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Keeping Your Capital Safe

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Client Newsletter for the period ended 31 December 2010

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for December 2010. We have passed the second anniversary of operations and are now in our third year. Your manager wishes all readers a happy Lunar New Year.

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

2. Market Commentary

Once again, recent stock market returns are at odds with economic reality.

In 2010, the US S&P 500 gained 12.8%, the UK's FTSE rose 8.8%, and the German DAX climbed 16.1%. Japan's Nikkei 225 fell 3.0% while China's Shanghai Composite Index dropped 14.3%.

It should be obvious to even the most causal reader of world news that none of the major economies mentioned had equivalent changes in GDP. Apart from China, major economies were weak in 2010. Germany was the strongest OECD economy in 2010, and even then it is estimated to have grown just 3.6%. China's stock market was one of the worst performers, yet its estimated 10% growth rate was the strongest among major economies.

The world economy appears to be in a "two-speed recovery" with developed markets such as the US, Europe and Japan in low gear, and emerging markets such as Brazil, Russia, India and China in high gear.

In America, the official unemployment rate fell to 9% in January. While still at historically high levels, the decline from the peak of over 10% suggests that a recovery is indeed in progress. In fact, several indicators of US manufacturing now point to increased orders, expanded production, and more exports[1]. The poor state of municipal finances is even sparking a buyout revival as investors buy out bondholders and take control of municipal projects[2].

Europe is in a little two-speed situation of its own. Broadly speaking, it can be divided into two groups: Germany, which is doing well, and not-Germany, which is not.

German exports continue to find enthusiastic buyers in Asia, Eastern Europe and North America. For exports within Europe, the problem PIG countries of Portugal, Ireland and Greece only accounted for €16bn in 2009, less than 1% of Germany's €2.5tn output. Yet the Germans cannot be complacent: if Spain, Belgium or Italy experience a major debt crisis, Germany will be hit, as these countries accounted for almost €125bn of German exports in 2009.

The problems in Portugal, Ireland and Greece are well-documented and will not be repeated, except to note that there is now increasing diplomatic pressure on Portugal to seek aid from the EU and IMF[3], in the hope that this will isolate the debt crisis and prevent a spread to Spain, a bigger – and sicker – economy.

[1] *ISM Index of Manufacturing in U.S. Rises to 60.8*, **Bloomberg**, 1 February 2011

[2] *Citigroup's Distressed Muni Deal May Point Way for Takeovers*. **Bloomberg**, 4 February 2011

[3] *Portugal under pressure to seek EU/IMF Aid*, **Reuters**, 9 January 2011

Spain's unemployment rate is back above 20% as it struggles to implement labour reforms. Its problems are emblematic of Western Europe: postwar prosperity led to union concessions, to the point that wage costs and benefits overwhelmed their edge in productivity. Now, there are decades of concessions to unwind.

Germany is unusual, because it began the reform process 20 years ago, when it had to rebuild East Germany after reunification. In the name of German solidarity, West Germans got used to working hard and not expecting too much. East Germans meanwhile were grateful to just have jobs.

Then, when the Euro came, the exchange rate set for the Deutschemark made exports expensive. More reforms followed, and over the next 10 years the unions' power was whittled away. Indeed, recent strikes by IG Metall, the dominant metalworkers' union, elicited little sympathy as Germans realized that companies would close factories if wage demands made the plants unprofitable. Germany is now reaping the rewards after 20 years of austerity. The rest of Western Europe has some serious catching up to do.

Japan, as usual, is not faring well. Its recent downgrade[4] is a belated acknowledgement of what capital markets have known for years: that its indecisive government and poor demographics foreshadow a dim future.

China continues to apply the brakes on an overheating property market and a near-runaway credit market. After trying a host of different measures, from official expressions of concern, to interest rate hikes, bank reserve ratio increases, lending quotas and mortgage restrictions, the government has introduced property taxes[5].

