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Keeping Your Capital Safe

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Client Newsletter for the period ended 30 June 2011

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2011.

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

2. Market Commentary

Economic growth and stock market performance continue to be disconnected. For the 6 months ended 30 June 2011, the US S&P 500 index gained 5.0% for the year, while the Dow Jones index was up 7.2%. London's FTSE 100 was flat with a gain of just 0.8%. Germany's DAX was up 6.7%.

In Asia, Japan's Nikkei 225 was down 4.0% and India's Nifty was down 7.9%. China's Shanghai Composite declined 1.6%, while Hong Kong's Hang Seng Index dropped 2.8%. Singapore's Straits Times Index was off 2.2%.

So much for market efficiency: the US and Europe are doing poorly, but their stock markets are doing fine. The reverse is true in Asia, with the exception of Japan whose stock market mirrors its poor economy.

Japan continues to struggle with its nuclear disaster. It has belatedly admitted that the three stricken Fukushima nuclear reactors probably suffered meltdowns, and that the radiation released in the first week of the disaster alone was about 40% of the radiation released in the Chernobyl disaster[1].

An investigative journalist has also revealed that poor construction and shoddy maintenance led to reactor damage from the earthquake, so even before the tsunami, the nuclear disaster had already struck[2]. It seems that at least in the nuclear industry, Japan's vaunted cultural attention to cleanliness and safety were masks for foot-dragging, gross negligence and cover-ups.

Unrest in the Middle East continues. President Ali Abdullah Saleh of Yemen has been injured in a bomb blast, while Al-Qaeda militants are fighting against the Yemen army in the southern province of Abyan[3]. In Syria, the latest anti-regime protests in Hama have been answered by troop deployments, sparking fears of a repeat of the 1982 massacre in Hama, when troops under then-president Hafez – the father of current president Bashar al-Assad – killed at least 10,000 people[4].

In Libya, meanwhile, rebel forces are preparing to wage battle just 50 miles from Tripoli[5]. France has lent them a helping hand by airdropping weapons, provoking a diplomatic firestorm. Yet it is clear that for the rebels to defeat Gaddafi, they need help. The Western powers have decided to contribute in ways their voters can accept: the US has handed operational command over to NATO, while the British and the French are flying

[1] *Radiation Understated After Quake, Japan Says*, **New York Times**, 6 June 2011

[2] *Meltdown: What Really Happened at Fukushima?* **The Altantic Wire**, 2 July 2011

[3] *Saleh Defiant From Hospital Bed as Yemen Slides Toward Chaos*, **Bloomberg News**, 27 June 2011

[4] *Syria: Troops 'deployed to restive city of Hama'*, **BBC News**, 3 July 2011

[5] *Libyan rebels prepare for battle 50 miles from Tripoli,* **The Telegraph**, 1 July 2011

most of the sorties, with the Danes and Norwegians also taking part. Germany has not contributed troops or aircraft, but is now being asked to supply ammunition.

That the French have taken a more practical approach than their allies to getting the job done is to their credit, though there is a very real risk that post-Gaddafi Libya will degenerate into a failed state dominated by gun-toting warlords. Somalia comes to mind.

Come what may, the civil war is approaching an end: the US has formally recognized the rebels' National Transitional Council as the legitimate government of Libya[6]. What this means is that the billions in offshore assets accumulated by the Gaddafi regime, and that are currently frozen, could soon be released for the rebels to use in procuring food, fuel, medicine – and weapons. A release of assets, or an issuance of loans against the assets as collateral, would mark a major shift in the war and accelerate its conclusion.

On the economic front, there is little new to report. Many of the headlines about the weak US economy, the European debt crisis and inflation in China, were headlines back in 2010. In other words, we have seen it all before. As the French say, *plus ça change, plus c'est la meme chose*. Or, to quote Yogi Berra, "It's déjà vu all over again".

In the US, unemployment is 9.2%. House prices remain weak, and 1 in 7 citizens is now participating in the food stamp program. It certainly does not look like the most prosperous country in the world right now.

In Europe, bureaucrats are finally admitting what the capital markets have known for over a year: that Greece is going to default. The EU's latest proposals now provide for an exchange of existing Greek debt into new long-term instruments[7]. Ratings agency Fitch has accordingly downgraded Greece to "restricted default" status[8].

