LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 31 December 2017

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for December 2017.

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

2. Market Commentary

2017 was a very good year in general for equity investors as all major stock markets climbed.

Market Index	4Q17	2017
S&P 500	+6.1%	+19.4%
UK FTSE 100	+4.3%	+7.6%
Nikkei 225	+11.8%	+19.1%
Shanghai Composite	-1.2%	+6.6%
Hang Seng Index	+8.6%	+36.0%

US president Donald Trump finally got something done, in the form of a tax reform bill. Its main effect was to permanently reduce taxes for corporations and the ultra-rich, while raising taxes in the long term for the middle class. It has been estimated that about half the total tax benefits will go to the top 1% of income earners, while 1 in 5 middle class families will see their taxes go up. Essentially, Trump's tax plan takes from the masses and gives to the rich. Of course, Trump never claimed to be Robin Hood, only that he was different from the average politician – which he certainly is.

The tax cuts might spur corporations to increase their business activity, but many large US corporations already pay far less than the headline rate by using tax planning strategies, so the official rate is unlikely to be meaningful to them. Apple, for one, has famously shielded hundreds of billions of dollars in profits from US taxes by using companies in Ireland and Jersey to book its profits[1].

Brexit negotiations continue, with the UK and the EU agreeing in principle to a Norway-style transition, where the UK accepts all EU rules and remains a full EU member in all but name, until December 2020[2]. Clearly this is just a delay tactic, with the EU hoping the UK will hold another referendum and this time vote to "Bremain", while UK Prime Minister Theresa May still believes she can get a favorable trade deal. Triggering Article 50 gave the UK two years to negotiate the exit, set for 29 March 2019, but now they have an extra 21 months to do so, to December 2020.

European economic activity remains subdued, as the region continues to depend on German exports of machinery and cars, though Airbus' beleaguered A380 jumbo has just been thrown a lifeline by key customer Emirates[3].

China had a good year with healthy economic growth, despite a crackdown on highly leveraged conglomerates such as Anbang, Dalian Wanda, Fosun and HNA. These companies are being forced to sell their overseas assets as the government has ordered the banks to not support any deals that are not of strategic interest. The risks of being "too big to fail" are clearly on the minds of Chinese

[1] *After a Tax Crackdown, Apple Found a New Shelter for Its Profits*, **The New York Times**, 6 Nov 2017.

[2] *Post-Brexit transition deal will resemble Norway single market membership – MEPs*, **Daily Mail**, 22 Jan 2018

[3] *Emirates hands Airbus A380 superjumbo a lifeline with $16 billion order*, **Reuters**, 18 Jan 2018.

officials, and they are reining in these mega-acquirers[4]. Of course, outward investments in infrastructure and acquisitions of critical technologies are still being financed[5].

Closer to home, privatizations are continuing in Singapore, pointing to undervaluation among the Lion City's small- and mid-sized companies. In Hong Kong, many companies trade below fair value as investors ignore them in favour of large-cap stocks surfing a wave of hot money flowing in, from both abroad and mainland China itself.

The wild ride of cryptocurrencies yields a cautionary tale about chasing returns: Bitcoin jumped over 1,400% during 2017, but then fell about 50% from its highs in January. Stocks that have been pushed up too high, too soon, may suffer similar declines. Indeed, the Chinese government issued a warning that "certain shares" were rising too fast.

Today's large tech companies such as Alibaba and Tencent are not loss-making dotcom duds headed for implosion; on the contrary they are profitable and growing rapidly. But the same could have been said of the "Nifty 50" stocks in the US during the 60s and early 70s. Companies such as Anheuser-Busch, Black & Decker, Bristol-Myers, Coca-Cola, Dow Chemical, General Electric, IBM, Johnson & Johnson, 3M, McDonald's, Merck, Disney, Walmart and so on. As household names making useful products and providing valuable services, they were widely regarded as "one decision", "buy and hold", "blue chip" investments. But once the bear market hit, their high valuations caused them to underperform the broader market.

There is a price beyond which a good company becomes a bad investment. Your manager simply prefers to err on the conservative side when setting a price limit.

The strong momentum from 2017 carried over to January, but volatility in February has erased the early gains. However, in China, economic growth seems robust as many companies are issuing positive profit alerts. Your manager expects the companies held by the Fund to do well this year. The Fund is essentially fully invested and welcomes additional subscriptions. The next newsletter will cover the quarter ended 31 March 2017.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
7 February 2018

3. Portfolio Review

As at 31 December 2017, the Net Asset Value (NAV) of the Fund was USD 109.41. Net of all fees, the return for the 4th quarter was +0.1%, while the full-year return was +21.3%.

