LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 30 June 2019

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2019.

This newsletter follows the same format as previous issues. The special topic for this issue is **Man in the Middle Attack**.

2. Market Commentary

Major stock markets now seem to be mostly driven by the US-China trade war. Markets have seesawed between worry and optimism as US President Donald Trump alternates between proclaiming a deal with China is "coming soon" and declaring more tariffs.

Trump wants a deal that he declare a "win" and be heralded as the biggest dealmaker of them all, but Xi cannot allow China to "lose face" as that would be the end of his own political career. Perhaps the best outcome is a deal that is big on rhetoric and light on details; Trump can claim a win at home, while the Chinese media can point out that no real concessions have been made. This would be like the 1984 Sino-British Joint Declaration on Hong Kong: both sides got to claim a good deal was struck, but China held all the cards.

Speaking of Hong Kong, the city has been hit by street protests over the government's proposed extradition bill, which would potentially allow anyone suspected (or falsely accused) of a crime in Hong Kong to be sent to China for trial. The protests have turned violent on multiple occasions, with police and protesters each blaming the other side for the escalation.

Hong Kong Chief Executive Carrie Lam declared the extradition bill "dead" on 9 July[1], but one month later the bill was listed in the Hong Kong Government Gazette[2], leading some to speculate that the bill was still up for debate and passage into law. The latest news however is that the bill has indeed been formally withdrawn[3].

Amidst the drops in stock prices, strong companies with market-leading positions have become reasonably priced. Those facing short-term headwinds now look cheap. Storm clouds will eventually pass, so too the market turbulence. Your manager continues to rebalance the portfolio, especially in the Hong Kong market. The next newsletter will cover the quarter ended 30 September 2019.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
4 September 2019

3. Portfolio Review

As at 30 June 2019, the Net Asset Value (NAV) of the Fund was USD 84.21. Net of all fees, the return for the first half was -2.8%.

[1] *Hong Kong extradition bill 'is dead' says Carrie Lam*, **BBC**, 9 July 2019.

[2] *Bills of the Hong Kong Special Administrative Region*, **Hong Kong Government Gazette No. 32 Vol. 23 - Legal Supplement No. 3**, 9 Aug 2019.

[3] *Hong Kong leader Carrie Lam announces formal withdrawal of the extradition bill and sets up a platform to look into key causes of protest crisis*, **South China Morning Post**, 4 Sep 2019.

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

Market (Index)	1Q19	2Q19	1H19
Singapore (STI)	+4.7%	+3.4%	+8.2%
Hong Kong (HSI)	+12.4%	-1.8%	+10.4%
Shanghai (SSE)	+23.9%	-3.6%	+19.5%
Fund	**+3.9%**	**-6.5%**	**-2.8%**

19 securities made up 73% 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 – Q2 2019 vs Q1 2019

Winners	Δ		Losers	Δ
Frencken	+21%		Clear Media	-34%
Huayu Auto	+6%		Goodbaby	-22%
			EVA Holdings	-21%
			Pico Far East	-17%

Frencken rose ahead of its 2Q results: sales and profits rose 11.5% and 59% respectively.

Huayu Auto held steady despite a 15% drop in sales and a 19% drop in profits, possibly due to already underperforming other automotive stocks in 2018.

Clear Media was hit by the slowdown in China as its largest customers in the e-commerce and IT industries cut back sharply on spending. First-half sales fell 13% and the company reported a net loss.

Goodbaby continued to be affected by trade war sentiment. Absent further delay, from 15 Dec 2019 the US will impose 15% tariffs on China-made baby strollers and car seats. North America accounts for 55% of Goodbaby's stroller/car seat sales and 32% of total sales. The actual effect on the Group is still unknown.

EVA Holdings continued to weaken amid persistent negative investor sentiment towards China-based exporters.

Pico Far East reported a 8% rise in revenues and a 4% decline in profits for the 6 months ended 30 Apr 2019.

