LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 30 September 2018

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for September 2018.

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

2. Market Commentary

The US-China trade war continues unabated, with US President Donald Trump threatening to increase tariffs one day and then chatting on the phone with Chinese President Xi Jinping about trade another day.

It seems nobody really knows how to deal with Trump, and preparing for all possibilities, expecting the unexpected, seems to be the only strategy. The latest news is that the Democrats have captured the House of Representatives in the US midterm elections. This means that Trump and the Republicans will not be able to automatically pass any bills they propose. Things may return to the negotiated horse-trading of the past, implying that the Trump presidency may be forced into a more conciliatory posture with its allies. We can only hope.

Meanwhile, in Europe, Brexit negotiations continue. The current sticking point is whether a proposed temporary customs union to ease the divorce will in fact prove to be permanent in order to avoid a "hard" border between Northern Ireland and the Republic of Ireland. Numerous companies have already concluded that the UK will make a mess of it; the exodus of corporate headquarters from the UK to continental Europe continues.

Asian markets have continued to sell off, with China predictably the worst hit. However the damage to stock prices has been far greater than the expected impact to corporate profits, with the result that Chinese stocks now represent a compelling opportunity. Little more needs to be said, as there are now ample examples of strong businesses selling at reasonable or even bargain prices. Your manager continues to reinvest all fees earned from the Fund back into the Fund.

The next newsletter will cover the quarter and year ended 31 December 2018.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
8 November 2018

3. Portfolio Review

As at 30 September 2018, the Net Asset Value (NAV) of the Fund was USD 94.25. Net of all fees, the return for the third quarter was -9.7%, and for the 9 months it was -13.9%.

For reference, below are the changes in the Fund's key markets:

Market (Index)	1Q18	2Q18	3Q18	9M18
Singapore (STI)	+0.7%	-4.6%	-0.03%	-4.3%
Hong Kong (HSI)	+0.6%	-3.8%	-4.0%	-7.1%
Shanghai (SSE)	-4.2%	-10.1%	-0.1%	-14.7%
Fund	**-0.4%**	**-4.3%**	**-9.7%**	**-13.9%**

21 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 – Q3 2018

Winners	Δ		Losers	Δ
Cityneon	+32%		Goodbaby	-34%
Sunningdale	+17%		China Sunsine	-32%
			Dawnrays	-26%
			Sarine	-26%
			IT	-25%
			Zhengzhou Yutong Bus	-24%
			EVA Precision	-23%
			Genting HK	-22%
			Giordano	-20%
			BAIC Motors	-16%

Cityneon jumped 32%. Profits for the second quarter ended 30 June increased by 115% due to the increased number of exhibition sets.

Sunningdale rose 17%. Profits for the second quarter ended 30 June rose 19%, largely due to foreign exchange gains. The interim dividend was increased.

Goodbaby fell 34%. Despite a 34% increase in sales, half-year profits ended 30 June rose only 7% due to one-off items, namely the bankruptcy of a major toy and juvenile goods retailer and the bankruptcy of a logistics provider. As the Group manufactures its goods mainly in China, it also suffered from investor pessimism over the US-China trade war.

China Sunsine dropped 32%, likely because it noted in its half-year results announcement that although first-half profits had more than tripled, selling prices had begun to decline.

Dawnrays was down 26% despite first half profits being up 12%. The interim dividend was maintained.

Sarine fell 26% despite second-quarter profits rising 28%, due to concerns that De Beers' recent decision to sell lab-grown diamonds would hit demand for natural diamonds.

IT was lower by 25%, likely because same-store sales for the 3 months ended May declined 4% in China.

Zhengzhou Yutong Bus dropped 24% because of poor 2Q results. Despite a 29% increase in sales, profits fell 23% due to margin erosion from reduced government subsidies for its New Energy Vehicles.

EVA Precision fell 23% due to first half profits falling 39%. Sales in both metal stamping and plastic injection molding rose but profits in both segments fell due to lower-margin component sales, startup costs at a new plant and foreign exchange losses.

Genting HK lost 22% despite a large reduction in losses. The interim dividend was maintained.

Giordano declined 20% despite first-half profits increasing 4%. Sales were up 9%. The interim dividend was increased.

BAIC Motors fell 16% despite reporting that first-half profits rose by 186%. Improved results were delivered by Beijing Benz and Beijing Hyundai, but the self-owned Beijing Brand lost more money.

Other holdings were not material contributors to changes in the Fund's NAV in Q3.

New Investments

There were no new investments during the quarter.

Divestments

There were no divestments during the quarter.

Other Developments

There were no other significant developments during the quarter.

4. The Deal Of The Art

Every once in a while, investment bankers will trot out the idea that fine art can be a great "alternative investment". The usual method is to construct some sort of index based on a few selected artists, and then track prices over the years as their works come up for sale.