For reference, during the 3 months and 12 months ended 31 December 2017, the changes in the Fund's key markets were:

Market	Index	4Q17	2017
Singapore	STI	+5.7%	+18.1%
Hong Kong	HSI	+8.6%	+36.0%
Shanghai	SSE	-1.2%	+6.6%
Fund	**n/a**	**+0.1%**	**+21.3%**

22 securities made up 92% of the Fund's holdings, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

Winners and Losers – Q4 2017 vs. Q3 2017

Winners	Change		Losers	Change
Huayu Automotive	+32%		IT	-21%
Greatview Aseptic	+19%		Sarine	-15%
Fuyao Glass	+14%		Clear Media	-14%
China Sunsine	+10%		Genting HK	-12%
			Hengdeli	-12%

[4] *China's Dealmaking Tycoons Scrutinized by Banking Regulator*, **Bloomberg News**, 22 June 2017

[5] *Paths diverge for Chinese firms chasing overseas assets*, **South China Morning Post**, 16 Sep 2017

Other holdings were not material contributors to changes in the Fund's NAV in Q4.

Winners and Losers – 2017 vs. 2016

Winners	Change		Losers	Change
Huayu Automotive	+86%		Sarine	-44%
Sunningdale Tech	+76%			
Fuyao Glass	+56%			
Greatview Aseptic	+43%			
SAIC Motor	+37%			
Pico Far East	+31%			

The Fund also benefited from several special situation exits in 2017:

Stock	Gain vs. cost	Notes
Auric Pacific	+18%	Privatization
Croesus Retail Trust	+19%	Privatization
Yingde Gases	+28%	Privatization
ARA Asset Mgmt.	+ >400%	Privatization

Although the Fund's special situation gains in 2017 paled in comparison to the price appreciation from its core holdings, they were an important source of uncorrelated returns. The Fund will continue to seek out and invest in special situations as and when they arise.

The Fund had several holdings which outperformed consistently due to strong operating results, so they generated good full-year returns. Only one stock, Sarine, was a meaningful loser on a full-year basis, as its business model came under attack due to piracy of its intellectual property.

Other holdings were not material contributors to changes in the Fund's NAV in 2017.

New Investments

Cityneon is an exhibitions company with 2 business segments. The legacy business is a contracting business which builds exhibits on behalf of companies participating in trade shows. This is a low-margin, cost-plus business. The new business is intellectual property licensing, where it acquires the exhibition rights to various intellectual properties and uses them to build traveling exhibition sets based on the licenses. This is a high-margin business, as it normally partners with local operators who stage and run the exhibitions. Cityneon collects a fixed fee plus a cut of the ticket revenues, so most of the risk is taken by the local operator.

Currently, Cityneon owns the exhibition rights to 3 intellectual properties: *The Avengers*, *Transformers* and *Jurassic World*. There are currently 6 sets: 1 permanently in Las Vegas, 2 touring China, 1 touring Australia, and 2 touring the rest of the world. It is likely that more sets will be added, most obviously for *Transformers* and *Jurassic World* which currently only have one set each, versus 4 sets for *The Avengers*.

The company is also likely to acquire additional intellectual properties in future, with its current success serving as leverage in negotiations. Obvious candidates include: *Star Wars*, *Avatar*, *X-Men*, *Justice League*, *Batman*, and *The Lord of the Rings*. *Harry Potter* is unfortunately not available, as the exhibition rights are currently owned by Global Experience Specialists (part of Viad Corp) through 2020.

The company's results in 2018 will see significant growth over 2017, as 2017 effectively included the contributions of only 4 sets, whereas 2018 should see the contribution of all 6 sets.

The shares were purchased at about 12 times trailing earnings.

Giordano is a budget/mid-range apparel company. It operates in North Asia (including Hong Kong, Taiwan and mainland China), Southeast Asia, and the Middle East. It was founded in Hong Kong in 1981 by entrepreneur Jimmy Lai, but in 1996 he was forced to sell his shares to save the company when the Chinese government shut Giordano stores in China in apparent response to his criticisms of then-Premier Li Peng.

Today, the largest shareholder of Giordano is the Cheng Yu Tung family of Chow Tai Fook fame, with a 24% stake, but they are passive shareholders, albeit with 2 non-executive board seats. Chairman and CEO Peter Lau is the real driver of the business. He joined in 1987, and has been both chairman and CEO since 1994. He owns 1.7% of the company.

In recent years, business in China has become difficult, as staff costs and rental pressures have combined with increased competition to impact earnings. The Group has restructured its business in China to focus on the franchisees, rather than self-operated stores. Sales in China are now declining because of 2 reasons: the sales mix is shifting from retail to wholesale, where the dollar value per item is lower, and underperforming self-operated stores are being closed, reducing retail sales. However, operating margins are improving, because wholesale margins are higher than retail margins, and loss-making retail stores are being closed. The effects are already visible. Also, e-commerce, the most profitable channel, now accounts for 16% of sales, and continues to increase as a percentage of sales.

