LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

Lighthouse Advisors Private Limited
Reg. No. 201212773E
Suite 1103, #11-00 The Octagon
105 Cecil Street, Singapore 069534
www.lighthouse-advisors.com

Client Newsletter for the period ended 31 March 2019

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2019.

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

2. Market Commentary

2019 started with a strong rally in many markets as investors deemed stocks oversold. The Chinese A-share market in particular went on a tear as foreign investors poured money into the usual darlings. However the tide has since reversed as the US-China trade war has stepped up a notch. Major markets have given back some of their early gains. More recently, markets have dived following a proposed ban on the sale of US goods and services to Chinese telecom Huawei over national security concerns. Major Asian stock indices now trade at February levels again.

It is not just Huawei smartphones that will be affected. Huawei's networking gear uses chips from Intel and Qualcomm. In fact, 33 of its 92 core suppliers are US companies, accounting for 16% of its purchases in 2018. Meanwhile, many European nations' plans to use Huawei equipment for their 5G network rollout have been derailed. Understandably, the tech sector has sold off[1].

The global economic status quo remains: continued growth in the US, no recovery in Europe, and still-positive (but slowing) growth in Asia. However, given that it is US importers and US consumers who have been paying for the tariffs on Chinese goods[2], US growth may not continue for much longer if the trade war escalates.

For stock market investors the same basic sit-tight strategy remains, though industry disruptions continue apace. The next newsletter will cover the quarter ended 30 June 2019.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
24 May 2019

3. Portfolio Review

As at 31 March 2019, the Net Asset Value (NAV) of the Fund was USD 90.04. Net of all fees, the return for the first quarter was +3.9%.

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

Market (Index)	1Q19
Singapore (STI)	+4.7%
Hong Kong (HSI)	+12.4%
Shanghai (SSE)	+23.9%
Fund	**+3.9%**

20 securities made up 80% 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.

[1] *Trump's Huawei 'ban' gives Asian tech firms 70 billion reasons to worry,* **South China Morning Post**, 18 May 2019.

[2] *Kudlow acknowledges U.S. consumers, not China, pay for tariffs on imports,* **Washington Post**, 12 May 2019.

Winners and Losers – Q1 2019 vs Q4 2018

Winners	Δ		Losers	Δ
Frencken	+29%		Genting HK	-24%
EVA Precision	+26%		IT	-12%
BAIC Motor	+24%		China Sunsine	-10%
VTech	+24%			

Frencken reported a 15% increase in Q1 sales and 27% increase in profits for 1Q 2019.

EVA Precision posted a 16% rise in sales but a 39% drop in profits, blamed on product mix and startup costs in Weihai and Mexico. The shares rallied due to being oversold in 2H18.

BAIC Motor announced that it expected a profit increase of over 95% for FY18 over FY19. The shares rose after being oversold in 2H18.

VTech had no news in the quarter under review, however it subsequently issued a profit warning for FY19 due to lower-than-expected telecom product sales.

Genting HK booked a 34% increase in revenues and reduced its pretax loss by about 10% for 2018. However it omitted the final dividend.

IT published its same-store sales data for the 3 months ended 30 Nov 2018. HK & Macau were down about 2%, while China was up 7% and Japan/USA was up 9%. Group gross margin fell by 2.2% due to currency depreciation.

China Sunsine 1Q sales and profits fell by 20% and 26% respectively, due to declines in selling prices.

Other holdings were not material contributors to changes in the Fund's NAV in Q1.

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.

Further Comments

It is obvious that the Fund has performed poorly in the last 15 months, both in absolute and relative terms.

The heavy losses fall into 3 categories:

Reason	Stocks
Regulation & Government Direction	BAIC Motor Dawnrays Pharmaceutical Zhengzhou Yutong Bus
Disruption	Sarine
Margin Erosion	EVA Precision
Trade War	Goodbaby

In some cases, such as BAIC, the stocks have been oversold and it makes sense to wait for a rebound. In other cases, such as Dawnrays and Sarine, it makes sense to exit, and the Fund is selling. These have been painful lessons that your manager does not intend to repeat. Note: for Goodbaby, its products have so far been excluded from the US tariff list. So in your manager's view, the sell-down is unjustified.

The Fund's past focus on growth in China (directly and via Hong Kong) has become a liability in the current environment. Going forward, the Fund will be positioned more defensively and actively seek exposure to markets outside China.

