LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

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Client Newsletter for the period ended 30 September 2010

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for September 2010. We are nearing the second anniversary of operations.

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

2. Market Commentary

Capital markets remain volatile, with sentiment swinging almost weekly between optimism that the world economy is firmly on the mend, and fear that a US double-dip recession is imminent.

Amidst a "flight to safety", blue-chip companies are issuing record amounts of investment-grade debt at record-low interest rates. No rate seems too low for risk-averse investors, even as any logical analysis must conclude that rates are likely to increase in the medium and long term, with negative effects on the market value of outstanding bonds.

At the other end of the quality spectrum, the bond market is also seeing plenty of action. Buyers are now so numerous that the debt markets have expanded greatly to serve them. With apologies to Ian Fleming, yield-hungry, income-seeking investors have found a new champion:

"The name is Bond. ***Junk*** Bond."

Charitably called "high-yield", junk bonds are issued by companies whose weak financial standing merits a poor rating, or no rating at all, from ratings agencies. The agencies have been discredited for ratings inflation in securitized products, but single-borrower issues have largely been rated fairly. In other words, if something is rated as junk, it probably deserves it.

Junk bond default rates are currently at all-time lows of just 2%. This reflects the current ability of borrowers to replace expensive old debt with cheap new debt. Eventually, when rates rise, default rates will soar, as borrowers become unable to refinance their debt at manageable rates. For now, the party goes on.

As for risk-averse investors in the herd who are still rushing to safety, many have merely looked at the *name* of the issuer without actually understanding the *financial strength* of the issuer. In many cases, this means they are actually making a risky investment when they think they are being conservative.

For example, the deficit problems of the US government are well-known and much-discussed. Municipal US governments have drawn less attention, but no less demand for their bonds. Yet investors forget that while the US government can print money if needed, the municipal governments <u>cannot</u>.

Some people have begun to tabulate the actual amounts owing. Their conclusions are sobering. The state of New York alone, for example, owes US$200bn in future retiree healthcare costs[1]. Previously, the obligations were simply not accounted for, so almost no money was set aside to pay them.

Robert Novy-Marx and Joshua Rauh recently documented the extent of pension liabilities, which are separate from the healthcare

[1] *N.Y. Faces $200 Billion in Retiree Healthcare Costs,* **The New York Times**, 12 October 2010

benefits just mentioned. They estimated that using the government's own accounting standards, local government employee pensions were underfunded by US$190bn[2]. Discounted at current US Treasury yields, the liabilities were US$383bn. This was in addition to the US$3tn of unfunded state-sponsored pension plan liabilities.

Such liabilities are not distant problems: if nothing is done, several cities will run out of money to pay pensions within a decade. Philadelphia will run out in 2015, while Boston and Chicago will do so in 2019. Cincinnati, Jacksonville and St. Paul will only last through 2020.

All these unfunded obligations are above and beyond the official deficit figures reported by the US government. In other words, the financial situation of the US government is very bad. If the US government was a company, and thus unable to print money, its debt would clearly deserve a junk rating.

Unlike the Europeans, who have largely come clean about their issues and are implementing austerity measures to pay down their debt and rebuild their economies, the US government seems intent on covering up the problem. Case in point: many states have changed their accounting methods to reduce the future pensions of workers whom *they have not yet hired*[3].

Obviously, no matter how "true and fair" the accountants may deem such accounting, any such pension "savings" are totally bogus. The US is headed towards an eventual default or hyperinflation if nothing concrete is done. There *is* some hope, of course – after all, Winston Churchill apparently once said that:

"Americans will always do the right thing, after they have exhausted all the alternatives."

As was discussed in the previous newsletter for 30 June 2010, creditors of sovereign entities cannot simply waltz in and empty the vault, or take possession of real estate.

There is an instructive case of a sovereign default in the capital markets today. Native American Indian tribes in the US are sovereign nations, with their own laws and taxes. Many make a living off selling duty-free cigarettes and alcohol. Others have developed casinos on their land. One such tribe, the Mashantucket Pequot Tribal Nation, took on a large amount of debt to expand its casino business. It defaulted last November.

However, the creditors have found their senior standing to be of little help. Because Indian casinos must be operated by Indians, if the creditors took over the casino they would have to shut it down. In fact, legally the creditors can neither seize the property, nor force the tribe to pay. The creditors are at the mercy of the borrowers. Being a bondholder in this case has simply meant that returns have been limited to the interest payments, while the risk has not been diminished at all. So lending the money was high-risk, low-return. Oops.