National pride aside, Greeks should take heart: the history of capital markets suggests that debt investors are amazingly naïve and willing to lend money at reasonable rates within a decade of a country's default. So Greece is not finished, even though some of their bondholders certainly will be.

Bureaucrats at the European Union fret that an official Greek default will reveal the emperor-has-no-clothes credit standing of other marginal EU members. This could drive up borrowing costs to reflect the true credit risk, which would further weaken the European economy. Other states might default too. The hope is that, by helping Greece, huge future losses can be avoided.

What the bureaucrats have missed is that everyone else in the capital markets has *already* given up hope on the three little PIG countries of Portugal, Ireland and Greece. Why else would their sovereign debt trade at yields representing 10% (or higher) premiums to German equivalents?

But the bureaucrats are at least partly right about poor credit being contagious: attention is now turning to Italy and Spain. Italy is the Eurozone's third largest economy. If it fails, chaos in Europe would be an understatement. Of course, it will not be the end of the world. But it will be painful for Europe – and the companies who derive a large part of their revenues from it.

Certainly the EU as a whole will do its utmost to help Italy and Spain. The European Central Bank does not have enough resources to bail out either country, let alone both. So either Italy and Spain manage to keep going on their own, or the ECB will – surprise, surprise – amend its rules to allow extraordinary measures to be used.

[6] *United States recognizes Libyan rebels as legitimate government,* **The Washington Post**, 15 July 2011

[7] *EU Leaders Offer $229 Billion in New Greek Aid*, **Bloomberg News**, 22 July 22, 2011

[8] *Players in a Greek Drama*, **The New York Times**, 22 July 22, 2011

After all, the ECB is no different from the US Federal Reserve in this regard; if at first you don't succeed, change the rules. The ECB has already done this once; after Greek bonds were officially downgraded to "junk" status, the ECB waived its rules requiring collateral to be rated "investment-grade" and continued to lend money against Greek bonds.

China and India have the opposite problem: rapid growth is stoking inflation. So far they seem to handling it well enough, though one can never be entirely sure. One worry is the continuing un-affordability of real estate in China. The government is now putting pressure on developers to do "national service" and build affordable housing. But given the thin margins on such projects, few developers are biting. Local governments are also too poorly funded to take on these projects directly, so at some point the central government will have to step in[9].

As for existing government projects, there are certainly risks from bad debts, as many loans will undoubtedly turn out to have been made using political rather than economic considerations[10]. But even after taking into account Moody's estimate that local government debts are in fact US$540 billion larger than reported[11], the adjusted local government debt totals US$2.2 trillion, which seems entirely manageable when measured against China's estimated 2010 GDP of US$6 trillion.

On the other hand, China's *external* debt, which must be repaid in foreign currency rather than local currency, was US$586 billion as of end-March this year[12]. Beijing's foreign exchange reserves are currently estimated at US$3 trillion. China's solvency is not an issue.

Going into the second half of 2011, your manager remains at ease with the portfolio's holdings. Some adjustments will undoubtedly be made, but for the most part, it is "so far, so good" with several companies raising their dividends in line with higher profits. Their share price movements are a different story, but that is the hallmark of inefficient capital markets. The next report due will be for the quarter ended 30 September 2011.

Benjamin Koh
Investment Manager
Lighthouse Advisors
23 July 2011

3. Portfolio Review

As at 30 June 2011, the Reference Account Net Asset Value (NAV) was $221.25 per unit, net of all fees. The highwater mark was $228.60, and the total return to date for 2011, net of all fees, was -3.2%.

16 securities made up 86.7% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

Divestments

There were no divestments for the quarter ended 30 June 2011.

New Investments

There were no new investments for the quarter ended 30 June 2011.

Other Significant Events

Hsu Fu Chi announced a deal with international food giant Nestlé on 11 July 2011. Under the terms of the deal, Hsu Fu Chi will be delisted and become a 60/40 joint venture between the Hsu brothers and Nestlé. The stock now trades at close to the proposed delisting price.