As per standard Chinese government practice, the initial steps are tentative: the taxes are only in Shanghai and Chongqing, and the maximum tax rate is just 1% of the properties' value. But Chinese government policies are like a steamroller: slow but inevitable. It can be taken for granted that other cities will soon follow suit, and that tax rates will rise over time. In any case, a property tax is eminently sensible, as otherwise local governments will remain dependent on land sales to generate revenues and have a vested interest in rising prices, as exemplified by Hong Kong.

India continues to struggle with inflation. Food prices have soared. Onions, a staple in Indian cuisine, have more than doubled in price against the previous year. The food inflation rate was 15.6% in the week ending January 15. The Reserve Bank of India has now raised lending and borrowing rates seven times since March 2010[6].

Economic uncertainties aside, there are now political crises too. The Middle East and North Africa are the latest flashpoint. Tunisia's president Zine El Abidine Ben Ali fled amid widespread protests, and Egyptian president Hosni Mubarak faces similar unrest. Clashes between protesters and the president's supporters have left several dead and hundreds injured. Mr Mubarak has volunteered to step down in September and has resigned from the ruling party, but remains as president for now. This seems to have pacified many, at least enough that Cairo is returning to some semblance of normality[7].

Despite the outpouring of concern worldwide, the truth is that few actually care about Mr Mubarak or his government. The real interest is in protecting commercial access to the Suez Canal and preventing similar chaos in the region. Israel is one of the few nations who do want Mr Mubarak to stay. He has honoured a 1979 peace treaty with Israel, making Egypt one of Israel's few non-hostile neighbours,

[4] *Japan's credit rating downgraded by Standard & Poor's*, **Guardian.co.uk,** 27 January 2011

[5] *Chinese cities to pilot property tax*, **Financial Times**, 27 January 2011

[6] *India Food Prices Stay High*, **Wall Street Journal**, 27 January 2011

[7] *Egypt Traffic, Life Start Moving Again*, **Wall Street Journal**, 7 February 2011

and Egypt now supplies about 40% of Israel's natural gas needs. A new Egyptian government might not be as accommodating towards Israel.

Elsewhere in the region, protests in Jordan have prompted the King to dissolve the cabinet and appoint a new prime minister. However, detractors note that the replacement, Marouf Bakhit, has a history of corruption from his first tenure as prime minister from 2005-2007, so he is hardly an improvement.

Many Arab nations share uncomfortable similarities: young populations, widespread unemployment, autocratic regimes, and unequal wealth distributions. These are a recipe for popular revolt. Young people with no hope for the future have nothing to lose in an uprising. Rulers should pay heed.

Political upheaval in key oil producers Saudi Arabia and Kuwait could create an oil shock and destabilize markets. Oil prices have already risen in anticipation of a supply shock, and now hover at about US$100 per barrel.

It all sounds like a bit of a mess. But ultimately, the world economy must move in the same general direction. Globalization is an overused word, but the numbers do not lie.

Given the deficits in the US, and the accumulation of US Treasuries by China, it is obvious that the US relies on China to buy its debt, so that Americans can then in turn buy Chinese goods. Similarly, Germany needs the rest of the EU to use the Euro so that they can afford German goods, and to weaken the Euro so that German exports are competitive. Germany needs the rest of the EU as much as they need Germany.

The MAD (Mutually Assured Destruction) military doctrine of the Cold War has given way to a new MED (Mutual Economic Dependence) economic doctrine today.

Citizens in the US and China may not know about or want to believe it, but businessmen on both sides of the Pacific have been keenly aware of this for at least the last 10 years. Likewise, ordinary citizens in Europe may not be aware of their interdependence, but Eurozone businesses are keenly cognizant that much of their pre-crisis prosperity was fueled by the adoption of the Euro.

As the current economic problems in the US and Europe get sorted out, the importance of China and Germany to their respective partners will only become more apparent. Already, China has tried to mitigate this sudden thrust into the limelight by buying advertising on Times Square in New York City. The message, of course, is that the peaceful rise of China is beneficial for everyone – including America. It remains to be seen if the man in the street will believe it, even though his employer already knows it to be true. And German businesses are belatedly admitting that the Euro is "a massive export-support instrument" for Germany[8].