The immediate outcome of the default is that other lenders are reducing the amount of funding they will extend to tribal casino projects. No problem for the Tribe, since its casino still generates about US$700m of profits a year, but possible problems for every other Tribe. It is to be hoped that there will not be a similar case in the US, where a municipal default causes the borrowing cost of every other local government entity to rise.

The US itself cannot afford to actually default or continuously print money. Either move would destroy confidence and permanently damage its credit standing. The US dollar will rapidly diminish in importance as the *de facto* reserve currency. This can only cause future borrowing to become more expensive.

Reserve currency status, once lost, is unlikely to be regained, especially as countries like China, India and Brazil become increasingly

[2] *The Crisis in Local Government Pensions in the United States*, Novy-Marx & Rauh, **National Bureau of Economic Research**, 13 October 2010

[3] *The Illusion of Pension Savings*, **The New York Times**, 17 September 2010

creditworthy and their currencies become convertible. In the meantime, gold is already displacing the US dollar as a reserve currency.

In the US economy, hope of recovery rides on consumer spending, yet precious little has been done to help the consumer. It is ironic that for a country whose economy depends so heavily on domestic consumption, most of the aid has gone towards big businesses. Perhaps this is not unusual, given that politicians are elected with corporate campaign contributions, and are often beholden to lobby groups.

To date, the only policies that were effectively implemented have been those helping businesses directly e.g. TARP for financial institutions, CARS for automakers and Homebuyer Credit for the homebuilders. The latter two provided benefits to consumers as well, but in reality were designed to help businesses sell new cars and new homes.

Programs intended to primarily benefit consumers have fallen far short of their goals. Credit card reforms to reduce extraneous fees have instead resulted in allowable fees going up and banks pushing "professional" cards exempt from the new rules.

Mortgage modifications to help homeowners has not helped more than a small fraction of affected homeowners, and most of the modified mortgages have subsequently gone into foreclosure anyway.

The recent revelation that many mortgages were not properly documented and thus simply illegal as written has not caused the government to force a halt to foreclosures. Instead, the government has merely appealed for calm and restraint[4], which has of course had the opposite effect. One extreme example of the mess: a Florida man had his house foreclosed on by Bank of America, *despite having no mortgage*[5].

[4] *White House Urges Calm on Lenders*, **The New York Times**, 17 October 2010

[5] *Man Who Had No Mortgage Faced Foreclosure Anyway*, **Bloomberg News**, 8 October 2010

Some investors are now forcing the banks to buy back mortgages that were not properly originated or serviced, or were not actually investment-grade (translation: they defaulted). It has been estimated that the banks may suffer an additional US$55-120bn in losses from buying back such mortgages at par[6]. Of course, since the banks created this toxic waste, they fully deserve to be made to take it back.

It will not be easy for the banks to escape: the aggrieved investors include Pacific Investment Management Company (PIMCO) and the New York Federal Reserve. PIMCO is one of the largest fixed-income investors in the world, while the New York Fed is of course part of the US government.

Fortunately for Americans and the rest of the world, the American economy continues to be a miracle, if only it because it has survived and prospered *despite* the government. No sensible analysis would discount a recovery of the US economy. The only question is when.

In Europe, austerity is finally taking hold. But it is hitting hard. In Italy, schoolteachers have become the latest victim of budget cuts, even though Italy already spends just 4.5% of its budget on education, the second-lowest level in the OECD[7].

Greece is enforcing austerity too, but its bureaucracy still blocks would-be investors who could bring much-needed capital and expertise, and create thousands of jobs. Take the case of Donkey Head Island: a group of investors offered to invest €15bn, conditional upon the government providing a formal letter of support to help cut through bureaucracy[8]. Simple, right? Wrong. The letter never came,

[6] *Ghosts Of Countrywide And $47 Billion Worth Of Bonds Haunt Bank Of America*, **Forbes**, 19 October 2010

[7] *Italian Teachers Seek Jobs, Help From Parents in Budget Squeeze*, **Bloomberg News**, 14 October 2010

[8] *Even $21 Billion Won't Get You a Greek Island Amid Red Tape*, **Bloomberg News**, 11 October 2010

and the investors quit. No wonder Kenneth Rogoff, co-author of *This Time Is Different: Eight Centuries of Financial Folly*, recently said: “a Greek bankruptcy is unavoidable”[9].

