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Keeping Your Capital Safe

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Client Newsletter for the period ended 30 September 2011

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for September 2011.

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

2. Market Commentary

Today's headlines are little different from those of the last 3 years: recession in the US and Europe, stagnation in Japan, overheating in China and India, and unrest in the Middle East and North Africa.

Behaviour in the stock market is likewise little different: panic selling is driving down prices to irrational levels.

Behaviour in the corporate world is also little different: strongly financed companies are doing business as usual and looking to buy assets cheaply, while credit-dependents are searching for sponsors with deep pockets to throw them a lifeline.

It looks like 2008 all over again. Once more, perfectly sound companies are selling at bargain-basement prices. The figurative babies are being thrown out with the bathwater, as fearful sellers dump whatever they can.

It has not been a pleasant quarter to be an investor in the equity markets, with anyone who was "long" being "wrong". In just three months, stock market sentiment has gone from cautious optimism to outright panic. Many major markets dropped more than 10% over the quarter. Hong Kong bore the brunt of the selling, falling 14% in September alone, and 21% over the entire quarter.

For the 9 months ended 30 September 2011, the US S&P 500 index lost 10.0% for the year, while the Dow Jones Industrial Average was down 5.7%. London's FTSE 100 fell 13.1%, and Germany's DAX dropped 20.4%.

In Asia, Japan's Nikkei 225 was down 14.9% while India's Nifty lost 19.4%. The Shanghai Composite fell 16.0%, Hong Kong's Hang Seng Index dropped 23.6% and Singapore's Straits Times Index was off 16.1%.

Anyone who believes in the strong-form of the efficient market hypothesis, that all information is already reflected in stock market prices, has clearly not been following the news. The global economy was little changed in the past 3 months, yet stock markets sold off over 15% in the same period. The carnage was worse in many individual stocks; some have fallen over 50%.

US unemployment stands at 9.1%, unchanged since August. House prices remain lower than a year ago. In a sign of how weak the housing market is, 30-year fixed-rate mortgages now cost less than 4%, a record low[1]. It is slowly becoming clear that the reports of a US recovery have been greatly exaggerated.

Meanwhile, in Europe, the major governments continue to bicker over Greece's sovereign debt problem. It is not that they do not know what to do. It is that *they do not know how to do so and still stay in power*[2].

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[1] *Mortgage rates drop to once unthinkable lows at less than 4%,* **Los Angeles Times**, 23 September 2011

[2] *Merkel Risks Own Downfall as Odyssey to Save Greece Nears Climax,* **Bloomberg News**, 19 October 2011

A Greek bailout is really a French and German bailout, since the largest holders of Greek sovereign debt are the French and German banks. Unfortunately, this has not been made clear to the people of France and Germany. Especially the Germans, who would really like the Greeks to be like them: work hard, save money, and (cough) *pay taxes*.

But habits of a lifetime are hard to break. In a recent photo exposé on Greece[3], the German daily *Handelsblatt* detailed some absurd subsidies dished out by the Greek government: a €420 monthly "hand hygiene" allowance for train employees, a €290 monthly bonus for messengers in ministries when they do actually carry documents(!), and a €310 monthly bonus for bus drivers who – gasp – show up for work on time. Judges get paid a bonus when they work faster, while civil servants in the Culture Ministry get a clothing allowance. Dentists in the government get a travel allowance, even if they don't leave their clinics. The list goes on.

As for paying taxes, *Zeit* recently pointed out that Greek taxpayers owe their government some €37 billion[4]. Yet, in 2009 there was some €5.5 billion held abroad, belonging to 3,718 persons. 542 of them reported annual incomes of less than €1,000. Clearly, it is going to be difficult for the Germans to support helping Greece, when the Greeks themselves do not wish to help Greece. Quotes like "Let the German taxpayers pay. It is our right not to pay tax" are certainly not winning the Greeks any sympathy[5].

Italy and Spain have come under the radar as well. Their too-big-to-fail status has amplified pessimism over Europe's ability to fix the crisis. As usual, the major ratings agencies have helpfully added fuel to the fire by downgrading Italian [6] and Spanish [7] banks, when this should have been done 3-4 years ago as a pre-crisis warning, instead of now as a belated after-the-fact correction. Not surprisingly, European stocks have sold off this year, with Italy's FTSE MIB index losing 26.5% as of 30 September, while Spain's IBEX 35 is down 13.3% in the same period.