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[9] *Lack of funding threatens China's affordable housing plan*, **People's Daily Online**, 29 June 2011

[10] *Auditor Warns of Risks from Local Debt in China*, **New York Times**, 27 June 2011

[11] *Chinese local debt understated by $540 billion: Moody's*, **Reuters**, 5 July 2011

[12] *China's external debt hits $586b by end of March*, **China Daily**, 7 July 2011

Kingboard Laminates (KBL) was denied a mandate for interested party transactions with its 64% subsidiary Kingboard Copperfoil (KCF). The key party voting against the transaction was Pope Asset Management, which owns 10.3% of KCF. Pope apparently thinks KCF is being shortchanged by KBL, resulting in below-normal margins for KCF.

KCF has a 10% share of global copper foil output. KBL is its main customer: in the last 5 years, sales to KBL ranged from 84% to 91% of total revenues. Finding disinterested parties for the copper foil will be difficult, as the likely customers are all competitors to KBL. However, KBL can source copper foil from other copper foil producers, as the only other vertically integrated producer of laminates is Nan Ya Plastics Corporation.

In other words, denial of the mandate is much worse for KCF – and Pope – than for KBL. It seems almost a given that KCF will soon incur operating losses. Should it be pushed into insolvency, KBL may well choose to liquidate it, and then buy the assets out of bankruptcy. As the only plausible buyer, KBL should get the assets cheap. So in exchange for a temporary supply irritation, KBL shareholders will come out ahead in the end. Conversely, KCF minority shareholders, including Pope, are likely to see a severe or even complete loss on their investment.

Sarin announced a turnaround in their business. Equipment sales are back to pre-crisis levels, while the *Galaxy 1000* service, which generates recurring revenues, now accounts for 20% of total sales and over 50% of profits. The stock has rallied accordingly. However, it is not yet overpriced, so it will stay in the portfolio for now.

4. Hedging

Hedging refers to the practice of fixing the value of a future uncertainty. A farmer may wish to fix the price of cotton that he will harvest and sell 6 months from today. A food company may want to fix the price of corn for the next year. A company may desire to fix the cost of its floating-rate bank borrowings for the next 12 months. And so on.

In the capital markets, hedging may also be performed by investors, but that deserves a separate chapter or even an entire book to do the topic justice. Indeed, in 1967 Edward Thorpe and Sheen Kassouf did publish a book, appropriately titled *Beat The Market*. It should be required reading for all hedge fund operators. The current discussion will be confined to hedging as done by operating companies in the normal course of business.

In business, hedging is aimed at reducing risks in the transaction i.e. the cotton farmer is paid for his labour regardless of cotton prices, the food company is for its processing services regardless of corn prices, and a borrower is insulated from interest rate hikes.

Of course, hedging is not free. For the hedger to *transfer* risk, someone else must *assume* that risk, and risk will be assumed only in exchange for appropriate compensation. So hedging is equivalent to buying insurance.

Insurers expect to make a profit from their premiums, net of claims, so hedgers must expect to make a loss from their hedges. Why would a hedger knowingly enter into a transaction where he would expect to lose money on average?

The most common reason is that the hedger is in an industry where price fluctuations exceed the expected profit margin. In such a situation, without hedging, a company will occasionally suffer huge losses, or reap huge gains, due to price movements.

For example, steel mills regularly see fluctuations in the price of steel. Without hedging, they sometimes face losses when their steel sells for less than the cost of the ore, labour and utilities used in production. To avoid this, mills usually enter into long-term supply contracts with their customers and index steel prices to the price of iron ore. In this way, the mills are hedged – when iron ore

prices rise, steel prices rise also. Conversely, when iron ore falls in price, steel prices also drop, and the mills forego the windfall profits.

Could a mill decide that in lieu of hedging, it would keep cash to absorb losses from declines in steel prices, and thus also benefit from spikes in steel prices? Certainly – if it had enough cash to absorb hundreds of millions of dollars in losses. However, most steel mills have a high level of borrowings due to the low returns of the industry. Cash is too precious to leave lying around to absorb losses from price swings. Ergo, hedging is the more efficient way to go. Many steel buyers in turn hedge their exposure by negotiating with *their* customers on the price of steel.

Likewise, jewelers often hedge the price of gold. Jewelry sells slowly; a gold bracelet may sit in a display case for 6 months or more before being sold. All this time, its selling price fluctuates with the price of gold. But the company can only make a profit if the price exceeds its cost.