Spain is struggling to contain its budget as programs initiated in the good times now cost too much. In particular, an attempt to boost the solar power industry backfired. The program was open-ended, with no cap on cost. The result: rapid expansion in solar power plants, which drove up panel costs. Worse, demand outstripped local supply, and panels were imported, so the goal of creating local jobs wasn’t met either. The government is proposing to cut the subsidies paid to solar power producers, but the producers protest that this would constitute a breach of contract and push them into bankruptcy[10].

In France, President Sarkozy has pushed through pension reforms to raise the retirement age, from 60, to... 62. Keeping with tradition, the French are protesting. However, the protests have turned violent, with rioters burning cars, blocking tunnels and blockading fuel depots, forcing the government to deploy the police[11]. The reforms are still not a sure thing: although 1993, 2003 and 2007 saw successful reforms, the protests of 1995 reversed some reforms.

Germany is in a dilemma. It generates a trade surplus from export earnings, while the other nations generate a trade deficit. In the past this was resolved through exchange rates, hence the strong deutschmark and the weak lira, weak drachma etc. With the euro, this is not possible. As a result, it is not possible for both the strong members (read: Germany) and the weak members (virtually everyone else) to prosper simultaneously. Something must give.

The EU currently has the worst of both worlds: a single one-size-fits-none currency and no political union. Eventually, either the euro is dismantled, or political union becomes a reality. Of course, in politics, “eventually” can extend beyond an individual’s lifetime.

Australia’s rapid recovery from the recession has drawn concern that its housing market is now in a bubble of its own. Some have highlighted the fact that modest homes in outlying suburbs now command million-dollar prices, similar to the US situation before the crisis hit. Still, if there is a bubble, it could well go on for longer than anyone expects, given the underlying growth in resource exports to China.

Speaking of resource exports to China, China is increasingly focused on securing key commodities, in an effort to bolster its own economic security.

Take potash, a key ingredient in fertilizers. With China desperately trying to raise agricultural yields to offset losses in farmland acreage as well as to meet increasing domestic demand, potash supply is becoming a strategic consideration. Unfortunately for China, most of the world’s supply is in the hands of only eight companies worldwide. These companies do their marketing through just five agents, further concentrating supplier power.

The largest miner, Potash Corporation of Sasketchawan, is currently “in play” as mining giant BHP Billiton has made a bid for it[12]. Sinochem, a key Chinese state-owned enterprise, has expressed interest too. Potash Corp. contributes a major proportion of Sasketchawan’s cash receipts, so the Canadian government would not be keen to sell except for a very high price, which would of course not suit the Chinese at all. So it is unlikely the Chinese will succeed this time.

Another key commodity is rare earths, but here the situation is reversed. Rare earths are

[9] *Money Is Power: An Inside View of the IMF's Massive Global Influence*, **The Spiegel**, 4 October 2010

[10] *Spain’s Solar Deals on Edge of Bankruptcy as Subsidies Founder*, **Bloomberg News**, 19 October 2010

[11] *French pension reform vote passed by parliament*, **Guardian.co.uk**, 22 October 2010

[12] *The Potash deal could change everything*, **Financial Post**, 22 October 2010

used in magnets, batteries, specialty glass, lasers and catalysts. China has about 36% of global reserves, but accounts for over 97% of world production.

Rare earths are a group of 17 elements called “rare” because, although the elements themselves are fairly common, the ores which contain them in economic concentrations are comparatively rare, hence the term “rare earths” or “rare earth elements”. The elements include scandium, yttrium, lanthanum, cerium, neodymium, samarium, europium and so on.

As rare earth usage has accelerated, so has China’s market influence and political bargaining power. The US has belatedly realized that many of its weapon systems rely on rare earths sourced from China. A recent border dispute between Japan and China saw rare earth exports to Japan stopped, risking a disruption to electronics production in Japan. Citing a need to close polluting mines and conserve resources, China has recently cut export quotas, causing prices to jump[13].

Slowly but surely, China is asserting its position as an equal to the US. The world will just have to get used to the rise of China, or, more accurately, the *return* of China. In 1820, China was the biggest economy in the world, by dint of its population[14]. When China opted out of the Industrial Revolution, productivity lagged other countries, and it fell behind. Now China is catching up with a vengeance. As the productivity gap narrows, so too will the GDP gap. Eventually, China will again be the largest economy in the world. India, for the same reasons, will be the second largest economy.

