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*Keeping Your Capital Safe*

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# Client Newsletter for the period ended 31 March 2012

1. **Foreword**
2. **Market Commentary**
3. **Portfolio Review**
4. **Inventory**

## 1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2012.

Discussions with service providers on setting up the fund are continuing. Your manager is hopeful that the fund will be up by the time the June newsletter is published.

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

## 2. Market Commentary

Markets have rallied strongly in 2012. Below are the returns for some stock markets for the 3 months ended 31 March 2012.

| Stock Market Index | YTD 31 Mar |
|---|---|
| US S&P 500 | 11.6% |
| US Dow Jones Industrial Average | 8.1% |
| UK FTSE 100 | 3.5% |
| Germany DAX | 17.8% |
| Shanghai Composite | 2.9% |
| Japan Nikkei 225 | 19.3% |
| Hong Kong Hang Seng Index | 11.5% |
| India Nifty Index | 14.5% |
| Singapore Straits Times Index | 13.8% |

Based on these stock markets' performance in the first quarter alone, it would appear that all is well in the world. Economies everywhere are growing strongly, everyone is prosperous and there is world peace.

Among the standouts, economic giants Japan and Germany are dividing up the world between them, while China is the "sick man of the East", lagging behind and struggling to catch up to the rest of the world.

The truth, as we know, is rather different.

The recovery of the US economy, today effectively the "sick man of the West", is still a work in progress. Unemployment stalled at 8.2% in March[1].

In Europe, the sovereign debt crisis continues, albeit with some small resolutions in Greece.

Greece has officially defaulted, with a haircut of 53.5% in nominal terms. For each €100 in bonds, creditors will get €15 in bonds from the euro zone rescue fund, plus €31.5 in new Greek bonds maturing in 11-30 years' time.

Losses in present-value terms are of course far higher, and the new Greek bonds themselves are being quoted at less than 25 cents on the dollar, which is another way of saying that market participants fully expect Greece to default yet again in the future[2]. Maybe some lessons are being learnt from history after all.

As long-time market watchers knew, the world did not end with the Big Fat Greek Default. Life, stubbornly, went on. Perhaps that will inspire the rest of Europe to let Portugal and Ireland default as well and be done with it.

Spain and Italy, of course, owe their creditors enough money to inflict real pain if they default. So that means the creditors won't let them default, since everybody loses that way. Better to "extend and pretend" so that Spain can sell assets to pay down debt, and Italy can export goods to make interest payments.

[1] *The Employment Situation – March 2012*, **Bureau of Labor Statistics**, 6 April 2012

[2] *Greece Defaults, and Tries to Move on*, **Wall Street Journal**, 10 March 2012



Updated 22 April 2012

The different "solutions" reflect the realities: Spain's economy is weak, but its level of borrowings are low enough that selling assets will help, while Italy's level of borrowings is high, but its industrial economy can earn enough to let it stay current on its debt.

Japan is not doing as well as its stock market might suggest. Japan's government forecasts growth of 2.2% for the fiscal year ending March 2013, but primarily because of reconstruction spending in the wake of last year's quake, which is hardly inspiring. The strength of the yen continues to weigh on export earnings, and the latest trade data continue the trend of trade deficits.

China's slowdown is real. But it is unfolding at different speeds, as befits its gigantic economy. The real estate sector is increasingly desperate for funds. Small private developers are going bankrupt[3], while the larger ones are setting up property funds and issuing bonds[4] to raise cash in order to replace fast-disappearing bank credit. At some point the surviving developers may well prove to be attractive investments.

Meanwhile, the Chinese consumer is suffering from indigestion as oversupply takes its toll. Domestic sportswear brands, led by Li Ning, are suffering after the overexpansion of the last 3-4 years. Heavy discounting to clear inventory is having knock-on effects on lower-priced casual wear, not to mention future sales, since discounting merely moves sales from one segment or time period to another without actually changing aggregate demand. The previously amazing profit margins are headed only one way – down.

In the face of such challenges, one might expect the government to be laser-focused on the economy. But China is currently caught up in the political furore surrounding the fall of Bo Xilai, the former Chongqing Communist Party leader and until recently a candidate for the Communist Party's supreme Politburo. What started as a simple purge of an over-reaching official is slowly turning into a page-turner of epic proportions as the intrigues amongst China's princelings come to light.

