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

Public Newsletter for the period ended 30 June 2021

Welcome to the Lighthouse Advisors newsletter for June 2021. The format has been revised following client feedback.

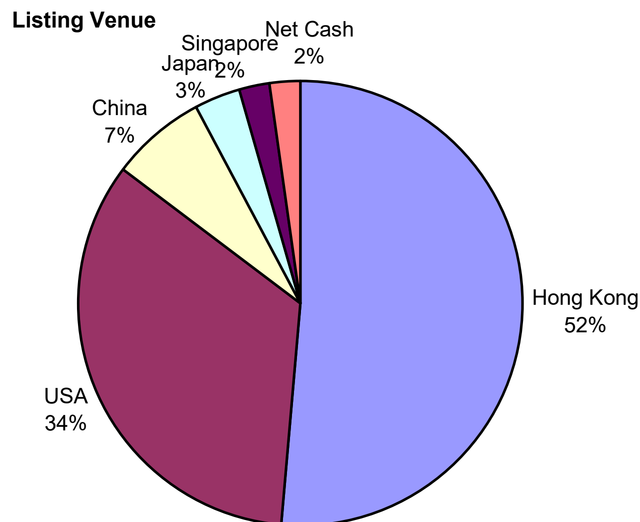
1. **Summary**
2. **Market Commentary**
3. **Portfolio Review**
4. **Chinese Regulators**

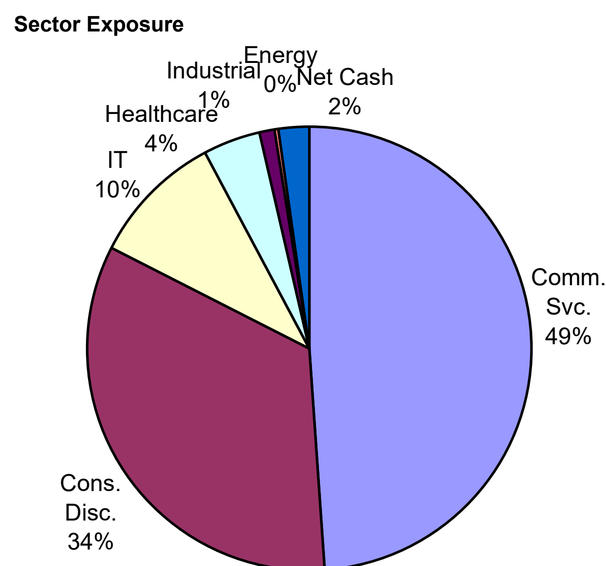
1. Summary

The NAV for June 2021 was USD 96.86. (SGD: 130.26). The year-to-date return was +3.9% (SGD: +5.8%).

Market (Index)	1Q21	2Q21	YTD
Singapore (STI)	+10.3%	-1.1%	+9.1%
Hong Kong (HSI)	+4.2%	+1.6%	+5.9%
Shanghai (SSE)	-0.9%	+4.3%	+3.4%
USA (NASDAQ)	+2.8%	+9.5%	+12.5%
Fund	**+1.9%**	**+2.0%**	**+3.9%**

25 securities made up 97.7% of the Fund's holdings, with the balance in cash and cash equivalents. The following charts show the approximate exposure by place of listing and sector (numbers may not add up or match exactly due to rounding).





NAV values in both USD and SGD are tabled in Annex I.

Updated 17 August 2021

2. Market Commentary

Chinese regulatory crackdowns are continuing. Skittish investors took a "sell first ask later" approach and divested most or all of their holdings in Chinese technology companies. The sell-off brought many stocks to attractive levels.

The Fund took the opportunity to rebalance, selling out its non-tech holdings to reinvest into existing holdings. Apart from one holding, the Fund's positions are now entirely technology companies of some sort, whether in advertising networks, video games, travel agencies or e-commerce platforms.

It is not possible to buy at the exact low, and many holdings dropped further after the Fund bought in. But when the fundamentals are sound, buying when everyone else is selling is ultimately the correct strategy, even if it feels unpleasant in the short term. The next few months will be interesting as companies report their 2Q results.

The next newsletter will be written for the period ending 30 September 2021.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
17 August 2021

3. Portfolio Review

To protect the interest of clients, detailed discussion is confined to the client-only version of this newsletter. Client newsletters are embargoed for one year, after which they are made available online.

4. Chinese Regulators

The recent buzz in the news is the ongoing crackdown by Chinese regulators across an increasing swathe of the economy. Some have pointed to the near-obliteration of the US$100bn/year tutoring industry as the signal to deem all of China off-limits to investors.