Giordano has an enlightened attitude towards dividends and capital management: each year the management decides how much money will be needed for the following year, and any excess is paid out. The result is that in the past 5 years the Group has paid out 94% of total earnings. While there is no guarantee that this high payout ratio will be sustained, the shareholder-friendly attitude is very welcome and bodes well for the future.

The shares were purchased at 14 times trailing earnings and a 7% yield.

Divestments

QAF was sold after it became apparent that the business had deteriorated. Besides the failed IPO which suggested that the pork business would face continued challenges, competition in the Philippines bakery business has increased. Your manager decided to divest and reinvest the proceeds elsewhere. Including dividends, gain on divestment was about 5%.

Other Developments

k1 Ventures suspended trading after selling its investment in Guggenheim Capital. It subsequently declared 2 large distributions. One was paid in December. The other was paid in late January. For December 2017, the k1 shares in the Fund were priced at the value of the January distribution.

4. National Service

National service, in the context of the stock market, refers to companies engaging in activities that are not truly commercial in nature, but that serve other strategic interests of the government. Obviously, companies involved in national service have less resources available for their core business. If the national service activities consume enough management time, the company can ultimately turn out to be a poor investment despite appearing attractive at first glance.

For example, wireless telecommunications businesses normally generate attractive cash flows, while power utilities grow steadily. But when these businesses are required to do national service, their underlying earning power and cash flows are dissipated.

There are 3 wireless communication operators in China: **China Mobile**, **China Unicom**, and **China Telecom**. All are state-owned, and all are forced to make investments in comprehensive network coverage, regardless of profitability. China Mobile, for one, was tasked to deploy China's proprietary TS-SCDMA 3G technology in 2009. The total cost, including network build-out, compatible device development and marketing, was estimated at US$32bn, yet by 2014 the TS-SCDMA network was obsolete as users had already migrated to 4G services.

Despite the elevated capital expenditures and suppressed cash flows from such forced investments, the telcos cannot recover the full cost of these projects, as the government has pressured them to reduce consumer charges. For example, domestic roaming fees have been abolished, and unused minutes and data now roll over to future months.

Meanwhile, excess cash on the balance sheet is not being returned to shareholders, so there is effectively no difference between China Mobile, which had net cash of RMB 400bn as of 30 June 2017, and China Unicom, which had *net debt* of RMB 138bn on the same date. Cash that will never be paid out might as well not exist. Those who think the cash gives China Mobile an advantage in making acquisitions need to ask themselves if they *really* think China Unicom will be unable to finance a purchase that the Chinese government believes will be important. Unsurprisingly the telcos have not generated impressive returns in recent years, whether via cash dividends or capital appreciation. Some pundits joke that **China Mobile** should be renamed **China *Im*mobile** because of the stock price's inaction.

A comparison of the Chinese telecos with those in Taiwan, Hong Kong, Japan, and Singapore makes clear that under normal conditions, when there are only 3 operators, cartel behaviour dominates and all the players are highly profitable. But China is decidedly *not* normal and investors who think the Chinese telcos will soon operate solely on commercial terms are fooling themselves.

As for power generation companies in China, they have a long runway of growth, given that China is transitioning to a middle-income country and per-capita energy use is likely to increase substantially. However, government mandates to keep electricity affordable for the masses take priority over cost-recovery concerns. During 2008 to 2012, when coal prices were elevated, **Huaneng Power**, **Huadian Power**, and **Datang International Power** all reported record-low profits or even losses, as they could not pass their high fuel costs on to consumers. Their profits recovered when coal prices subsequently fell, but coal prices rose again in 2017. Indeed, Huadian has just issued a profit warning, stating it expects 2017 profits to be 83% to 93% lower than 2016, due to high thermal coal costs.