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

New Investments

Convenience Retail Asia operates the *Circle K* convenience store franchise in Hong Kong. *Circle K* and *7-Eleven* (owned by **Dairy Farm** of the Jardines group) are a duopoly in Hong Kong. Although overall supermarket sales are stagnant, both operators continue to gain market share against smaller operators.

The company also operates the *Saint Honore* bakery chain, and has recently ventured into selling eyeglasses via a franchise from Japan's *Zoff* brand. *Zoff* is already profitable and will be expanded, but will take time to become a material contributor to profits. 2019 is expected to be a good year as the company recently sold off an unprofitable e-commerce business and Zoff's profits will increase. The shares were acquired at about 16 times trailing earnings and yielded over 5%.

Divestments

Dawnrays Pharmaceutical was sold due to negative regulatory changes. While previously pharmaceutical companies competed in individual cities, last year the Chinese government conducted a large-scale tender across 11 major regions, comprising 4 municipalities and 7 provincial cities. It was a huge success for the government: drug prices fell average 52% and in one case by over 90%. Given the outcome, the trend is clear: drug prices will be on a downward trend. Although Dawnrays did not take part in the tender, it is only a matter of time before its key customer cities hold similar exercises.

Including dividends received, the shares were sold at a loss of about 33%.

Sarine Technologies was sold due to a deterioration in the business. The diamond processing industry has been upended in recent years by man-made diamonds, whose price-to-quality ratio has improved greatly with technological advancements. At retail, man-made diamonds are now 30-50% cheaper than mined diamonds. At wholesale, the discount for man-made roughs can reach 85%. Over the longer term, man-made diamonds are likely to dominate the market, just as cultured pearls form the majority of pearls sold today.

Diamond processors in India, Sarine's main market, are expected to shift to buying man-made roughs given the lower cost and similar quality. While diamonds made by the high-pressure high-temperature process (HPHT) still need Sarine's inclusion mapping services, those made by chemical vapour deposition (CVD) do not. Sarine has tried to develop new lines of businesses targeted at helping diamond retailers "tell a story" but such revenues remain in their infancy, and are unlikely to ever replace the lost inclusion mapping revenues.

When the shares were transferred into the Fund from the original managed accounts, they had appreciated substantially from the original purchase price, so the Fund's cost basis was elevated. Including dividends received during the holding period, the Fund booked a loss on divestment of 54%.

<u>Other Developments</u>

There were no other significant developments during the quarter.

4. Man in the Middle Attack

"Middleman" businesses have existed since time immemorial. They provide a valuable service connecting producers and consumers. Between the initial producer and the final consumer, a supply chain can be viewed as a series of middlemen, with some providing processing services, and others merely logistics and transportation.

Processors convert the product from one form to another, so in some sense they are the endpoint of one supply chain and the start of another. Because they are manufacturers of a sort, their business can be differentiated by proprietary processes (yielding superior quality or lower prices) or unique end-products.

It is the logistics middlemen, who provide sourcing and arrange for transportation, that have come under serious attack. Transportation is a commodity-type service: as long as the goods arrive on time and in acceptable condition, the lowest price wins. But *sourcing* - knowing where to obtain said goods at a lower price, or where to sell them at a higher price - is an important source of proprietary profits. In the past, traders relied on their private networks for non-public information to exploit for additional profits by buying into gluts and selling into shortages. This boosted margins and return on invested capital. Suppliers and end-customers, unaware of where to source cheaper or sell dearer, were forced to surrender these profits.

But the Internet has changed the balance of power. Disintermediation means farmers with a bumper harvest are no longer forced to sell their crops to the nearest trader, but can send them elsewhere for better prices. Crop buyers are likewise no longer forced to take the trader's offer, but can check online to see prices from competing suppliers.