For now, China continues with its efforts to manage its growth. In particular, it is reining in bank lending. Reserve ratios have been increased yet again, but this time only for the six largest banks[15]. While increased capital is good for the solvency of the banking system, it has negative implications for bank earning power, since leverage will be reduced. The uncertainty has rattled investors and kept bank share prices depressed relative to other companies in their respective stock markets. Property developer shares have similarly suffered, since they are among the primary users of bank financing.

Chinese manufacturing, though, has already rebounded. The National Bureau of Statistics’ Purchasing Managers’ Index was 53.8 in September. A PMI score above 50 signals continued expansion.

India is still battling inflation. The wholesale price index rose 8.62% in September against a year earlier. The rupee has been allowed to appreciate, but in the words of Duvvuri Subbarao, the governor of the Reserve Bank of India, inflation is still being “quite stubborn”. The domestic economy remains strong: purchases of cars and cement, proxies of personal income and household income respectively, are still rising.

As 2010 draws to a close, it is clear that the last decade was one of transition, from a world dominated by the US and Europe, to one shared by the US, Europe, Brazil, Russia, India and China. More than ever, it is a multi-polar world. Stock markets reacting to events halfway around the world merely reflect this new reality.

As for the markets now, what does your manager think? Well, it is currently October, which is supposedly one of the poorer months historically for stock markets. Perhaps the American writer Mark Twain said it best:

“October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February.”

[13] *Rare-Earth Prices Soar as China Quotas Hit Manufacturers Abroad*, **Bloomberg News**, 21 October 2010

[14] *The World Economy: A Millennial Perspective*, **Angus Maddison**, 2001

[15] *China raises big banks’ reserve ratio*, **China Daily**, 12 October 2010

The droll remarks aside, stock markets have always been treacherous for the unprepared. But by focusing on the companies' underlying business and their financial condition, worries about sentiment can be sidestepped. It remains only for the investor to be emotionally prepared for fluctuating market value, as opposed to *business* value which changes far more slowly.

The continued volatility presents opportunities to your manager, firstly to realize gains on existing holdings, and secondly to make new investments at attractive prices. While bargains no longer abound like they did in late 2008 and early 2009, diligent research continues to yield worthy investments. Your manager remains “cautiously optimistic” and will write again when the report for the quarter ended 31 December 2010 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
26 October 2010

3. Portfolio Review

As at 30 September 2010, the Reference Account Net Asset Value (NAV) was $210.53 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 26.8%.

16 securities made up 99.0% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II. Note that invested exposure has been recalculated as a percentage of gross value, before fees. The previous calculations used net value, which would result in exposure exceeding 100% if there were significant unrealized gains, as performance fees would be accrued against the gains.

Divestments

There were no divestments for the quarter ended 30 September 2010.

New Investments

Dah Chong Hong Holdings (DCH) is a subsidiary of Chinese state-owned conglomerate Citic Pacific. There are 3 key businesses: car dealerships, food and consumer products distribution, and logistics services. DCH operates in mainland China, Hong Kong, and Macau.

In recent years, the Chinese car dealership network has become the main contributor to revenues and profits. Given the historically low levels of car ownership and the strong economic conditions currently persisting in China, this is likely to continue.

The dealerships cover many brands, including Bentley, BJ Hyundai, Isuzu, Nissan, FAW Toyota, DF Honda, GZ Honda, FAW Mazda, FAW Audi, Renault, SGM Buick and Qingling. Foreign brands are mostly tie-ups with local factories, thus the unusual prefixes.

Car dealerships are mostly standalone outfits, where the dealer cultivates relationships with customers in the hope of repeat business, service fees and referrals. In the US, most listed car dealership companies have been built from “roll-ups” where the listed company is a serial acquirer that buys existing dealerships from ageing entrepreneurs who wish to cash out and retire.

Unsurprisingly, such acquisitions seldom work out, because the acquirer is buying a mature business whose key manager intends to leave once the service agreement expires. As a result, the tendency is to operate for short-term profits. The damage to long-term profitability shows only after the original owner is long gone, and slow (or zero) growth in a mature market makes fixing issues more difficult.