Therefore, most jewelers hedge their gold exposure by selling gold futures. In this way they "remove" the price of gold from their goods and are left only with their own mark-up. In recent years some goldsmiths have reduced their gold hedging on expectations that gold prices will keep rising; essentially they are now speculating i.e. they are "long" on gold. If the price of gold falls, their mark-ups may not suffice to cover their losses.

What is one to make of a company that refuses to hedge appropriately?

A case study may prove illustrative. **Hu An Cable** is a copper cable manufacturer in Yixing City, Jiangsu Province, China. It listed on the Singapore Exchange in January 2010, and that same October it also listed Taiwan Depository Receipts in Taiwan.

Hu An Cable claims to be among the top 10 wire and cable manufacturers in China, producing over 18,000 types of wires and cables. It dates back to 1998, when the CEO co-founded the key subsidiary Wuxi Hu An. Its IPO prospectus states clearly under the heading *Risk Factors* that:

"Our costs of copper and aluminium accounted for approximately 86.7%, 86.6%, 87.9% and 78.6% of our total costs of sales for FY2006, FY2007, FY2008 and FP2009, respectively.

Copper and aluminium are commodity metals and subject to market price fluctuations. For instance, for the period under review, our Group's average purchase cost of copper has fluctuated between approximately RMB 33,100 per tonne and RMB 54,400 per tonne; while our Group's average purchase cost of aluminium has fluctuated between RMB 12,100 per tonne and RMB 18,000 per tonne.

In the event of any significant increase in the prices of these raw materials and if we are not able to pass on such increase to our customers on a timely basis or find an alternative source of supply on commercially acceptable terms, our financial performance will be adversely affected."

In other words, if the group does not hedge or otherwise find a way to pass on changes in the costs of copper and aluminium, it may lose money. Should the company hedge? To the extent that it cannot pass on price increases, yes. Does the company do so? **No.** The company states in its IPO prospectus that it does *not* hedge the cost of copper and aluminium because:

(a) it keeps inventories low;

(b) it tries to use variable or open price contracts to cater for raw material price fluctuations; and

(c) it monitors spot and future prices on the Shanghai Metal Exchange on a daily basis.

In 2010 the "wires and cables" segment earned an operating margin of 10.7% in 2010, against 12.3% in 2009 and 10.2% in 2008. In 2006 and 2007, wires and cables were the only

segment, and gross profit margin was 15.5% and 15.9% respectively. So for wires and cables, the company *has* been able to pass on changes in copper prices.

But for the "metal rods and plastic materials" segment, operating margins have varied wildly, from 0.6% in 2008 to 8.5% in 2009, and then to 2.4% in 2010. What is going on?

In 2008 and 2009, the "metal rods and plastic materials" segment had been separately reported as "copper rods", "aluminium rods" and "plastic cable materials". A look at the separate segments offers some clues.

Copper rods booked an operating loss of 0.08% in 2008 and an operating gain of 8.5% in 2009. The management also admitted in a briefing that in 2010 the gross margin for copper rods was 4%, whereas in 2009 it had been 8%. So for copper rods, the company is not able to pass on changes in the cost of copper, nor is it doing any hedging.

Aluminium rods also suggest there was neither cost pass-through nor hedging. In 2008 the operating margin was -2.7%, while in 2009 it was -0.7%. The management mentioned that in 2010 the gross margin for aluminium rods was 1%, so it likely had an operating loss too.

When asked why the company could maintain a consistent margin for *copper* wires and cables but not for *copper* rods, the management claimed that copper cable pricing was not transparent, so it could pass on cost increases. But the IPO prospectus clearly states that copper and aluminium account for 87% of the cost of goods. The management also admitted that copper was now 95% of the cost of goods in wires and cables.

How could a customer *not* know the cost of copper in the wires and cables they were buying? On the contrary, it would be *because* the customer knew the cost of copper in the wires and cables, that they would be willing to accept a price increase, to let the company earn a reasonable profit. So the management's explanation does not make sense.

What about copper rods? These are basically 100% copper. That should make the cost of copper easy to hedge, either by passing on price changes to customers by indexing to published copper prices, or by using forward contracts to remove the cost of copper, akin to how jewelers use forward contracts to effectively hedge on gold.

Asked why they did not hedge for copper rods, the management claimed they did not use copper in sufficient volume to justify using futures contracts. But the 2010 annual report states that the company quintupled its sales of copper rods over 2009, which means that this segment had sales of about RMB 800m. So on average, the company sold RMB 67m of copper rods per month.