Your manager's response amidst all this sound and fury is to focus on Asia. With the exception of Japan, Asian economies are economically so far behind OECD nations that growth can only be fast, or very fast.

Many industries will skip entire generations; from no phone to cell phone, no electricity to solar power, no roads to highways, no rail to high speed rail, no airport to jet travel, even no car to electric car. Skipping intermediate stages is cheaper – and faster. The wheel doesn't have to be reinvented – the requisite knowledge can be bought, licensed, reverse engineered, or simply stolen.

Investing in Asia ex-Japan is like watching a movie in a particular genre, such as a spaghetti Western, a fantasy adventure, or a romantic comedy. The details differ, but you already know the broad outlines of the story and the way it will end. As long as you don't mind watching such movies, it can be both fun and financially rewarding to make some educated guesses about the plot and the ending.

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[8] *Businessmen Regret Leaving Merkel in Peril Over Euro's Benefits*, **Bloomberg**, 25 January 2011

Currently, global fund flows are shifting away from emerging markets and into developed markets. There seem to be two main reasons.

Firstly, institutional investors are ultimately directed by humans, and most of these humans hail from the OECD nations. By default, people prefer to invest in their home market. As most emerging markets have done rather well recently, there is the normal temptation to "take profits" and move the money home.

Secondly, emerging markets are showing signs of overheating, especially in India and China. Fear of a crash is leading some investors to reduce their exposure. The current upheavals in the Middle East are yet another convenient excuse to sell first and think later.

Should these reasons concern your manager?

True, emerging markets have done well recently. But that should be seen in the context of how badly they did in the financial crisis, and their subsequent recovery.

Many emerging market indices fell over 50% from their pre-crisis peaks, and have yet to recover all their losses. On the other hand, many leading companies in these same economies have emerged stronger, and some have already seen earnings surpass their pre-crisis peaks. So perhaps selling out now is premature.

Overheating is certainly a concern in India and China. However, the companies most at risk are those which depend on credit markets to prosper. These are principally the banks and property developers, as both banking and real estate are capital-intensive activities. Your manager's general aversion to debt-ridden companies has resulted in a general avoidance of these two sectors.

Government measures that target banking and real estate will have much less effect on other sectors. In fact, your manager would welcome another credit shock, as it would allow well-financed companies to take market share and emerge from the crisis stronger than before. It would also temporarily depress share prices, which can only improve future returns.

As for the current uncertainty in the Middle East, there will likely be little lasting negative impact on commerce. The powers that be will ensure that ships will continue to sail, and that oil will continue to flow. There are precedents: in the 1956 Suez Crisis, the UK, France and Israel attacked Egypt to secure the namesake canal. And in 1990 and 2003 the two Gulf Wars were fought, ostensibly to liberate Kuwaitis and Iraqis from Saddam Hussein, but the unspoken goal was to secure access to oil. Depressed stock prices caused by fear of trade disruptions should be viewed as opportunities for profitable long-term investment.

For now, to recycle an overused term, your manager is "cautiously optimistic" and will write again when the report for the quarter ended 31 March 2011 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
7 February 2011

3. Portfolio Review

As at 31 December 2010, the Reference Account Net Asset Value (NAV) was $228.60 per unit, net of all fees. The highwater mark was $166.03, and the total return for 2010, net of all fees, was 37.7%.

15 securities made up 85.7% 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 made and lessons learnt will also be discussed.

Divestments

Vietnam Manufacturing and Export Processing (VMEP) was sold as the company's sales performance did not match the recovery in the Vietnamese economy.

Further analysis revealed that the company had been losing market share for several years. Honda Vietnam is the runaway leader, having grown sales for 14 straight years. Its market share went from 7% in 2001 to a staggering 63% in 2009. Honda Vietnam is operating at full capacity, and this past June it announced a capacity expansion of 500,000 units, to bring total output to 2 million units per year. This will further cement Vietnam Honda's market domination, and consequent economies of scale and profitability.

VMEP had a 6% market share in 2009, down from its peak of 14% in 2002. Its capacity of about 300,000 units per year puts it at a disadvantage in terms of scale, and it has not operated at full utilization for some time, which further impacts profitability.