As expected, bank shares have led the decline, with Italian bank Unicredit SpA plunging 47.1%. Wholesale banks, which depend on borrowing from other banks rather than relying on customer deposits, have been hit particularly hard as their sources of funding have dried up. Dexia SA, part-owned by the French and Belgian governments, appears to be the most badly affected. An agreement was recently concluded to rescue Dexia[8].

For Dexia, this will be its second bailout, having already received €6 billion in aid during 2008. For France, perhaps it is good practice for rescuing Greece: Dexia's balance sheet is about the size of the *entire* banking system in Greece, and larger than all the Irish lenders that were bailed out in the last 2½ years *combined*.

Still, hope springs eternal. The latest announcement is that Greek bondholders will take a 50% haircut, and that the European rescue fund will be boosted to €1 trillion[9]. Details, as usual, are still scant. But at least Europe is finally heeding Benjamin Franklin's quote: "we must, indeed, all hang together, or most assuredly we shall all hang separately."

Next door to Europe, Turkey has suffered an earthquake. In the afternoon of 23 October, a

[3] *Welche skurrilen Prämien die Griechen kassieren,* **Handelsblatt**, 23 October 2011

[4] *Griechen schulden ihrem Staat 37 Milliarden Euro,* **Zeit**, 14 October 2011

[5] *Greeks Told to Pay Tax,* **Daily Squib**, 16 June 2011

[6] *S&P downgrades 24 Italian banks,* **BBC News**, 18 October 2011

[7] *S&P downgrades Spain on weak growth outlook,* **BBC News**, 14 October 2011

[8] *Dexia Agreement Reached by France, Belgium as Bank's Board Meets,* **Bloomberg News**, 9 October 2011

[9] *EU Sets 50% Greek Writedown, $1.4T in Fund,* **Bloomberg News**, 26 October 2011

tremor of magnitude 7.2 struck eastern Turkey, leveling hundreds of buildings. Over 260 are confirmed dead and some 1,000 have been injured[10]. Rescuers are racing against the clock amid forecasts of snow that could drop temperatures to minus 2 degrees Celsius.

In the Middle East and North Africa, Libya's revolt has ended with the death of Colonel Gaddafi[11]. So far, Tunisia, Egypt and Libya have seen a change of government. Yemen is widely seen as the next "favorite" to join the list, given the poor reception that greeted President Ali Abdullah Salleh when he returned home from medical treatment abroad.

In neighbouring Syria, despite the protests, President Bashar al-Assad has managed to stay in power. Still, one sign of Syria's unraveling is an astonishing documentary by a TV station linked to the president, which claims that the footage of protests being broadcast worldwide were fabricated using movie-set replicas of the actual cities[12].

Given the enthusiastic worldwide support for the "Arab Spring" movement, the other oil-rich nations of the Persian Gulf have quietly decided to eschew further crackdowns in favour of massive welfare spending to pacify their peoples. So far, the total projected bill for the UAE, Saudi Arabia and Qatar is about US$150bn[13]. It has been earmarked for wages, housing, schools and hospitals, so it should help improve the lot of the ordinary people.

Further east, Japan continues to make little progress on the economic front. Hopes of a post-Fukushima rebuilding boom have quickly evaporated as it has become apparent that the radiation-affected areas are likely to remain uninhabitable for decades.

In China, there has literally been a crash. Two, actually. On 28 July, two bullet trains collided in the eastern city of Wenzhou, killing 40 and injuring 200. Inexplicably, local authorities quickly buried the wreckage, sparking widespread accusations of a cover-up. Beijing has yet to release a report on the incident, but has blamed a "signaling failure". Then, on 27 September, two subway trains collided in Shanghai. Coincidentally, it was also attributed to a "signaling failure".

Critics have pointed out that if this was true, then the supplier, Casco Signal, a joint venture between French transport giant Alstom and the state-owned China Railway Signal & Communication Corp (CRSC), should be taken to task[14]. But if the equipment was functioning normally, then the *management* of the rail companies would be to blame. For its part, Alstom has denied that it or Casco Signal was at fault, and blamed a power failure that interrupted the signal system.