Copper prices averaged RMB 59,000 per metric ton in 2010, so each month the company bought, processed and sold over 1,100 metric tons of copper rods. As the rods are produced by a continuous process, daily output would be essentially constant. Thus, on any given day the company held over 36 metric tons of copper. The Shanghai Futures Exchange trades copper contracts on a per-tonne basis. The company could easily sell 36 contracts to essentially remove its exposure to copper price fluctuations, so this "insufficient volume" reason does not seem valid.

The bottom line: Hu An Cable's copper rods business is exposed to fluctuations in the price of copper, and should hedge to protect its margins, but does not.

It might be a good idea for the management to review their non-hedging policy if they want the copper rods business to be profitable. In the meantime, investors would do well to be skeptical and observe from afar.

~ End ~

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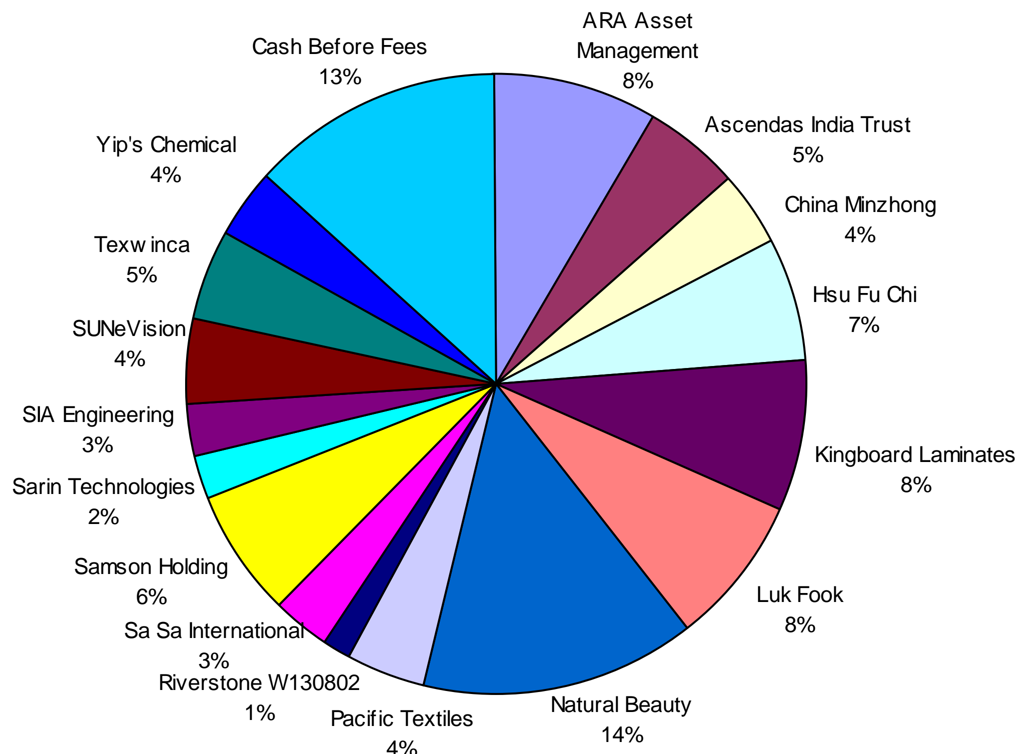
Annex I



Annex II

Monthly Net Asset Values								
	2008		2009		2010		2011	
Date	**NAV**	**Invested (Gross)**	**NAV**	**Invested (Gross)**	**NAV**	**Invested (Gross)**	**NAV**	**Invested (Gross)**
31 Jan			$103.03	52.48%	$163.97	83.91%	$220.13	86.53%
28 Feb			$102.42	69.23%	$169.35	93.00%	$216.56	93.66%
31 Mar			$100.11	51.25%	$179.88	93.26%	$219.13	85.79%
30 Apr			$106.95	67.37%	$184.58	90.31%	$224.22	86.13%
31 May			$131.61	73.01%	$177.16	80.77%	$221.20	87.01%
30 Jun			$131.39	78.62%	$180.97	84.17%	$221.25	86.70%
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%**		**-3.2%**	

Updated 23 July 2011