Perhaps an objective review of past major fines and regulatory changes can shed some light on this issue.

Time Period	Company	Industry	Key Issues
Aug 2013	Various	Infant Milk Formula (Consumer Goods)	Price-fixing
2014-2019	Various	Automotive	Price-fixing
Dec 2016	Medtronic	Healthcare	Price-fixing
Sep 2017	Ant Financial	Fintech	Systemic risk
Mar 2018-Apr 2019	Various	Video Games	Loot boxes. Anti-addiction policies for minors.
Nov 2018-ongoing	Various	Drugs and Medical Devices (Healthcare)	Change to volume-based procurement
Oct 2020	Various	Real Estate	Excessive leverage, systemic risk
Nov 2020	Various	Microlending (Fintech)	Co-funding of loans
Apr 2021	Alibaba	E-Commerce	Abuse of market power
Apr 2021	Meituan	Food Delivery	Abuse of market power
May 2021	Various	Cryptocurrency (Fintech)	Money laundering
Jul 2021	Didi Chuxing	Ride-Hailing	Abuse of market power
Jul 2021	Various	Private Education	Cost burden on parents

Time Period	Company	Industry	Key Issues
Jul 2021	Tencent Music Entertainment	Media	Exclusive agreements

It is obvious that the crackdowns all had clear goals in mind: the proper functioning of the Chinese economy, or of the wider Chinese society itself. This discussion will cover three that have attracted widespread coverage: Ant Financial, the private education industry and video games.

Ant Financial

Much has been written about Ant Financial having its IPO cancelled due to Jack Ma criticizing Chinese state-owned banks. But the fact is that Ant was parasitizing Chinese banks. Its Yu'e Bao (余额宝) money market fund paid market-leading returns, so millions of Chinese savers moved their funds from the banks to Yu'e Bao. This drained the banks of deposits, forcing them to pay above-market rates to source funds in the interbank market.

However, *Yu'e Bao was itself one of the largest players in the interbank market*. Essentially, Ant held banks hostage, forcing them to pay above-market interest rates to reclaim deposits that were originally theirs to begin with[1]. This irony was not lost on the banks, nor on the banking regulator.

Just 4 years after Yu'e Bao launched, it was the world's largest money market fund, at US$233bn. It alone was 25% of the Chinese money market. Its size meant that its duration mismatch* posed a threat to the Chinese monetary system itself if there was ever a mass withdrawal – this would be the equivalent of a "bank run" that could not be halted by a government guarantee on savers' deposits[2].

* Yu'e Bao offered same-day withdrawal to customers, but its own funds were locked up in bank deposits for an average of 60 days.

The Chinese government issued regulations in 2017 to reduce Yu'e Bao's size and duration risk. This was bad for savers in the short term, as Yu'e Bao interest rates fell from 6.8% to 3.9% (now 1.4%), but it improved the resilience of China's monetary system, a long-term benefit.

A second problem posed by Ant was its loan origination business. Payments data from Alipay allowed Ant to develop an alternative credit scoring system: people with regular and "normal" purchasing habits were more likely to repay their loans. The banks were happy to partner Ant to lend to these "underbanked" consumers who were potentially good credits, but had little or no collateral to pledge.

However, Ant kept as little of 2% of the loan amount on its books. This was offset by the referral fee it earned for helping the banks find the loan. In addition, it collected as much as one-third of the interest on the loan. So Ant made a profit, but took almost no risk. This created a moral hazard: heads, Ant made money, but tails, the banks lost money.

Similar arrangements seeded the US mortgage meltdown of 2008. Loan originators lent regardless of borrowers' ability to repay, then quickly securitized and sold the loans off to other lenders. They made their money from originating and servicing the loans, and had no capital at risk if the borrowers defaulted.

Subsequently, the US passed the **Dodd-Frank Wall Street Reform and Consumer Protection Act**, which, among other things, required risk-retention: originators had to retain a 5% interest in the loans. Lenders were also required to verify the borrower's ability to

[1] *Alibaba's Yuebao dents Chinese banks' profitability*, **Reuters**, 20 March 2014

[2] *China's giant Yu'e Bao money market fund riskier than US rival, Fitch says*, **South China Morning Post**, 15 December 2017

repay: previously, they could rely on mere "declarations" i.e. lies. No more. Since then, mortgage default rates in the US have fallen from a peak of 11% in Q1 2010 to 2.5-3% today, a far healthier situation.