A *Wall Street Journal* article hints at some of the problems in Chinese rail technology: besides Casco Signal, the only other provider of signaling gear in China is Beijing-based Hollysys Automation, which buys key components from Hitachi, but <u>does not have access to the technical blueprints</u>, so it is unable to fully understand or troubleshoot the components when issues arise[15]. Still, Hollysys' CEO released a statement that the company's equipment was not to blame for the Wenzhou accident. On the other hand, a CSRC unit issued a statement of "sorrow" and pledged to "shoulder our responsibility". Perhaps there is a clue here…

The immediate outcome of the crashes has been a slowdown in the travelling speeds of both the high-speed rail and the metro trains.

[10] *Turkey Quake Toll Rises to 264, Hundreds Missing Under Rubble,* **Bloomberg Businessweek**, 24 October 2011

[11] *Muammar Gaddafi killed as Sirte falls,* **Al Jazeera**, 21 October 2011

[12] *The 'Fake' Cities of Syria's Unrest*, **The Atlantic Cities**, 27 September 2011

[13] *Arab Spring has cost Gulf Arab states $150bn,* **Arabian Business**, 8 September 2011

[14] *Shanghai rail crash raises demands for better oversight,* **Asia Times Online**, 30 September 2011

[15] *China Bullet Trains Trip on Technology,* **Wall Street Journal**, 3 October 2011

In a way, this mimics the broader Chinese economy, as the government's measures to contain overheating finally appear to be working, as the constantly increasing reserve ratio requirements for banks have curtailed credit availability in the private sector.

In fact, there are now signs of a credit shortage, with recent reports of businessmen in Wenzhou fleeing or committing suicide due to usurious interest rates on money borrowed from private lenders[16]. Ordos, which shot to fame as the "empty city" frequently cited by investors bearish on China, is another city where private lending is rampant[17].

Though Beijing has since ordered banks to lend to small- and medium-sized enterprises (SMEs), it remains to be seen whether this will solve the credit crunch. Furthermore, lending to SMEs requires credit assessment, a skill redundant in communist China when the state was merely lending to itself. It is unlikely that there are enough people working in the banks today who have the requisite skills needed to make good loans. The logical conclusion, then, is that any new lending spree is only going to seed the next loan crisis. Ominously, private equity giant Kohlberg Kravis Roberts is expanding into Hong Kong to prepare for more distressed investments in China[18].

There is little to report on India. Still, given the world events of the past 3 months, perhaps no news is good news.

Closer to home, Thailand's new Prime Minister Yingluck Shinawatra is having a baptism of water as the country battles its worst floods in half a century. Torrential rains have caught Thailand unprepared, and seven industrial estates are now beneath as much as 10 feet of water[19]. The water has reached Bangkok, and soon many parts of it will be underwater. The latest update is that the water may take up to 6 weeks to recede. The death toll now exceeds 300, over 110,000 people have been displaced, and some 14,000 companies employing 600,000 workers have stopped operations. Economic damage has been estimated at 2% of GDP.

In Singapore, the government has forecast that GDP growth will probably slow to 5-6%, from 2010's 14.5%[20]. Singapore remains highly dependent on exports to the US and Europe, whether directly, or indirectly via China. The weakness in the US and Europe will filter back to Singapore soon enough.

We are now in the last quarter of 2011. It seems like bad news is being released daily. Investment results have been poor so far, with emotions trumping reason. True, the macroeconomic outlook is poor. But stock prices have also declined materially. One important indicator: company after company is announcing share buy-backs. So things are probably not as bad as share prices imply. In the portfolio itself, cash is being put to work, albeit slowly. Your manager hopes to uncover some promising new investments amidst the selling. The next report will be for the quarter (and year) ended 31 December 2011.

Finally, your manager is in discussions with service providers to set up a fund to consolidate the managed accounts into a single investment vehicle. The target launch date is 1 January 2012. More details will be made available as we move closer to the launch.

Benjamin Koh
Investment Manager
Lighthouse Advisors
24 October 2011

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[16] *Debt panic in China's Wenzhou may augur wider woes,* **Associated Press**, 20 October 2011

[17] *Ordos anxiously watching Wenzhou debt crisis,* **WantChinaTimes.com**, 12 October 2011

[18] *KKR bets on China slowdown with HK expansion,* **Financial Times**, 20 October 2011

[19] *Thai Prime Minister to Take Command of Flood Control Efforts,* **New York Times**, 21 October 2011

[20] *Recent Economic Developments,* **Monetary Authority of Singapore**, 1 September 2011

3. Portfolio Review

As at 30 September 2011, the Reference Account Net Asset Value (NAV) was $177.28 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 -22.4%.