The princelings are the descendants of China's first generation of political and military leaders. While they share a common heritage, and have frequently parlayed it into positions of wealth and power, they do not all have the same ideas for China's future. Indeed, there is a power struggle going on behind the scenes between the leftists and the reformists[5]. For now, the reformists are ahead.

It is not all bad in China, of course. The inland cities, long the poor cousins of their coastal counterparts, are proving to be attractive markets for fresh foreign investment otherwise put off by high wage and land costs in coastal cities[6]. So China, in some sense, is catching a second wind. It remains to be seen if China's economy can function, at least temporarily, with a distracted government.

In India, following evidence of slowing economic growth, the Reserve Bank of India has cut interest rates. Whether this will further fuel inflation is anyone's guess. Certainly, the optimism over India is fading. Growth estimates for 2012 are now running at just 6%, still very decent, but nowhere the 8-10% needed to keep up with China.

In Africa, chaos continues in Syria. The UN has voted to send 300 truce monitors to Syria, but local activists are skeptical given that "shelling stops and tanks are hidden when they visit somewhere, and when they leave, shelling resumes[7]." The UN's latest estimates

[3] *Developers fail in Hangzhou, Guangdong,* **South China Morning Post**, 20 April 2012

[4] *Chinese Developers Set Up Funds as Cash is Squeezed Amid Crisis,* **Bloomberg News**, 20 March 2012

[5] *The Revenge of Wen Jiabao,* **Foreign Policy**, 29 March 2012

[6] *China Inland Cities Power New Growth Offsetting Slowing on Coast,* **Bloomberg News**, 10 April 2012

[7] *Syria Troops Accused of Douma Attack,* **Wall Street Journal**, 22 April 2012

are that over 9,000 have been killed since violence broke out.

In conclusion, stock markets are (mostly) booming, but the world is (mostly) a mess. What is one to make of this topsy-turvy world, where stock markets imply the best of all worlds and the reality is almost quite the opposite?

Your manager's response is to go back to basics. Fundamentals win, eventually. But patience will be needed. Your manager will write again when the report for the quarter ended 30 June 2012 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
22 April 2012

## 3. Portfolio Review

As at 31 March 2012, the Net Asset Value (NAV) of the Reference Account was $204.78 per unit, net of all fees. The highwater mark was $228.60. Against the end-2011 NAV of $186.42, the year-to-date return for 2012, net of all fees, was 9.8%.

17 securities made up 79.5% 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 during the quarter ended 31 March 2012.

### New Investments

**Pico Far East** is the world's largest exhibition services company. Founded in 1969, today the company operates with 2,500 staff across 35 cities worldwide. Pico went public in Hong Kong in 1992.

The founding Chia family is still heavily involved in the management, and the second generation of the family is already working at the company. One of them, Jean Chia, became managing director in 2008.

Pico's main business is the design and manufacture of booths used at meetings, incentives, conventions and exhibitions (MICE). These include global events like the World Expo and the Olympics. It also makes outdoor signage for petrol stations, automotive dealerships and fast-food restaurants.

While the entry barrier to the business seems low, delivering at Pico's scale requires significant capital investment into a factory. Pico made this outlay long ago in Hong Kong, Singapore, Thailand and Malaysia, and are completing their plants in Shanghai and Beijing. Replacement costs today would be much higher than their stated value on Pico's books, especially in Singapore and Hong Kong, where land has become much more expensive in recent years.

Rivals are far smaller and arise primarily from designers striking on their own. Some actually worked at Pico previously. But these firms quickly find that designing an exhibit stand is one thing, while manufacturing 100 of them on time and within budget, using a factory they don't own, to deliver and install within a 2-day window, is quite another. And for one-off custom exhibits for multinational companies, it is far simpler to give a global contract to Pico than to negotiate individual deals with local operators in different cities.

The main market is Greater China, accounting for 52% of revenues. From any sensible viewpoint, it seems likely that China's share of the world's MICE events will continue to grow, and Pico with it.

The shares were purchased at about 9 times FY2011 earnings and 1.7 times book value. Dividend yield was 6.5%.