Further growth in the Vietnamese motorcycle market seems limited on further study. In the 2007 Master Plan for the motorcycle industry, Vietnam's Ministry of Industry estimated that the market would reach saturation around 2015-2020. By then, the market would be mainly parts and replacement sales. The odds are that Honda will continue to take the lion's share of sales and profits, leaving the rest i.e. Yamaha, Suzuki, VMEP and the local players to fight over the scraps.

Obviously, all this information would have been much more useful if your manager had obtained it *before* investing. As it was, your manager bit the bullet and decided to exit before things got worse. In local currency (HKD) terms, the loss on sale was about 9%.

Suntec REIT was sold when ARA Asset Management, the manager of the REIT, directed Suntec to acquire a 1/3 interest in Marina Bay Financial Centre at a prospective yield of just 4%. Your manager considered the price to be very aggressive and more beneficial to Cheung Kong (the seller) than to Suntec REIT unitholders.

Given the minimal improvement in yield from the acquisition, and the fact that Suntec REIT was not trading at a particularly attractive yield, your manager decided to exit. Gain on divestment exceeded 70%.

New Investments

Riverstone Holdings is a manufacturer of cleanroom and healthcare gloves. It serves mainly the high-tech industries, where cleanliness and electrostatic discharge dissipation are key considerations. It is the sole supplier to its customers in the hard disk drive industry, and is also the sole supplier to some plants in Japan and Korea.

Growth in cleanroom gloves is coming from the semiconductor industry, where its nitrile gloves are displacing PVC gloves. In healthcare gloves, growth is being achieved by displacing larger suppliers who are unable or unwilling to customize gloves for customers.

Focusing on high-end gloves has enabled the company to average a 15-20% return on equity despite a negligible debt load and a large cash reserve.

At investment, the company's shares sold for 11 times the trailing 12 months' earnings and about 2.4 times book value. Dividend yield was 4%. Debt to equity was just 1%, and cash on hand exceeded all liabilities.

Your manager purchased the 2 August 2013 warrants instead, as they offered an appealing combination of long life (almost 3 years), meaningful gearing (about 2.5 times) and low premium (zero!). There is a 4% cost in terms of foregone dividends, but your manager deemed it an acceptable tradeoff, as the gearing gave the same nominal exposure with less money at risk. These factors made the warrants a superior investment to the underlying shares.

Mistakes Made and Lessons Learnt

Goodpack W121130 was a mistake as your manager decided to sell when trading liquidity dried up temporarily. As it turns out, the liquidity soon returned, and the warrants more than doubled in value by year's end. Embarrassingly, this was basically a repeat of the mistake made with **CH Offshore**, which was sold down at a low price due to poor trading liquidity, and which tripled in market value shortly after. This mistake will not be repeated with the **Riverstone W130802** warrants, which will be held for as long as they remain attractively valued, regardless of trading liquidity. The (repeat) lesson: **liquidity is worst when prices are lowest**.

Vietnam Manufacturing and Export Processing (VMEP) was a mistake as your manager did not do sufficient research before investing. As discussed previously, there was a wealth of additional information available online about the Vietnamese motorcycle market, especially the market shares held by the various players. Your manager now visits or calls the companies as part of the research process, and more extensive searches are made online to gather intelligence beyond the annual reports. Lessons learnt: **talk to management, and search online for information beyond the annual reports**.

4. Rational Management

It is a cliché that investors should act rationally if they wish to maximize their net worth in irrational markets. This is supposed to give them nerves of steel to "buy low, sell high" and thus reap big profits. But what about the management of the companies that said rational investors buy shares in? Can they be expected to act rationally? Let us examine some examples where management is apparently rational, and others where they seem otherwise.

City Developments Limited (CDL) is a major landlord and property developer in Singapore. It is led by Kwek Leng Beng, who took over the reins from his father Kwek Hong Png in 1984. CDL has a reputation for fiscal conservatism: investment properties are carried on its books at "cost less depreciation" which understates their true market value, cash on hand exceeds short-term debt, and dividend payouts are a modest fraction of earnings.