18 securities made up 84.1% 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 September 2011.

New Investments

LMA is involved in the design, manufacture and marketing of laryngeal masks. The masks are used to deliver anesthetic during surgery. They were invented in 1981 and launched commercially in the UK in 1988. LMA essentially created the market, and remains the global leader in laryngeal masks. It went public on the SGX in 2005, but made some poor acquisitions after IPO which eroded shareholder value. In 2010, it acquired its Australian distributor, and hired the founder, William Crothers, as CEO of LMA.

William took partial payment in shares, and now owns 8% of LMA. He has made important changes since coming on board. Among them: self-manufacturing the masks instead of relying on a single contract manufacturer, and only buying companies whose products can be cross-sold by the existing sales force. The company also executed a one-off tender to buy back 10% of its shares, in which William did *not* participate. Finally, LMA has committed to paying dividends.

These changes, at both the operating and corporate level, made the stock a special situation "turnaround" investment. The stock was purchased at about 10 times forward earnings and a 3% dividend yield.

Lung Kee (Bermuda) is a manufacturer of mould bases, which are steel blocks with cavities into which plastic injection moulding machines inject hot molten plastic. The plastic fills the space and takes on the shape of the desired product. The mould bases are sold to mould makers, who perform the final finishing and detailing. The finished moulds are then delivered to contract manufacturers, or paired in-house with plastic injection moulding machines to produce the plastic parts.

Lung Kee was founded in 1975, when brothers Siu Tit Lung and Siu Yu Lung began supplying steel to Hong Kong mould makers. In 1985 they began making moulds bases themselves. Today, Lung Kee is the leader in Guangdong, China, with a market share of about 40%. Because mould bases are very heavy, Lung Kee has a freight cost advantage over faraway competitors when supplying to nearby customers. It faces the same disadvantage when exporting, but most plastic goods manufacturing today occurs in Southern China, not the US or Europe.

The plastics manufacturing chain has a bottleneck in mould base manufacturing. In Guangdong province, there are 5,000 mould makers, but only 40 mould base makers. This gives mould base makers bargaining power. At the same time, it creates a barrier to entry, because a new mould base maker will have to poach a large number of customers to obtain enough volume to fully utilize its capacity.

The mould base business is also recession-resistant, as many products receive cosmetic facelifts during their life cycle even when internal components are unchanged. Cars are an obvious example, where new models are typically released on a 4-year cycle, but cosmetic changes are rolled out at the mid-way mark. This benefits mould base makers like Lung Kee, since the new plastic parts require new mould bases. The automotive sector makes up 20% of Lung Kee's sales.

Reflecting the attractive economics of the business, gross margins have been steady at about 30% since 1999. In 2006, its worst year, Lung Kee reported a 6.7% net margin and earned 11.5% on equity. The long-term averages are materially better; net margins have averaged 10-11%, while the return on equity has averaged 16%.

Dividends have been paid every year since 1997, and since 1998 the payout ratio has been at least 45%. The stock was bought at 10 times forward earnings and an expected yield of 6%.

Other Significant Events

Kingboard Laminates (KBL) was served a litigation claim by Pope Asset Management alleging that the affairs of KBL's 64% subsidiary Kingboard Copperfoil (KCF) were and are being conducted in a manner prejudicial to Pope's interests in KCF. This may be linked to KCF's recent deal to license out its manufacturing facilities to a 3rd party to manufacture copper foil.

The licensing deal itself was the outcome of Pope voting against KCF's interested party transactions with KBL. So Pope got what it wanted – no more KCF sales to KBL – and is not happy about it.

There is no logical way for Pope to get a happy ending from this saga. In the meantime, KBL shareholders will have to be patient. Fortunately, the inherent strength of the laminates business – and its ability to pay dividends – remains intact.

4. Auditors and Investors

Auditors, as investors know, are the firms charged with "blessing" the financial statements of companies. Widely regarded as experts on accounting standards, they are often expected to ensure that the companies are being run fairly for all shareholders. This expectation is incorrect.