### Other Significant Events

**Sincere Watch HK** is in the process of receiving a general offer. Its parent company, Sincere Watch Limited, has been acquired by Hong Kong billionaire Pollyanna Chu Yuet Wah. Under the Securities and Futures Commission's *Codes on Takeovers and Mergers and Share Repurchases*, the change of control requires a general offer to be made for the shares of Sincere Watch HK as well.

Ms Chu's company has stated that it intends to keep Sincere Watch HK listed. Nonetheless, as the acquisition of the parent serves as a benchmark price, shares of Sincere Watch HK have appreciated accordingly and now trade at close to the imputed offer price.

Interestingly, two conditions of the buyout are: that Sincere Watch Limited must pay a huge dividend to its current owners, and that it must not be in a net debt position at the point of handover. A check revealed that this will require Sincere Watch Limited to borrow to finance the dividend. This debt will most likely be partially repaid via a special dividend from Sincere Watch HK.

## 4. Inventory

Inventory refers to items that have not yet been sold to customers. It is made up of raw materials, works-in-progress, and finished goods. The descriptions are self-explanatory. While inventory seems entirely mundane and unworthy of discussion, it can be a key factor affecting profitability as well as growth.

Under stable conditions, the cost and selling price of inventory changes only slowly. As a result, gross profits are predictable and the management can easily make plans with a good idea of what net profits will look like.

Reality intrudes on this simplicity. For many companies, especially manufacturers, raw material price fluctuations can heavily influence profitability.

Some companies are fortunate enough to have such special products that they can dictate pricing and thus pass on cost increases at will. Most companies are not so lucky, and have to negotiate with suppliers and customers alike to try to preserve their margins.

Other companies take another tack by taking a view on raw material prices. They stock up or de-stock if they think prices will rise or fall. But the question then arises: if they were so good at figuring out price trends, why bother with their core business at all?

Continuing on the theme of cotton prices mentioned in the last newsletter, a look at two companies illustrates the pitfalls of trying to guess raw material prices.

**Weiqiao Textiles** is a manufacturer of yarn, grey fabric and denim. It is among the largest textile enterprises in China by turnover. Weiqiao buys raw cotton, cleans and combs it, then feeds it into yarn spinners to form yarn. Some of the yarn is then used to weave grey fabric (untreated cloth) and denim.

During 2010, cotton prices rose, peaking in the first half of 2011, before crashing in the second half.

Weiqiao's response was to stock up as prices rose. At the end of 2010, inventory went from 75 days to 138 days of purchases. Initially, this worked: Weiqiao reported gross and net margins well above those of previous periods.

Weiqiao then did what many gamblers do when they win: it doubled down. On 30 June 2011, inventory reached 243 days of purchases. But gross and net margins had come down to normal levels, a warning sign. Then, in the next 6 months, things fell apart. As cotton prices crashed, Weiqiao was stuck with high-cost inventory that it had to sell at the new lower price. Gross margin in the second half of 2011 was *negative* 11%, and the company reported its first semi-annual loss in 10 years.

**Texhong Textiles** looks very similar to Weiqiao Textiles. It, too, produces yarn and grey fabric. Like Weiqiao Textiles, it stocked up as cotton prices rose. And, like Weiqiao, it reported abnormally high gross and net margins initially, its inventory peaked on 30 June 2011, and it lost money in the second half of 2011. If Texhong was trying to copy Weiqiao's strategies, they certainly succeeded all too well.

Weiqiao and Texhong were not the first corporate gamblers, nor will they be the last. Investors would do well to steer clear of companies attempting to outsmart the commodities markets.

Yet, inventory management taken to an extreme can also be a problem. Take the case of the floods in Thailand at the end of 2011. The floods put many factories underwater, paralyzing manufacturing operations. Many Japanese companies subsequently experienced shortages of key components that were produced at their Thai plants. They were using a Just-In-Time (JIT) approach to inventory to keep a minimum amount of stock on hand, but it backfired when the stocks ran out and no more were forthcoming from the plants in Thailand.

It would seem that companies face a Catch-22: if they keep more inventory they risk getting whipsawed by raw material price swings, if they keep less inventory they risk running out when suppliers have problems.

But perhaps JIT is the lesser of two evils. Running out of key parts means foregone profits as workers and machines are idled. But getting whipsawed on raw material prices can result in heavy losses. Better to forego unrealized profits than to incur realized losses. Giving up money that hasn't been made yet is relatively painless, if frustrating. Losing hard-earned capital, on the other hand, is much more painful.