With the benefit of hindsight, the price appreciation on said artworks is invariably impressive and apparently uncorrelated to other asset classes. High, uncorrelated returns: an asset allocator's wet dream.

Of course, the problems are seldom as well documented as the historical returns from investing in some paintings by Van Gogh or Rembrandt. Here is just a short list of issues commonly raised:

i. *Liquidity*. Selling an artwork can take months or even years.

ii. *Transaction Costs*. Reported auction prices exclude dealer or auctioneer commissions, which can reach 25% of the hammer price[1].

iii. *Storage and Insurance*. Insurance is costly, more so if the work is on public display. Storage in a secure temperature- and humidity-controlled vault is not cheap either.

iv. *Monetization*. Museums charge at best a modest fee for "special" exhibitions.

v. *Scarcity*. The number of high quality "investment grade" pieces is limited, in turn limiting the amount of money that can be deployed.

Some argue that the above problems can all be adjusted for and that these in fact make them ideal for long-term investors with no immediate liquidity needs, on the basis that they can extract an illiquidity premium, adjust prices to account for the dealer's cut, factor in storage and insurance into their costs, and extract all the value as long-term capital gains instead of short-term income. Scarcity is also seen as a benefit, propping up prices, rather than a limiting factor to scale.

However, there are other non-monetary issues which are harder to account for:

vi. *Dead or Alive*. While the value of many artists' works rises during their lifetime, the greatest gains have come after their death, when there is no more supply. But it is impossible to know when an artist will die; van Gogh was gone 10 years after starting, while Dalí died 64 years after his first exhibition.

vii. *Classic or Modern*. The works of famous artists such as Michaelangelo, Leonardo Da Vinci, Rembrandt van Rijn or Caravaggio are well-known and likely to keep their value, but are also very expensive by any reasonable measure, which limits future appreciation. Modern artworks are far more affordable and hold the potential for enormous gains from modest investments, but public taste for unproven artists can be fickle. A $10,000 sculpture can multiply 10 times in value, or become totally worthless.

viii. *Genuine, Fake or Mass-Produced*. The classic artists are well-studied; successful forgeries are difficult to pull off. The announcement of a lost or undocumented Rembrandt invites extreme scrutiny, but decent forgeries of lesser-known artists can pass under the radar. And there is the problem of "mass-production" artists like Salvador Dalí, Andy Warhol and Jeff Koons, with large studios and many assistants. At what point is a given piece essentially the work of assistants and apprentices (and thus far less valuable)? It is known that at one point Warhol's studio was so busy that even the *security guard* was painting[2]. For Dalí, thousands

[1] *Update Regarding Sotheby's Buyer's Premium*, **Sotheby's**, 29 May 2018.

[2] *Holy Terror: Andy Warhol Close Up,* **Bob Colacello**, 1990.

of fake prints exist, and some of the paintings he signed might actually be by his friend Antoni Pitxot[3]. As the **New York Times** itself stated, quoting Dalí: "Le more confusion is more better"[4].

Undoubtedly, fine art can give great pleasure to its owner, and for wealthy art lovers who are not driven by returns, this can more than offset the second group of risks. But an institutional investor unable to tell Monet from Manet and which is focused only on financial returns may find the vagaries of death, public taste and forgeries too much to bear.

Some companies have attempted to invest into art, and have paid dearly for it. The case of Hong Kong-listed **Champion Technology Holdings** is a cautionary tale. Originally a technology company focused on the sale of systems and software licenses, and the provision of related services, in 2012 the chairman and controlling shareholder, Paul Kan Man Lok, decided the company would move from merely sponsoring cultural events to actively trading in "cultural products" i.e. antiques and relics.

Initially, instead of buying these artworks and carrying them on its balance sheet, it made advance payments to the suppliers of said cultural products, perhaps as deposits to secure selling rights. These payments ballooned as the business grew, even as it admitted in its annual reports that these deposits might not be fully recoverable. From HKD 204m the year before it entered the cultural products business, these deposits reached HKD 3.8bn in FY2015.

Initially, the cultural products business did well. Starting in FY2012, it was reported as a separate segment and grew rapidly. In just four years, it became larger and more profitable than the original technology business (which was now losing money).

HKD mn	FY12	FY13	FY14	FY15
Segment Sales	162	986	2,502	3,041
Segment Results	-2	62	107	267
Advances to Suppliers	765	1,726	3,648	3,758

This move into cultural products initially appeared to be a masterstroke by Paul. Then came the fateful decision to invest into directly into cultural products. In the chairman's statement in the 2015-2016 annual report, dated 28 Sep, Paul declared that the Group would "adjust our inventory to capture the appreciation potential" of "exquisite and rare artworks". In a single year, the inventory of cultural products skyrocketed from zero in FY15 to HKD 8.5bn in FY16.