Fortunately for DCH, China is by no means a mature market, which is to say that although competition is intense, the pie is growing rapidly enough that each player can still do well. In addition to acquiring profitable dealerships, DCH can start new dealerships itself. Car sales in China are growing at amazing rates; since 2007, DCH's own car sales have grown at 24% per year. Of course, such rates are unsustainable in the long term, but growth rates will likely be high for at least several more years.

Eventually, as the Chinese market matures, the dealerships will become less profitable, and companies may resort to "roll-up" acquisitions to produce growth. In the meantime, the car dealerships provide a free ride on Chinese consumption. As per capita GDP increases, the Chinese will buy more (and more costly) cars. This can only bode well for car dealerships. As they use the same premises and staff to sell more costly cars and services, returns on invested capital, and the accompanying operating cash flow, will rise.

At investment, the company's shares sold for 12 times the trailing 12 months' earnings and 2 times book value. Dividend yield was 4%. Debt to equity was 49%, but the Group is selling non-core assets, including a property in Hong Kong and a 50% stake in Shiseido DCH. The sales proceeds and cash on hand together exceed short-term debt, so there is little cause for concern.

SUNeVision is a subsidiary of Hong Kong property giant Sun Hung Kai Properties. The company was listed in 2000, at the height of the dotcom mania, ostensibly to provide Internet infrastructure and related internet services, as well as to make venture capital investments into technology companies.

At IPO, the company's market capitalization reached HKD 30bn, versus shareholder's equity of just HKD 4bn. Such were the hopes of "dotcom" investors.

Needless to say, such great expectations were not fulfilled. In fact, the venture capital operation lost over one billion Hong Kong dollars in the next 3 years before it was finally stopped. Today, only a few small legacy investments remain on the balance sheet.

Fortunately, during the same period the company's other businesses faired much better. There are now 3 core businesses: data centres, satellite antenna installation and property management. The latter two businesses are relatively steady cash cows. Data centres is by far the largest and most interesting business segment.

Data centres are purpose-built facilities for racks of computer servers. The data centre operator provides power, cooling and Internet bandwidth. Typical users are multinational corporations looking to outsource some of their backend technology infrastructure.

In line with the growth of information technology services, data centre usage has been booming. Many centres are near full occupancy, and lease rates have been climbing. Frost & Sullivan expect data centre revenues in the Asia-Pacific to grow 16% in 2011 over 2010.

Another measure of the growth of the business comes from another data centre operator, Keppel Telecommunications & Transportation (Keppel T&T). In June this year, Keppel T&T announced the closing of the Securus Data Property Fund, a US$100m Shariah-compliant fund data centre fund. Keppel T&T invested US$30m and the balance came from Islamic institutional investors. The aim is to buy or develop data centre assets in the Asia-Pacific, Europe and the Middle East, and commitments are target to exceed US$200m.

The fund's launch has some important implications. Firstly, there are investment opportunities in the data centre space that Keppel T&T is unable to fund by itself. Second, because Shariah principles forbid the use of debt, the underlying returns in the data centre business must be very attractive.

Obviously, the fund will compete with SUNeVision, but it should be occupied outside Hong Kong and mainland China for a while, given that its investors will probably first identify projects in their home countries.

SUNeVision's own results suggest strong demand. Since inception in 2000, data centre revenues and operating margins have grown for 10 consecutive years. Capacity has been added in the past 3 years, but both revenues and margins have continued to increase, indicating insufficient supply.

As margins have expanded, operating cash flow has improved. The company began paying a dividend in 2004, and has increased the cash payout in 5 of the last 6 years.

On a fully diluted basis, the stock was bought at about 20 times forward earnings, and at about 2 times net tangible assets. This is not cheap by traditional valuation metrics. However, the underlying business is growing rapidly and should generate a satisfactory return. Forward yield is 4%. There is no debt, and cash on hand exceeds all liabilities.

4. Debt versus Equity

At first glance, the division between debt and equity is clear-cut: one is a lender, the other a borrower. One seeks return *of* capital, the other seeks return *on* capital.

Of course, things are not so simple. Context is key. Hybrid securities can count as debt or equity, depending on the point of view. There are even cases where debt is effectively equity, and vice versa.

Preference (or preferred) shares are the most common form of hybrid security. They are often issued by corporations wanting to borrow money at favourable rates for long periods of time, preferably forever. Banks, in particular, like to issue preference shares, because regulators, an important constituency, count them as equity.