4. Retail Investors

The Internet revolution is over 2 decades old at this point. The modern world has changed drastically. Some businesses have vanished, while others can exist only because of the

Internet. The most visible change has perhaps been in retailing: many prominent retailers have failed as upstart competitors leveraged the Internet to disrupt the incumbents. But as we shall see, the internet did not destroy retail entirely. It merely made some types of retail business models obsolete.

"Online shopping" is an easy excuse when a large retail operator goes bust. Yet, there are also counter-examples of retailers continuing to thrive, and online retailers have opened brick-and-mortar stores or bought companies with substantial physical operations.

What do bookstores, discount retailers and department stores have in common? They carry a large quantity and variety of inventory. In these operations, scale confers a *sourcing advantage* against smaller rivals, an edge that improves the variety of inventory and lowers their unit costs. But pitted against the Internet's search engines, online portals and shopping sites, which provide essentially infinite inventory at near-zero margins, this edge is severely blunted.

For any given item made by a third party, a search engine can find the lowest price in the country or even the world. It is no longer enough to have the lowest price in town, or the best selection in town; it is now necessary to have the lowest price *and* the best variety **in the world**. Inevitably, orders flow away from the local retailer, eroding its economies of scale and eating away at profits.

Search engines can sell ads, while online portals can earn commissions. Which retailers capture the sales? The ones that have the lowest rent, the lowest warehousing cost, the lowest sales force cost, and still have the item in stock, at the lowest price. Online retailers fit these descriptors well: They pay no street-front rent, faraway warehouses can be used to store less-popular products, and there is no human sales force drawing commissions.

A simple rule of thumb might then be:

"Sell physical retailers, buy online retailers."

In plain English: sell **Walmart**, buy **Amazon**. But if things are so simple, why did **Amazon** buy supermarket operator **Whole Foods**[3]?

One answer is that one of the things the Internet does *not* do well is fresh food. Fresh food, by its nature, invites consumers to touch and smell it before buying. Factory-made goods provide no equivalent stimulation during shopping, so only price and availability matter. But fruits, vegetables and seafood are individually grown or harvested, and are therefore non-identical. Even when sold by the weight, consumers want to believe they have chosen the sweetest peppers, the freshest fish, or the crunchiest apple out of all those on offer. Price becomes only one of the considerations in the *shopping experience*. Indeed, Whole Foods' price premium has led some wags to dub it "Whole Paycheck".

So a second level of understanding could be:

"Sell non-perishables offline retailers, buy fresh food retailers and online retailers."

Consider **Costco**, a members-only discount retailer. Its gross margin is only about 11%, and net margin is just 2%. These make it seem quite ordinary. But unlike most other discount retailers, it levies an annual membership fee, currently US$60, and it averages 3,800 unique items (SKUs) per warehouse store, versus over 100,000 at a typical retail superstore. These create two things: customer loyalty (they must shop enough to "earn" back the membership fee), and economies of scale.

Many Costco members have high levels of income and spend accordingly. They are not budget-constrained customers trying to spend the least amount possible, but informed shoppers looking for the **best value**.

What is "best value"? An example is Costco's private label *Kirkland Signature*, which is well regarded for both quality and affordability. "Cheap and good" is a formula for success,

[3] *Why Amazon bought Whole Foods,* **The Atlantic**, 16 June 2017.

and being available only at Costco guarantees customer loyalty – renewal rates in the US are 90% (87% globally). *Kirkland Signature* is a unique brand that cannot be "Amazon'd" – bought online for less. To quote **American Express**, "membership has its privileges".

Another factor in "best value" is the *shopping experience*. Costco pays its employees far above the minimum wage. As a result, its staff turnover levels are extremely low (10% overall, 6% among those working there at least a year). This means that employees are *happy* to work at Costco. Happy employees mean higher productivity and a more pleasant experience for customers, which translate into higher sales and profits for Costco. Low prices combined with a positive shopping experience have created extraordinary results for shareholders: Costco went public on 1 Dec 1985 at US$10 per share. 35 years later, on 1 Dec 2018, the stock had split 6 times, and each share was worth $231.28, so a US$1,000 investment had become US$138,768, a return of over ***137 times***.

Therefore, in retailing, the customers focus not merely on *price* but also *unique products* and the *shopping experience*.