For investors, it means the traders' edge has been severely blunted. Besides the "ABCD" commodity trading quartet of **Archer Daniels Midland**, **Bunge**, **Cargill**, and **Louis Dreyfuss**, sourcing agents such as **Li & Fung** have also seen their arbitrage profits eroded.

Li & Fung enjoyed decades of prosperity helping Western companies like **Walmart** move their supply chain to China. Initially Walmart was happy to let Li & Fung make arbitrage profits, because its own cost savings were so large. But after Walmart's competitors had done the same, prices drifted downwards, and margins eroded back to the old levels. Pre-

Internet, Walmart would be forced to continue sourcing through Li & Fung. But with business-to-business ("B2B") portals such as **Alibaba**, Walmart could either bypass Li & Fung to deal directly with manufacturers in China, or squeeze Li & Fung's margins by threatening to do so.

A case in point: on 28 Jan 2010, Li & Fung signed an agreement with Walmart, its largest customer (14% of sales in 2009). The agreement was laughably lopsided: Li & Fung's subsidiary WSG had to build US$2bn of annual buying capacity for Walmart but *could not serve any other customer*, while Walmart was *free to buy from any other supplier and had no obligation to WSG on any sourcing or shipment volumes*. Furthermore, Walmart had a free option to buy all of WSG from 1 Jan 2016 onward. In other words, if Li & Fung managed to make WSG work despite the constraints, Walmart would buy it and internalize the sourcing capabilities. If WSG didn't work out, Walmart could just walk away. **Heads, Li & Fung would lose. Tails, Walmart would win.**

What happened? On 20 Sep 2012, a new agreement was signed. Walmart's option to buy WSG (now named DSG) was terminated, and Li & Fung would henceforth also trade with Walmart as a supplier, instead of merely as a trading agent. The implication was clear: Li & Fung's margins as a pure sourcing agent were becoming too thin, and it had to integrate upstream to become a manufacturer or brand owner, in order to earn acceptable returns. Did it work?

Li & Fung's recent group results:

	2013	2014	2015	2016	2017	2018
Sales (USD bn)	19.0	19.3	18.8	14.2	13.5	12.7
Core Op. Profit (USD mn)	737	604	512	314	356	285
Margin	3.9%	3.1%	2.7%	2.2%	2.6%	2.2%

Short answer: No.

The new strategy did **not** work. In fact, Li & Fung ultimately divested several businesses, resulting in both revenue and profit shrinkage.

In the last 5 years, Li & Fung has exited the following businesses:

	Description	Value
Jul 2014	Apparel, footwear, fashion accessories (Global Brands Group)	N/A. Spun off via dividend-in-specie.
Jun 2016	Asia consumer, healthcare distribution	US$326m
Apr 2018	Furniture, Beauty, Sweaters	US$1.1bn

Clearly, even though sourcing has not done well, being a principal has been no better.

The stock market has not been kind: Li & Fung's share price peaked at HKD 25.08 on 2 Feb 2011. On 30 Aug 2019, it closed at HKD 0.89. From top to bottom, shareholders have lost over 96% of their investment. Bottom-fishing stockpickers who bought in after a 50% decline, thinking Li & Fung was a great business facing short-term problems, still lost over 92% of their capital. At the end of 2017, before the US-China trade war began, Li & Fung's share price had already reached HKD 4.29, a loss of 83%, so the trade war has merely accentuated the company's problems. It seems likely that Li & Fung's business model is in **structural decline**.

The source-from-China model Li & Fung pioneered has been automated by the likes of **Alibaba**, which now directly connects thousands of customers and suppliers without the need for a trusted middleman; the platform *is* the middleman. It is true that agents like Li & Fung perform valuable additional services, such as audits on workplace safety and worker welfare, but history shows that ultimately, consumers are largely indifferent to the sufferings of factory workers.

