, few do so, for fear of triggering hyperinflation and economic collapse. The experiences of Germany (1919-1923), Hungary (1945-1946) and Zimbabwe (2001-2009) loom large in the minds of finance ministers.

Instead, the usual action is to default and force creditors to reschedule the debt, take a haircut, or both. Throughout modern history, kings and finance ministers alike have proven more willing to stiff external creditors than to tax and anger the local populace who grant them their power. Greece, for example, defaulted in 1826, 1843, 1860, 1893, and 1932, and it had drachma hyperinflation in 1944. This sort of track record hardly inspires confidence in the quality of sovereign debt.

Reinhart and Rogoff's 2009 book *This Time is Different: Eight Centuries of Financial Folly* offers a detailed look at the capital markets over almost eight hundred years. The data is depressing, and the conclusion inescapable: even so-called "advanced" countries went through periods of default before becoming good credits, while "emerging" countries showed a pattern of serial defaults.

In other words, the good reputations and low borrowing costs enjoyed today by "investment-grade" countries were hard-won over decades of consistent repayment. The corporate bond offers the safety of collateral or control in the event of default. A sovereign bond offers neither. Therefore, only countries with an established history of good credit should be able to issue sovereign bonds at a cost below that of a good corporate issuer.

Logically, a new sovereign issuer should pay a premium against a good corporate issuer, and a sovereign with a poor reputation should not be able to issue bonds at all, except at usurious rates. Unfortunately, the history of debt capital markets shows otherwise.

American currency carries the motto **IN GOD WE TRUST**, but **IN HISTORY WE TRUST** would probably serve bond investors better.

Bond investors who refuse to learn from history have been badly burnt. Moody's has estimated that from 1983-2009, investor losses from sovereign bond defaults averaged 50%, with individual losses ranging from 5% to 80%, while a 2005 IMF study covering sovereign bond defaults across 1998-2005 found that losses ranged from 13% to 73%, with most in the 25-35% range.

In the defaults, sometimes the haircuts were unilateral, while at other times they were negotiated.

Of course, "negotiating" with a sovereign is necessarily one-sided: with creditors unable to invade or seize assets, the sovereign's decisions on the changes to the coupon, principal, maturity and currency of its debts are driven only by political considerations.

A student of economic history should refuse to lend money to all but the most reputable sovereigns. Sadly, capital markets show that most bond investors do <u>not</u> know their history.

To quote German philosopher Georg Hegel, "we learn from history that we do not learn from history."

As a result, "serial defaulters" such as Greece, Portugal, Spain, Turkey, Nigeria and virtually all of Latin America have repeatedly borrowed money in the capital markets at rates comparable to or even cheaper than proven corporate borrowers.

Africa does not host as many serial defaulters, but that may be because most African nations only became independent in the second half of the 20th century. Many have since defaulted at least once. Nigeria, for one, has defaulted on its debts no less than five times since independence in 1960.

One might hope that the current European sovereign debt crisis will permanently cure bond investors of their optimism. But these "sophisticated" investors have had many chances to learn and have not done so, despite often-horrific losses from defaults. Why should this time be any different?

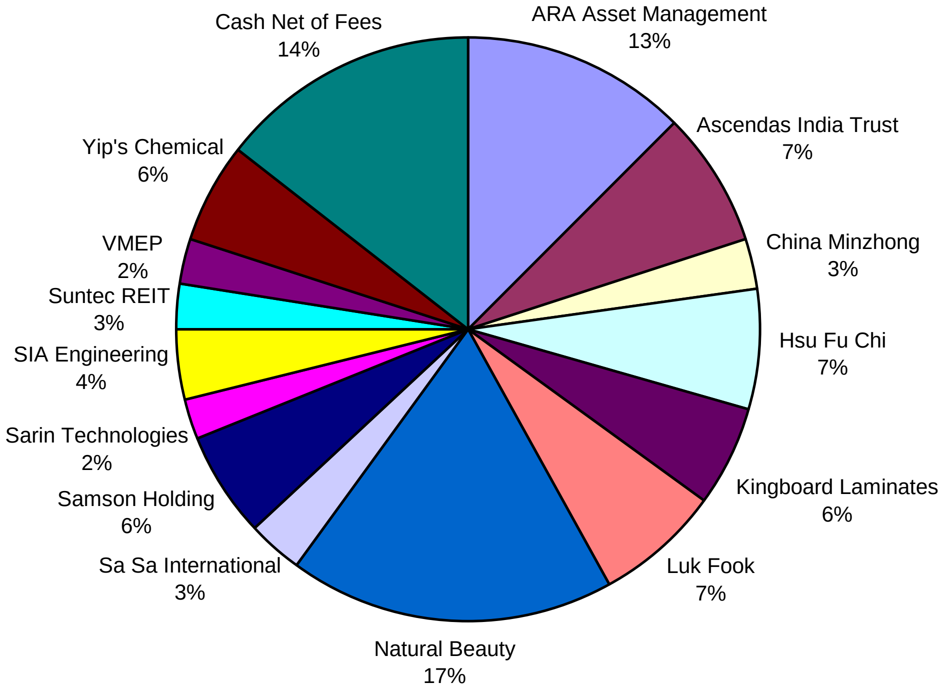
End

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Annex I

Reference Account as of 30 June 2010



Annex II

Monthly Net Asset Values						
	2008		2009		2010	
Date	**NAV**	**Invested**	**NAV**	**Invested**	**NAV**	**Invested**
31 Jan			$103.03	52.65%	$164.00	83.96%
28 Feb			$102.42	69.37%	$169.35	93.43%
31 Mar			$100.11	51.35%	$179.88	94.92%
30 Apr			$106.95	68.24%	$184.58	92.43%
31 May			$131.61	77.07%	$177.16	81.71%
30 Jun			$131.39	82.95%	$180.97	85.55%
31 Jul			$142.18	85.58%		
31 Aug			$141.28	91.92%		
30 Sep			$146.38	94.84%		
31 Oct			$149.29	97.56%		
30 Nov	$100.00	16.20%	$154.88	94.34%		
31 Dec	$101.02	52.67%	$166.03	86.44%		
YTD	**+1.0%**		**+64.4%**		**+9.0%**	

Updated 12 August 2010