One more wrinkle remains: *convenience*. Instant gratification is the goal of many consumers. No online or mega retailer can fulfill this, because convenience requires an extensive offline presence. Convenience store operators like **7-Eleven**, **FamilyMart** and **Lawson** still thrive because the geographic radius for a consumer looking for a chocolate bar or a cup of coffee is tiny. Consumers pay a meaningful premium to have their snack or drink *right now*. One extreme case: coffee giant **Starbucks** opened a new store across the road from 2 existing stores, which were themselves just down the road from yet another store[4].

[4] *Starbucks to open a Starbucks opposite a Starbucks next to a Starbucks down the road from a Starbucks*, **Independent**, 17 September 2015.

Thus we have at minimum four factors in retailing: *price*, *unique products*, *shopping experience* and *convenience.*

So the much talked-about "future of retail" is likely to be a mix of convenience stores ("grab and go") and stores offering unique products and/or positive shopping experiences. This bodes poorly for generic retailers focused on price alone, since online competitors can offer superior pricing.

We now have a third level of understanding:

"Sell generic non-perishables offline retailers, buy convenience stores, retailers with unique products or shopping experiences, and online retailers."

Even so, there are no ironclad rules in investing. As a parting shot, one cannot ignore the German discounter **Aldi**, which is totally focused on low prices. Solving for low prices has led to extreme specialization: 90% of items are house brands, selections are extremely limited (1,300 SKUs, even fewer than Costco), and they sell mainly non-perishables.

The Aldi shopping "experience" is famously bare-bones, with products sold straight out of packing boxes. Cashiers are trained to ring up sales as quickly as possible, while customers have to bring their own bags and return shopping carts on their own. Clearly, shopping at Aldi hews to the convenience store "grab and go" philosophy, versus the pleasant "treasure hunt" adventure at Costco.

Starting from a single store in 1948, the Aldi Süd and Aldi Nord groups now operate over 10,000 stores worldwide, dwarfing Costco's 700-odd warehouses. As perhaps the exception that proves the rule, Aldi shows what it takes to compete solely on price, and any retailer unwilling to make similar sacrifices is unlikely to prevail.

End

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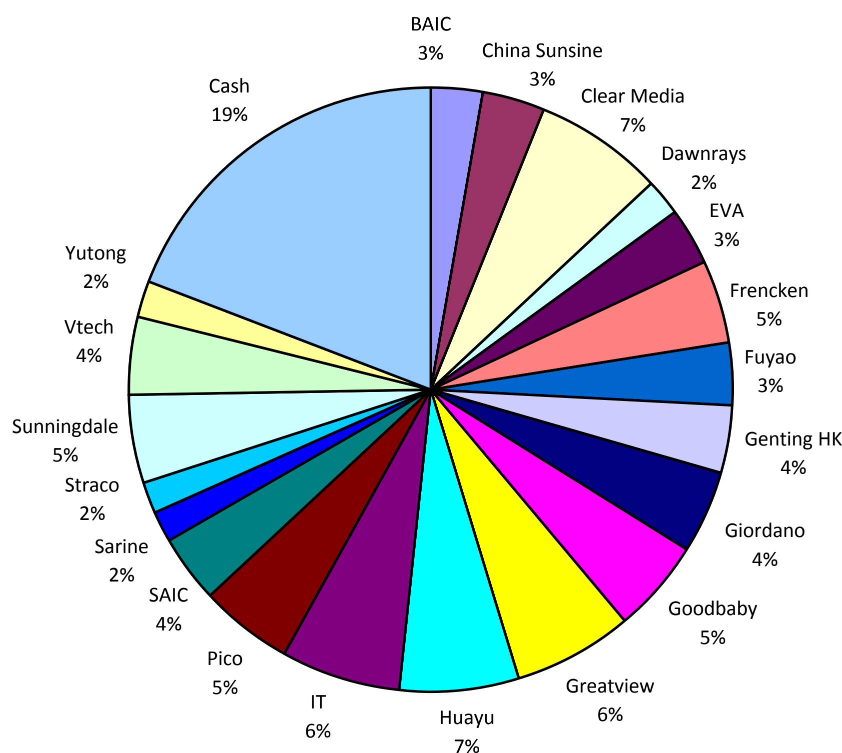
Annex I



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	85.19	86.83	86.66	**-20.8%**
2019	91.98	92.36	90.04										**+3.9%**

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 24 May 2019