End

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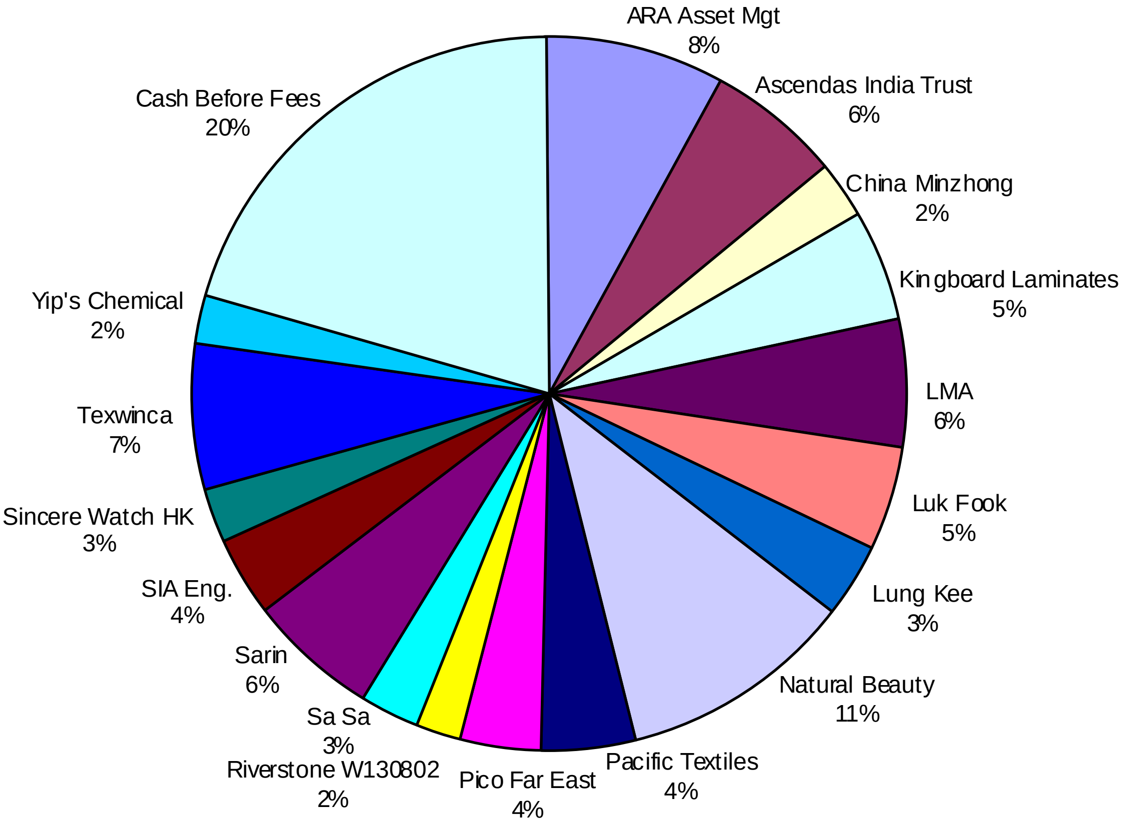
Annex I

## Reference Account as of 31 March 2012




Annex II

| Monthly Net Asset Values | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | | 2009 | | 2010 | | 2011 | | 2012 | |
| **Date** | **NAV ($)** | **Invested (Gross)** | **NAV ($)** | **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% | 192.15 | 73.35% |
| 28 Feb | | | 102.42 | 69.23% | 169.35 | 93.00% | 216.56 | 93.66% | 204.12 | 79.44% |
| 31 Mar | | | 100.11 | 51.25% | 179.88 | 93.26% | 219.13 | 85.79% | 204.78 | 79.53% |
| 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% | 193.17 | 83.38% | | |
| 30 Nov | 100.00 | 16.19% | 154.88 | 87.41% | 221.65 | 92.52% | 184.76 | 83.96% | | |
| 31 Dec | 101.02 | 52.56% | 166.03 | 79.26% | 228.60 | 85.71% | 186.42 | 76.01% | | |
| **YTD** | **+1.0%** | | **+64.4%** | | **+37.7%** | | **-18.5%** | | **+9.8%** | |



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