When a company receives an "unqualified opinion" from the auditor, the audit firm is not issuing a "clean bill of health" as so many newspaper articles like to report. The audit firm is merely *expressing an opinion* that the accounts present a "true and fair view" of the company's situation, as per required accounting standards.

What does "expressing an opinion" mean? Legally, it means absolutely nothing at all. The plethora of financial scandals that have rocked the world in the past 10 years have made it abundantly clear that the normal work done by auditors i.e. stating that the accounts were "true and fair" has been of absolutely no help at all in preventing fraud.

Short of gross negligence or outright abetment of fraud, audit firms bear no legal liability for their opinions. Arthur Andersen was the only major audit firm ever convicted, and that was for obstruction of justice, because it actually shredded important documents relating to the Enron scandal[21].

Auditors argue that they are not being paid to detect fraud. Given the fees paid and time allotted, this is not wrong. One cannot expect outsiders who spend a few weeks leafing through a small sample of documents to uncover fraud, unless they are lucky, the perpetrators are stupid, or both. Actually, most frauds are discovered by chance, when a company employee comes across suspicious documents or unusual transactions, and makes a police report.

But if auditors are not looking out for fraud, who is? **Nobody.** Should regulators be responsible? At present, laws allow the courts to *punish* fraud. But regulators are not responsible for *preventing* fraud. Indeed, many regulators have moved to what they call a "disclosure-based regime", which means that it is up to companies to disclose what they are (or are *not*) doing. In plain English, it means that investors are on their own.

Many investors have learnt at great cost that having a big-name auditor at a company only

[21] *Enron and Arthur Andersen: The Case of the Crooked E and the Fallen A,* **Global Perspectives on Accounting Education Volume 3, 2006, 27-48.**

means they are paying big-name fees. One might imagine that big-name auditors would have the resources to thoroughly check the financial statements prepared by companies, so that scandals would be more common at companies audited by small, no-name firms.

In fact, the largest scandals usually had a big-name auditor signing off on the accounts, up until the actual blow-up occurred. The connection rests on the simple fact that generally, only large firms can afford the high fees of big-name auditors.

Enron was audited by Arthur Andersen, Royal Ahold by Deloitte & Touche, Satyam by PricewaterhouseCoopers, and Sino Forest by Ernst & Young.

Closer to home, on the Singapore Exchange, a long list of Chinese companies have been involved in financial scandals in the last few years. A casual search by your manager yielded 14 names: Beauty China, Celestial Nutrifoods, China Food Industries, China Gaoxian Fibre Fabric, China Hongxing, China Milk, China Printing & Dyeing, China Sun Bio-chem, Ferrochina, Fibrechem, Hongwei Technologies, Oriental Century, Sino-Environment, and Sino Techfibre. There are undoubtedly more, but these will suffice to make the point.

Apart from having "China", "Sino" or "Oriental" in their names, what many of these companies shared was having a "Big Four" auditor. Fully 10 of the 14 scandal-hit companies had KPMG, Ernst & Young, Deloitte & Touche or PricewaterhouseCoopers as their auditors, who all proudly expressed their <u>unqualified opinion</u> that the accounts were "true and fair", until they were plainly untrue and very unfair, by which time hapless investors had already lost essentially all their money.

So if investors cannot trust the Big Four audit firms, who can they trust? One sad, but probably true, answer comes from the 1990s television series *The X-Files*: "Trust No One".

What is one to do in the face of such overwhelming odds? The answer is not to give up and leave the money in the bank, but to develop a healthy skepticism about what is being reported, and to seek out independent verification of the reported data.

Company executives have an incentive to report good results. It affects their cash bonus, and the stock price, which affects the value of their options. Therefore when there is a grey area, the tendency will be to minimize liabilities and to inflate assets. This leads us to the first principle, as quoted from Berkshire Hathaway vice-chairman Charlie Munger:

"One thing about accounting, you know the liabilities are always 100% good. It's the assets you have to worry about."

But Mr Munger's witty quip does not capture the full story. To be accurate, a company's liabilities are *at least* the amount stated. There may in fact be additional off-balance sheet liabilities. But the real amount of liabilities will not be less than that stated on the balance sheet. On the other hand, assets are often worth *less* than the balance sheet suggests, whether due to limitations in accounting, or over-optimistic assumptions.