CDL has issued some non-redeemable convertible non-cumulative preference shares, which pay a 3.9% dividend and are convertible at the option of CDL by paying S$640 plus 0.136 ordinary shares per preference share.

Some investors have proposed the preference shares as a profitable speculation. They reason that CDL can now borrow money cheaply to convert the preference shares, and thus enjoy savings on the preference share dividends. The preference shares currently trade at a deep discount to their converted value i.e. far below S$640 plus 0.136 times the price of an ordinary share. Conversion would yield a windfall profit for investors who bought the preference shares at current prices.

But these investors have forgotten that Mr Kwek is a shrewd businessman with decades of operating experience. The preference shares contain two features which are extremely favourable to CDL: perpetual financing, and a low, non-cumulative dividend rate. The financing is perpetual as conversion is only at the option of CDL. The dividends are non-cumulative, so they can be reduced or omitted if it is ever deemed necessary, without CDL having to make up the lost payments later. When CDL does pay, 3.9% is cheap compared to long-run average interest rates.

Clearly, while CDL can borrow money today at less than 3.9%, no bank would make a perpetual loan, nor let CDL skip interest payments at will. Therefore there is no realistic chance that CDL will convert the preference shares. So long as Mr Kwek is rational, conversion prospects for the preference shares are in fact very poor.

Indeed, as one might expect, since issuance, no preference shares have been converted, and it is unlikely that any preference shares will ever be converted. Anyone buying the preference shares in the hope of a profit is counting on irrational behaviour from Mr Kwek, when history suggests otherwise.

The next example is **Dapai International Holdings**, formerly known as **China Zaino**. Dapai claims to be the largest double-strapped backpack manufacturer in China. It went public on the SGX in 2008. On 23 April 2010, it announced a placement to raise money for "overseas working capital purposes" such as "a proposed listing of the Company's Shares or depository receipts on a second stock exchange". The placement was duly completed on 7 May 2010, and raised about S$11.8m.

The placement seems at odds with its financial statements for 31 December 2009, issued on 24 February 2010. The reported accounts show that the Company indeed did not have a meaningful cash balance. But there was ample cash held in the *subsidiaries* of the Group. It would have been trivial for any of these subsidiaries to pay a dividend to the parent company, for uses as stated in the placement.

There were retained earnings of RMB 714m at the Group level. There was RMB 22m of debt, against cash and bank balances of RMB 542m. A dividend payment of RMB 60m from the subsidiaries to the parent would have sufficed to produce the same S$11.8m at the parent company without the need for a placement. And given its financial strength, the Group could hardly have been injured by the upward remittance of just 12% of its cash balance.

Instead, the managers chose to place out new shares. They did so not only at a discount to the prevailing market price, but also at a discount to the company's net asset value. Assuming the financial statements were accurately reported, the exercise was an unnecessary dilution of shareholder equity. Investors should think carefully about buying into in a company whose managers exhibit such apparently irrational decision-making.

The last example is **Lizhong Wheel**, formerly known as **China Wheel**. Listed on the SGX in 2005, Lizhong Wheel is said to be the second largest aluminum wheel manufacturer by aluminum remelting capacity in China.

A close look at the 2010 interested party transaction mandate yields some "interesting" information. Namely, that the founding Zang family controls many of the various inputs and outputs pertaining to the company's business.

Specifically, the company is only 64% owned by the Zang family, but it transacts with entities that are 90-100% owned by various members of the Zang family for the supply of aluminum ingots, molten aluminum, auxiliary raw materials, the lease of land, factory, facilities and equipment, the supply of water and electricity, sale and processing of scraps, recycling of scraps and rejects, and even the distribution of wheels. In other words, the family is able to influence some or all of the costs, revenues and thus profits that accrue to the listed company.

Clearly, Lizhong Wheel is a <u>captive enterprise</u> within the Zang family's business network. So why bother listing it? One clue can be found in the nature of the business. Lizhong Wheel must occasionally incur significant costs for capacity expansion. It would be most helpful to the Zangs if they could "share" such a burden with minority shareholders by doing a rights offering or issuing new shares.