From a bondholder's point of view, preference shares *are* equity since they form another cushion protecting bondholders. A bondholder might object to the issue of more bonds, but not to an issue of preference shares. From a shareholder's point of view, preference shares are debt, since their coupons must be paid before ordinary dividends can be paid.

For example, **DBS Bank** has several issues of preference shares outstanding. From the regulator's viewpoint of view, these preference shares count towards the bank's capital requirements i.e. they are equity since they will be impaired before creditors are endangered. But from the bank shareholders' point of view, the preference shares are debt, since preference shares receive their dividend before ordinary dividends can be paid out.

Convertible debt is another type of hybrid security. Nominally it functions as debt, but as the stock price rises, the convertible's market value will fluctuate with the common stock. The conversion option allows convertible debt to pay a lower interest rate than conventional debt. From the company's point of view, convertible debt is just debt that is less expensive to issue. From a shareholder's point of view, convertible debt is debt that is *more* expensive because it can potentially become equity and dilute existing shareholders. So what is convertible debt: debt, equity, or both? As we can see, it depends on the point of view.

For example, in 2009, **Swiber** issued 5-year convertible bonds paying a 5% coupon. If the stock does not appreciate sufficiently by 2014, the bonds mature and are redeemed at par. They would thus have functioned as debt. But if the stock appreciates beyond the strike price, the bonds will be converted. In this case, they have functioned as equity. In other words, the status of the convertible bonds depends on the stock price.

If the stock price is high enough, the convertible bonds effectively act as equity, since they will probably be converted. Many bonds actually have a forced conversion feature to make this a reality, to lock in the conversion at an attractive price, rather than risk the share price declining, and the convertible bond then reverting to a "normal" bond that has to be repaid.

Unfortunately, this feature also has the side-effect of giving management a perverse incentive to manipulate the share price, to keep it artificially high and force conversion. After conversion, manipulation stops, and the price drops, causing losses for the hapless bondholder-turned-shareholder. Also, because forced conversion kicks in at a predetermined price, the maximum gain for a convertible bondholder is limited. Thus, a feature designed to protect the company actually hurts investors.

Leaving hybrids behind, let us look at more interesting situations, where debt is effectively equity, and equity is effectively debt.

In a company heavily burdened by debt, cash generated from operations will largely go towards creditors. Little is left for the business itself, let alone shareholders. It then follows that those who call the shots at the company are the creditors, not the shareholders.

If the company misses an interest payment or breaches a loan covenant, creditors can demand immediate repayment, force the company into default, and take control. Ergo, they already control the company *before* default occurs. Since the company is being run for the creditors' benefit, the debt is in economic reality the equity. The equity interest is only a call option with voting rights.

Liverpool Football Club exemplifies this situation. The club was bought in 2007 by George Gillett and Tom Hicks. The deal was financed by debt secured against the duo's shares in the club itself. The debt proved too heavy a load, and early this year, Royal Bank of Scotland put the club up for sale. Martin Broughton, the chairman of the board, publicly stated that "**in a situation of Liverpool's, where we are in default, then your primary obligation is to the creditor not the shareholder.**"

The club has since been sold to New England Sports Ventures, so the debt woes are temporarily over, and the equity is once again in the driver's seat. As for Gillett and Hicks, it has been estimated that they will realize a loss of some £144m on the sale.

How about the reverse, when equity is effectively debt? Many conglomerates embody this situation. Often, a conglomerate has many listed entities, and the parent company itself is also listed.

One example involves the Kingboard Group of companies. **Kingboard Chemical** is the parent company. It has two key subsidiaries, Kingboard Laminates and Elec & Eltek.

Kingboard Chemical has grown tremendously in the past 10 years. An investor might want to partake in its future success. However, the company has a significant debt load. As of 30 June 2010, excluding the key subsidiaries, the net debt to equity ratio was 42.5%. Gross debt to equity was 69%.

A conservative investor should pick the strongest security available. In theory, this would be the debt of Kingboard Chemical, since it is backed by all the assets of the Kingboard Group. **This is not correct.**

It is not enough to think about seniority in *liquidation*, where the owner of Kingboard Chemical debt will indeed be paid before the shareholders of Kingboard Chemical. One must also consider the *order* of cash payments when the Kingboard Group is viewed as a *going concern*, which is the more realistic view given its operating history.

With its high level of borrowings, Kingboard Chemical is dependent on *dividends* from Kingboard Laminates and Elec & Eltek to help it meet the principal and interest payments on its debt. Kingboard Laminates is by far the larger contributor in terms of cash payouts.