There are many ways for companies to hide liabilities. Perennial favourites include repurchase agreements and sale-leasebacks.

Repurchase agreements, commonly referred to as "Repos", are transactions where companies sell assets in exchange for cash, but agree to buy the same assets back, at a premium.

When one follows the flow of money, it is obvious that these companies are merely pledging collateral for a loan, to be paid back with interest. It is telling that the entity on the other side of a repo is almost always a bank. But because the transaction is legally a sale, albeit with a repurchase obligation, the assets disappear from the balance sheet and are replaced by cash. Investors who see the dressed-up balance sheet feel reassured that the company's "net debt", or total debt less cash, seems manageable. What they do *not* see are the repo agreements which will shortly force the company to hand over cash and take back the assets.

Who would use this type of transaction? The answer: many, many companies. The most (in)famous may have been the late Lehman Brothers, which used repo agreements on each balance sheet date to hide the fact that it was using a huge amount of leverage. Investors were kept in the dark until Lehman collapsed one fateful weekend in October 2008.

Apart from investment banks, trading companies also use repos, because their thin margins encourage the use of unearthly amounts of leverage. Banks don't like to see too much leverage, so the traders may use repos at a bank to dress up the statements, before presenting them elsewhere for a loan.

Who are the major trading companies of the world? Globally, in agricultural commodities there is **ABCD**: Archer Daniels Midland, Bunge, Cargill and Louis Dreyfus. In hard commodities, two of the obvious players are Glencore and Trafigura. On Asian exchanges, one can find Noble, Olam, Wilmar, Chemoil, and Glencore, among others. Investors in these companies should be skeptical about the balance sheets being presented, especially if they are accompanied by the chief financial officers' claims of "low net gearing".

If one avoids proprietary financial traders and commodity traders, which rely on high leverage to generate acceptable returns on equity, the repo problem can largely be avoided. That brings us to sale-leasebacks.

In a sale-leaseback transaction, an expensive asset, usually a building, an airplane, or a ship, is sold off. Simultaneously, the vendor agrees to lease the same asset back from the buyer. Effectively, the company retains the use of the asset, but has removed it, and any accompanying debt, from the balance sheet.

Why would a company do this? Again, it improves the appearance of the balance sheet. Of course, nothing has really changed. The company has swapped one form of on-balance sheet liability, bank debt, for another, the off-balance sheet lease agreement.

Singapore-listed Swiber did a series of sale-leasebacks in 2007 and 2008. The company reported total disposal gains of US$37m for the transactions and its balance sheet improved considerably. But in Swiber's Medium Term Note Programme, the loan covenants explicitly include *capital lease obligations* when calculating whether Swiber is within its gearing limits. Clearly, the leases still count as debt.

So if the company can't fool the buyers of its Notes, who can it fool? Investors of its shares, of course. The typical buyer of junk bonds (for that is what Swiber's Notes really are) is almost always a fund staffed by skeptical investment professionals aware of credit risk.

But the typical buyer of shares is all too often a retail investor who lacks either the time or the interest to look more deeply into the financial statements. As a result, the stock can trade based on its distorted financial statements, far above its true value, for a long period of time. This in turn allows the management to place out shares at a premium to raise cash for the company, or to let management sell their personal holdings to realize abnormal profits. Either way, there is a transfer of wealth from the ignorant to the knowledgeable, and a corresponding transfer of financial risk in the opposite direction.

Coming to the second part of Mr Munger's quote, assets are often worth less than their carrying value. One obvious example is trade receivables. Trade receivables are counted as assets, on the basis that they will soon turn into cash, but they can also harbour unrecognized bad debt. Shareholders often find out the hard way that receivables seldom convert into cash at their full value.

Trade receivables were already discussed back in the newsletter for 30 June 2009. Therefore we shall now use a different example: *cash*.

In theory, cash is the simplest asset of all and the hardest to fake. After all, one can just check the bank account. But company directors do not always do so. It is common practice to assume that the accounts, as presented, are "true and fair" unless proven otherwise.

Some examples of disappearing cash may help drive home the point.