College student protests which started in the 1990s (and still continue today) forced Nike to improve working conditions at its suppliers in

Asia[4]. But there is no similar outpouring of sympathy or organized protests in support of the workers making iPhones, Macbooks, Thinkpads and the like in China, despite numerous worker suicides at Apple's key supplier Foxconn over poor working conditions, conditions which still persist today[5]. Of course, it is not just tech that has gotten a pass; the apparel industry has long been notorious for safety lapses. Recent textile factory tragedies in Bangladesh[6] and Pakistan[7] merely reinforce the point that the developed world's comforts are built from the misery of workers in poor countries. Workplace safety and decent working conditions are the exception, not the rule.

In short, customers don't care. And since they don't care, neither do the retailers. Which means that while audits are useful for lip service and public relations, **the bulk of the business goes to the lowest bidder**, with safety or welfare being minor considerations at best. And where being the lowest bidder is concerned, Li & Fung's human agents cannot compete with Alibaba's automated platform.

Anyone looking to invest into relationship-based middlemen businesses should be aware that past results are totally irrelevant; the healthy information arbitrage profits of the past are long gone and unlikely to return.

End

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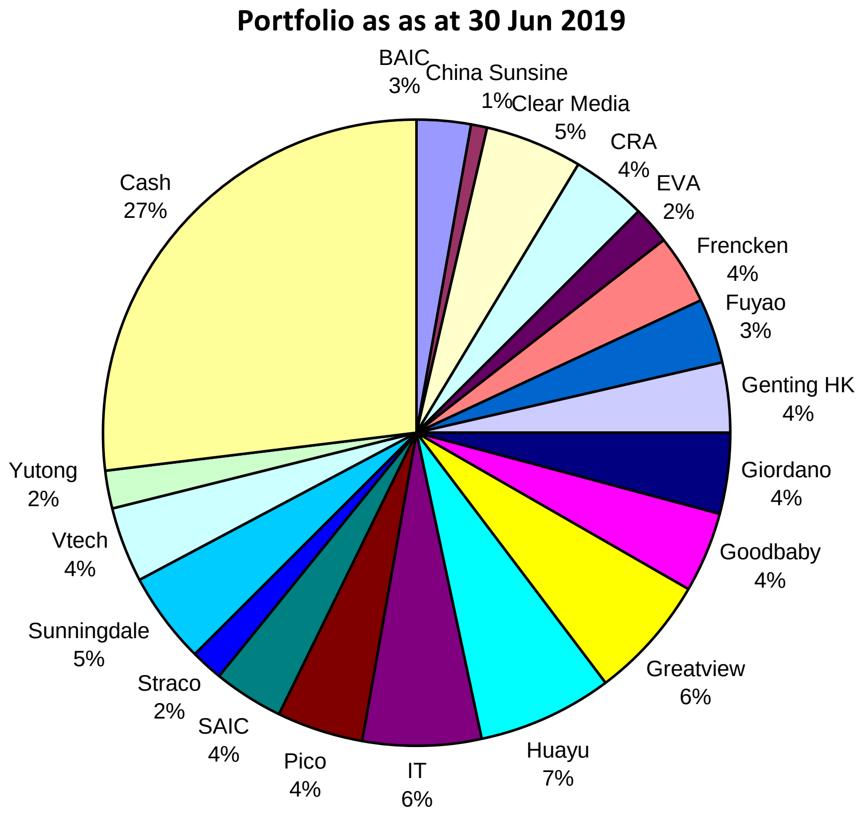
[4] *How activism forced Nike to change its ethical game*, **The Guardian**, 6 Jul 2012.
[5] *Life and Death in Apple's Forbidden City*, **The Guardian**, 18 Jun 2017.

[6] *Binding Power: The Sourcing Squeeze, Workers' Rights, and Building Safety in Bangladesh since Rana Plaza*, **Pennsylvania State University Center for Global Workers' Rights**, 22 March 2018.

[7] *Quiet burns the fire: The Baldia Tragedy*, **Herald**, November 2014.

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	90.21	82.80	84.21							**-2.8%**

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.