Soon after, the company learned that the products were *not* "exquisite and rare". An independent professional valuer was hired *after* the purchases were made, and its report forced the company to slash the value of the products by 50%. It booked an impairment loss of HKD 4.3bn on them in FY17.

In FY18 the company paid for scientific authentication of its 360 remaining pieces, and the results were unequivocal: the cultural products, which had already been written down in value from HKD 8.5bn to HKD 4.2bn, had to be written down further to just HKD 33m, a *99.7%* loss of value against the original purchase cost. In other words, **the products were fake**. The fraud destroyed nearly all of the shareholders' funds.

HKD mn	FY15	FY16	FY17	FY18
Cultural Products	Zero	8,536	4,235	33
Shareholders' Equity	7,735	7,713	3,565	48

What about Paul Kan Man Lok, who was responsible for this ill-fated foray into cultural products? He is long gone: on 30 Sep 2016, just 2 days after his chairman's statement declaring the company's intent to invest into

[3] *The Art of Forgery: The Minds, Motives and Methods of the Master Forgers,* **Noah Charney**, 2015.

[4] *Putting Some Order To All the Dali Prints, Both Real and Fake,* **The New York Times**, 14 March 1998.

cultural products, Paul resigned as chairman and director.

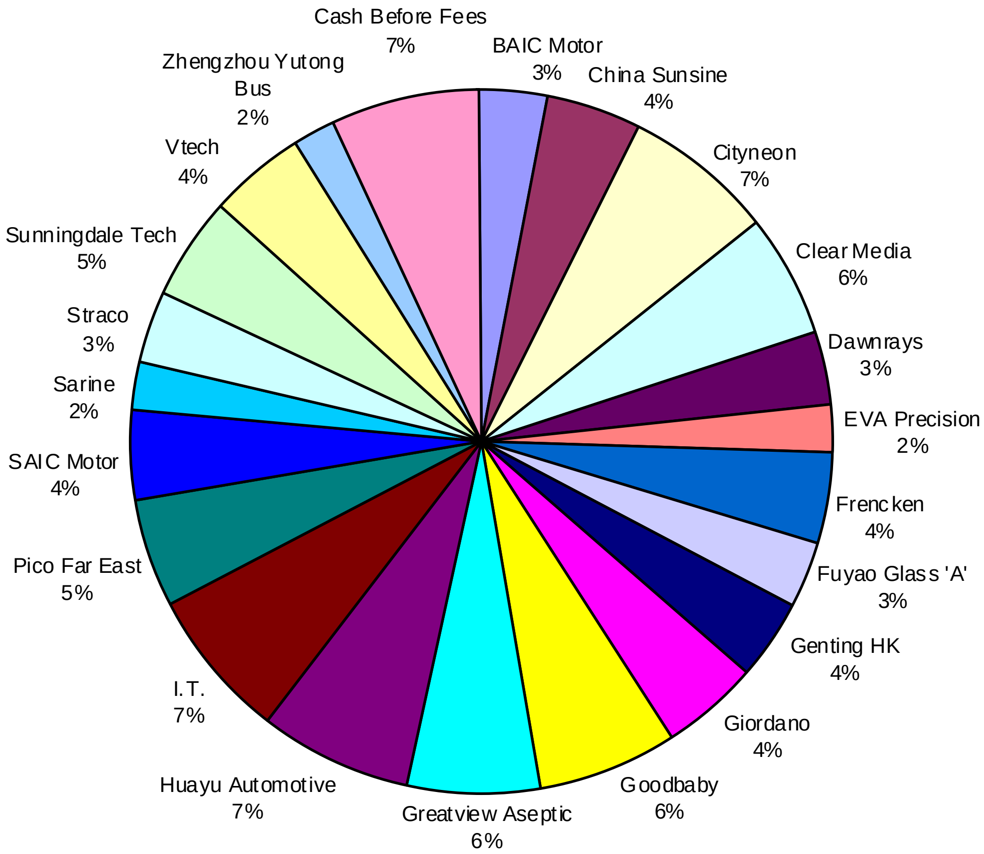
The very next day, on 1 Oct 2016, Paul's holding company Lawnside International sold its entire 28% stake for HKD 270m, or HKD 0.153 per share. Minority shareholders would have done well to do the same: 2 years later, on 30 Sep 2018, the shares traded at HKD 0.40, *after* a 20% dilution from new shares issued and a **20-to-1** share consolidation. Adjusted for the dilution and the consolidation, the effective trading price per share would be HKD 0.0167, a loss in value of 89%.

Caveat collector.

End

Annex I

Fund Holdings as of 30 Sep 2018



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%**
2018	113.04	109.56	109.03	105.39	109.62	104.37	101.26	93.71	94.25				**-13.9%**

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.

Updated 8 Nov 2018