China Gaoxian Fibre Fabric was listed on the SGX in September 2009, raising $78.2m. In January 2011, it had a second listing in Korea, this time raising $223.8m. Two months later, its auditors Ernst & Young reported that it "could not verify nor confirm the bank balances in the Company's subsidiaries". Trading in the shares was halted, and the auditors were tasked with an expanded scope of audit. In the meantime, the company has made a full provision of the missing cash, and its 2010 annual report shows an "extraordinary loss" of RMB 980m.

What does China Gaoxian do, anyway? Its IPO prospectus says they are "principally engaged in the production and sale of premium differentiated fine polyester yarn and warp knit fabric." Among their products are fully-drawn yarn (FDY), drawn textured yarn (DTY), blended polyester yarn, triangular fibre yarn and warp knit fabric.

Hongwei Technologies listed on SGX in October 2005, raising $8.6m. In May 2007 it issued new shares for $10.9m, and in September 2010 it did another placement, for $4.2m. On 26 February 2011, its auditor Ernst & Young reported "issues pertaining to the cash and bank balances confirmation in its subsidiary company in China".

KPMG was tasked to do a special audit, and its audit report released on 21 October 2011 reported that over 99% of the purported cash on the balance sheet was simply gone. The evidence KPMG uncovered strongly suggested the company had forged bank statements and tax invoices, and had made unauthorized loans to suppliers, one of which was majority-owned by the *father* of one of the executive directors.

What does Hongwei do? The IPO prospectus says they "manufacture and sell polyester differential fibre". The principal products are: polyester differential pre-oriented yarn (POY), and drawn and textured yarn (DTY). Sounds a lot like China Gaoxian…

Were there hints that China Gaoxian and Hongwei's cash might not be there? Yes. The biggest hints came from the income statements. Not just those of China Gaoxian and Hongwei, but also those of other synthetic fibre producers, specifically, China Sky Chemical Fibre and Li Heng Chemical Fibre.

China Sky and Li Heng are nylon manufacturers. Nylon, like polyester, is a synthetic fibre made from hydrocarbons, usually crude oil. Nylon and polyester are chemically different, but have similar properties and end up in similar products, namely textiles. Apparel companies typically use both nylon and polyester for use in various fabrics across their product ranges.

China Sky claims that it manufactures "four types of high-end chemical fibre (nylon) products, namely: Full Drawn Yarn (FDY), High Oriented Yarn (HOY), Air Textured Yarn (ATY) and Drawn Textured Yarn (DTY)." These sound very similar to Hongwei and China Gaoxian, even if they are made from nylon instead of polyester.

Li Heng's IPO prospectus says they make Partially Oriented Yarn (POY), Highly Oriented Yarn (HOY), Fully Drawn Yarn (FDY) and Drawn Textured Yarn (DTY). It is China Sky's virtual twin, and is at least a close cousin of China Gaoxian and Hongwei.

Given similar equipment, similar raw materials, similar products and similar customers, both polyester and nylon manufacturing should give similar economic results. Differences should be attributable to economics of scale in raw material purchasing, and the final price point of the product. Nylon is generally regarded as superior to polyester, and commands a higher selling price.

So the basic premise is that all four companies should have broadly similar margins, with advantages for the larger producers and the nylon producers. Importantly, changes in supply and demand in the textile market should affect all four companies similarly. Here is where the clues emerge.

In 2009, both China Sky and Li Heng reported steep declines in revenues and gross margins. China Sky's sales fell 43%. It blamed lower sales and high fixed costs for the gross margin declining from 30.9% to just 4.7%. Average selling prices (ASP) dropped 43.2%.

Li Heng's story was similar: sales dropped 46%, and gross margin went from 28.7% to 12.6%. It blamed the slowdown in the global economy for pricing pressure. ASP fell 37.3%.

What about China Gaoxian and Hongwei?

China Gaoxian's sales fell just 1%. It reported *higher* gross margins in 2009, at 31.8% versus 30.4% in 2008. It also had higher *net* margins; 22.6% against 21.3% the year before. ASP fell only about 10%.

Hongwei's sales fell 18%. Gross margins went from 30.4% to 25.5%. ASP fell about 18%.

From the viewpoint of apparel companies, nylon and polyester are interchangeable; retail customers don't care. While the two materials are chemically different, their properties are similar enough that clothing can be designed to use one or the other, or both. If the price differential is large, it is not difficult to change the mix to use more of the cheaper material.