Indeed, Lizhong Wheel incurred over RMB 600m in capital expenditure from the begininng of 2005 up to 30 September 2010. During this period, it obtained over RMB 400m from issuing new shares, bank loans, convertible bonds and government grants. In particular, RMB 84m was raised in the public offering, and RMB 184m was raised from the convertible bonds.

This sum of RMB 268m, which was over 60% of the total money raised, would have been very difficult or expensive to obtain if Lizhong Wheel had been a private enterprise. So the Zangs were quite rational to list a captive enterprise after all. Whether *investors* would be rational to invest in such a captive enterprise is a different matter entirely.

Going forward, what can shareholders expect? Perhaps a hint can be found in the recent agreement to redeem the convertible bonds. US$25m of these bonds were issued to an entity of Lehman Brothers on 29 August 2007. On 10 February 2010, Lizhong Wheel agreed to fully redeem the bonds for US$15m. In other words, the company would save/gain US$10m on the bonds.

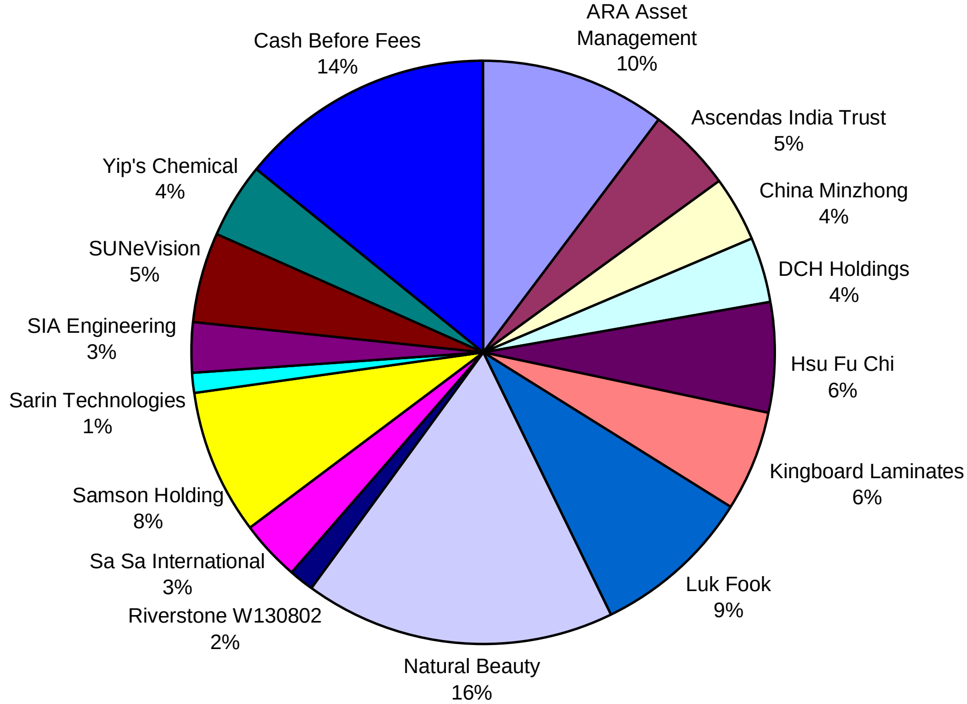
However, the agreement contains two contingent clauses that obligate Lizhong Wheel to additional payments of up to US$3m if the company's shares trade above a certain price range within two years of the agreement.

Since the Zang family can directly influence the earnings of the company, which would in turn affect the share price, and thus determine whether the company will be liable for further payouts, it seems possible, and even rational, to suppose that the Zangs may try to moderate the company's profits, so that the share price does not climb, and the company does not need to make the additional payments. Only time will tell.

End

Annex I

Reference Account as of 31 December 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%	$189.62	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%	$213.32	95.13%
30 Nov	$100.00	16.19%	$154.88	87.41%	$221.65	92.52%
31 Dec	$101.02	52.56%	$166.03	79.26%	$228.60	85.71%
YTD	**+1.0%**		**+64.4%**		**+37.7%**	