The minority shareholder of Kingboard Laminates will be paid his dividends *before* the creditor of Kingboard Chemical is paid his interest and principal. So long as the Kingboard Group is not liquidated, this order of cash payments means that a minority interest in the *equity* of Kingboard Laminates is economically a senior interest in the *debt* of Kingboard Chemicals.

Things are seldom what they seem;
Skim-milk masquerades as cream;
High-lows pass as patent leathers;
Jackdaws strut in peacocks' feathers.

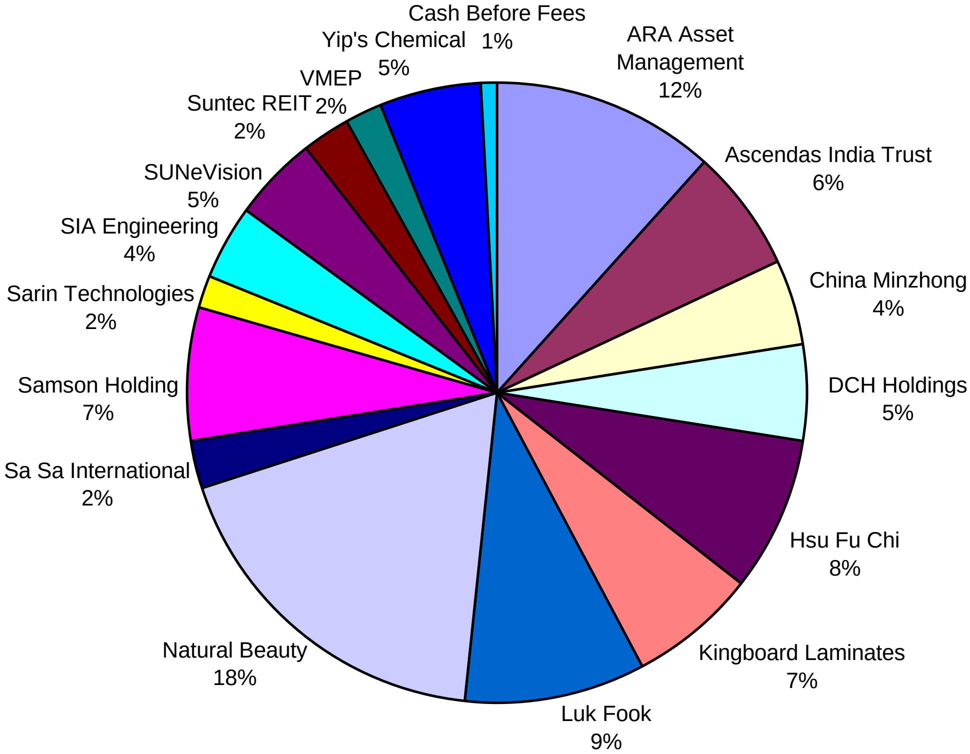
– **The Story of H.M.S. Pinafore**, Sir William S. Gilbert

This brief discussion should make clear that finance, while fascinating, is seldom simple. A security can be debt, equity or both. Debt can be equity, and equity can be debt. It all depends on context. Perhaps the only good thing that can be said about such complexity is that it means your manager still has a job!

End

Annex I

Reference Account as of 30 September 2010



Annex II

Monthly Net Asset Values						
	2008		**2009**		**2010**	
Date	**NAV**	**Invested (Gross)**	**NAV**	**Invested (Gross)**	**NAV**	**Invested (Gross)**
31 Jan			$103.03	52.48%	$163.97	83.91%
28 Feb			$102.42	69.23%	$169.35	93.00%
31 Mar			$100.11	51.25%	$179.88	93.26%
30 Apr			$106.95	67.37%	$184.58	90.31%
31 May			$131.61	73.01%	$177.16	80.77%
30 Jun			$131.39	78.62%	$180.97	84.17%
31 Jul			$142.18	80.00%	$189.24	86.50%
31 Aug			$141.28	86.22%	$193.05	92.43%
30 Sep			$146.38	88.44%	$210.53	99.04%
31 Oct			$149.29	90.70%		
30 Nov	$100.00	16.19%	$154.88	87.41%		
31 Dec	$101.02	52.56%	$166.03	79.26%		
YTD	**+1.0%**		**+64.4%**		**+26.8%**	

Updated 26 October 2010