It is therefore amazing that the nylon companies suffered so badly, while the polyester makers were only slightly affected. Logically, all four companies should have suffered together. Apparel companies would have surely taken advantage of the 40% decline in nylon prices to use more nylon, or to force polyester makers to cut prices severely too.

With this as background, the simplest answer to the conundrum of China Gaoxian and Hongwei is that their 2009 income statements were *fake*. Fake sales generate fake profits, which show up as fake cash on the balance sheet. So of course the auditors could not find the cash, since it was never there to begin with. This could have been deduced in early 2010, when the 2009 results were announced, so investors could have sold out one year before the auditors announced the issues.

So we have 3 lessons here.

Lesson 1: On the balance sheet, all liabilities listed are worth *at least* their carrying value, while assets are usually worth somewhat less.

Lesson 2: There may be significant *additional* liabilities that are not on the balance sheet, but that still need to be paid.

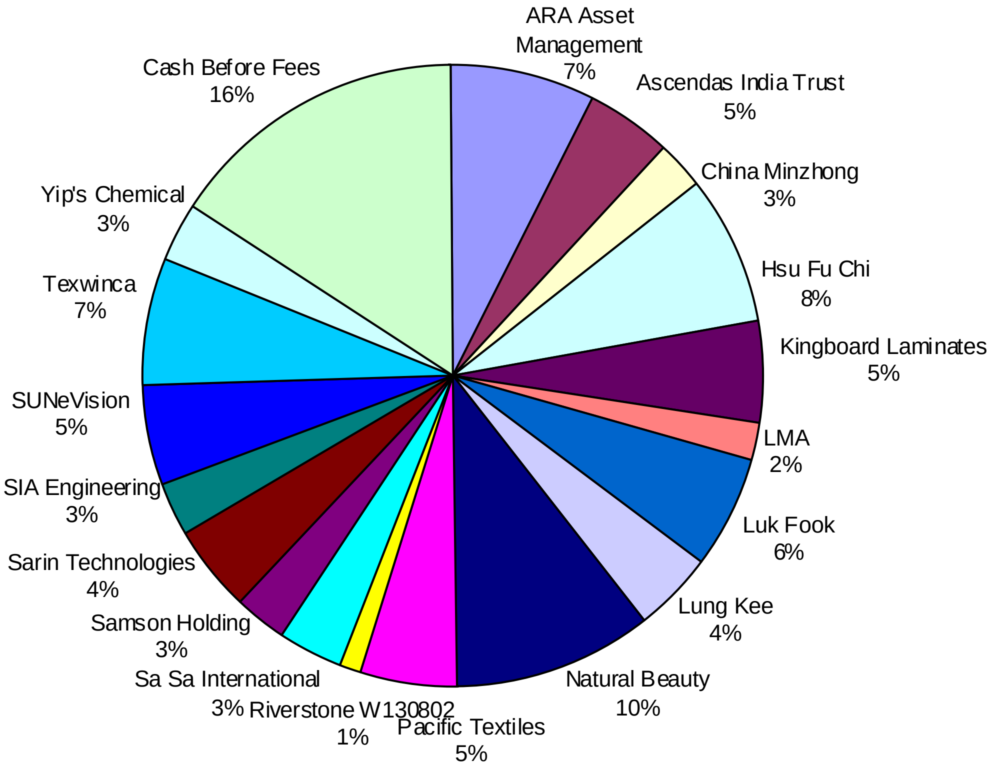
Lesson 3: Few companies are *truly* special. Usually, someone, somewhere, is doing the same thing, and making the same money.

One final caveat remains about detecting and avoiding frauds: a smart thief is unlikely to be caught. History records several famous unsolved thefts. Fortunately for investors, most thieves are not so smart. They usually leave clues, like forgers with paintings – many forgers are good, but they still make small mistakes. The few forgers who are true experts are seldom (or never) caught. Even expert investors who remain skeptical cannot hope to avoid all the frauds. But a little homework goes a long way.

End

Annex I

Reference Account as of 30 September 2011



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%	$216.53	83.65%
31 Aug			$141.28	86.22%	$193.05	92.43%	$198.69	82.60%
30 Sep			$146.38	88.44%	$210.53	99.04%	$177.28	84.05%
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%**		**-22.4%**	