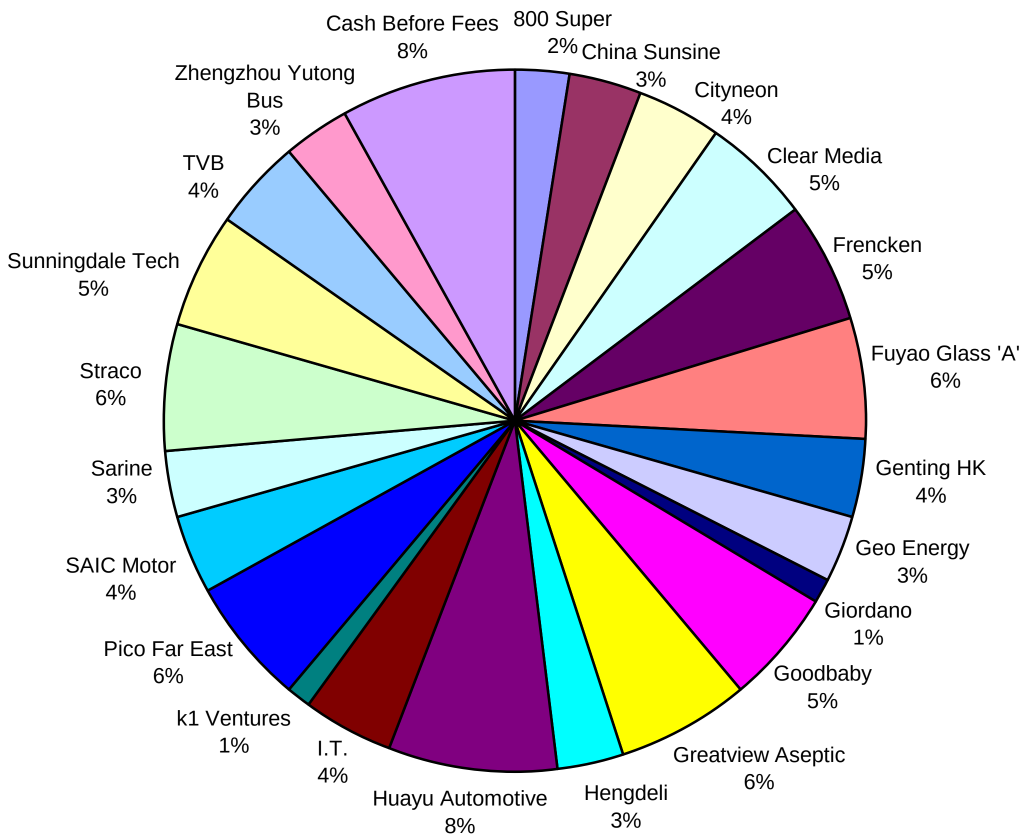
A private equity buyout is unlikely as power generation and transmission-related assets are seen as critical infrastructure in China. The minority investor's return must therefore come from dividends (paid from profits) and capital appreciation (driven by earnings). But since earnings can be depressed at will to keep power affordable, long-term capital appreciation is uncertain, and the dividend is no sure thing. The power generation companies' shares are thus little more than long-lived put options on coal.

Unsurprisingly, the shares of state-owned enterprises whose core businesses have been "hijacked" for national service trade at a discount to their privately-owned for-profit peers. Doing national service means they cannot deliver shareholder value: while they may aim to be profitable, their true goal is to serve their political masters. Investors who expect a "reversion to the mean" may be in for a long wait. Perhaps they might do better to bet on the companies that are receiving such government largesse, rather than on the hapless ones doling it out.

End

Annex I

Fund Holdings as of 31 December 2017



Annex II

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2008										34.16	33.49	35.62	**+4.3%**
2009	34.57	33.52	33.37	36.69	46.20	46.00	50.06	49.68	52.66	54.17	56.68	59.94	**+68.3%**
2010	59.05	61.09	65.17	68.27	64.14	65.69	70.65	72.24	81.06	83.56	85.10	90.30	**+50.6%**
2011	87.21	86.29	88.13	92.81	90.85	91.35	91.17	83.69	69.04	78.23	73.00	72.88	**-19.3%**
2012	77.40	82.90	82.52	83.32	76.36	77.25	77.27	77.91	80.57	79.44	82.70	84.92	**+16.5%**
2013	91.43	97.36	99.96	100.24	99.14	95.09	98.50	100.00	100.86	102.24	102.63	102.93	**+21.2%**
2014	99.15	101.78	99.80	101.84	105.45	106.57	109.05	108.58	103.60	103.91	101.87	99.94	**-2.9%**
2015	97.97	98.16	97.74	103.80	103.69	100.99	96.17	85.91	84.17	88.91	86.20	86.35	**-13.6%**
2016	81.56	83.81	88.82	92.18	91.50	91.52	94.48	94.86	94.87	93.34	91.92	90.20	**+4.5%**
2017	93.18	97.08	101.10	101.39	105.74	107.11	109.67	108.57	109.35	112.57	108.28	109.41	**+21.3%**

Note: The Net Asset Value of the Fund has been linked to the rebased NAV of the Reference Account, which had the same investment style. Until the launch of the Fund, the Reference Account served as the model portfolio for all the separately-managed client accounts. Its trading records were distributed to clients as proof that the Manager's interests were fully aligned with those of the clients. The Reference Account was started at the end of 2008 and became inactive following the launch of the fund on 1 September 2013.