Chinese regulators surely noted how risk-retention and verification of repayment ability improved US mortgage lending. So it is no surprise that they drafted similar-but-stricter requirements for online microlending, requiring 30% of loans to be retained by the originator. Ant was not the only target – microlenders included other tech companies, from **Didi Chuxing** (ride-hailing) to **Qihoo 360** (antivirus software) and **Meituan Dianping** (food delivery) – but it was surely the most visible. It would not have been good for investors to be sold a company whose business was going to be upended by forthcoming rules. The logical thing to do was to suspend the IPO and restructure Ant to comply with the new regulations.

Private Education

The private education industry has been hit by new Chinese rules requiring tutoring businesses teaching compulsory subjects to operate on a non-profit basis, with no new licenses to be issued, and capital market activities such as mergers and acquisitions and joint ventures disallowed[3]. While the news itself was sudden, the writing had been on the wall for some time.

Back in 2018, Beijing cracked down on the early education industry, citing safety lapses, poor teaching standards and excessive profit-seeking[4].

Short-seller reports highlighting poor teaching quality and outright fraud[5] alerted regulators and investors alike that all was not well. Investors anxious not to miss out on the gold rush continued to fund the industry regardless.

The nail in the coffin may have been the "race to the top" with fees. For many consumers, **price is an indicator of quality**. Many companies hired star tutors and foreign teachers to justify fees. Heavy advertising added to costs. These investments had to be earned back. The obvious strategy was raising prices, which would send a signaling effect to parents, hopefully in turn increasing demand, which would allow further increases in prices, a supposed virtuous cycle.

But an unintended consequence was that high education costs discouraged parents from having more children. China's population is aging[6], and fewer babies now mean a smaller workforce – and a weaker economy – in the future. A weaker economy is the last thing any government wants. In other words, the private education industry was unwittingly conspiring against the national interest.

Parents could not simply opt out: in 2016, over 75% of children aged 6-18 attended after-school tutoring, so children who did not attend fell behind their peers. Top Chinese universities admit less than 2% of applicants, so no parent who could afford the fees would possibly forego tutoring. It is unsurprising that after fining 15 companies for fraud [7] the government decided to sweep the table clean.

Other countries have faced similar issues in for-profit education: in September 2013 **The Atlantic** republished a lengthy *Reuters* article about predatory practices at American for-profit colleges[8], and in Singapore the industry had a regulatory shake-up in 2016 after years

[3] *Why China Is Cracking Down Now on After-School Tutors*, **The Washington Post**, 26 July 2021

[4] *China private education firms tumble as Beijing tightens grip*, **Reuters**, 16 November 2018

[5] *GSX Techedu Inc – The Most Blatant Chinese Stock Fraud since 2011*, **Citron Research**, 14 April 2020

[6] *China's Aging Population Is a Major Threat to Its Future*, **TIME**, 7 February 2019

[7] *China fines 15 educational firms for false advertising and fraud*, **Reuters**, 1 June 2021

[8] *The Reform of For-Profit Colleges: Can They Give Up Their Predatory Ways?* **The Atlantic**, 20 September 2013.

of complaints. So it is hardly fair to tar Chinese regulators for trying to reform a broken industry. Even if one disagrees with the *how*, the *why* cannot be faulted.

Video games were recently feared to be under attack, with a news article denouncing them as "spiritual opium", a loaded reference to the Opium Wars which led to the "century of humiliation" when parts of China were ceded to or occupied by Western powers. However, the article was soon pulled and republished without the incendiary term, indicating that video games (for now) are not a target[9].

In fact, video games had their crackdown in 2018-2019. Like the restrictions on Ant Financial and the tutoring industry, the government's stated goal was not to cripple the underlying activity (entertainment), but to protect vulnerable consumers, in this case minors. Once companies implemented playing time limits and blocked youngsters from making in-game purchases, the games were approved, and the industry recovered and reached greater heights.

To sum up, it is clear is that in every case tabled above, there was good reason for the Chinese government to impose fines and require changes. The unhappiness of foreign investors stems from the common misconception that business in China is simply Western-style capitalism with a China-sized market i.e. "sell every Chinese person a Coke and get rich". China's economic system is "capitalism with Chinese characteristics" and it has to be accepted, if not understood, on that basis.

Some Chinese companies will grow much larger than their Western counterparts, while others will not. Similarly, profitability may be better – or worse – than Western peers. Chinese regulators have been guided by "moral" choices when directing large changes to China's economy. These decisions, on the whole, aim to foster an orderly development of Chinese society.

A company that provides useful goods and services that improve the lives of Chinese consumers can be expected to be left alone to prosper, as long as it does not abuse its market position to earn excess profits. Predatory behaviour may be profitable in the short term, but eventually the Chinese regulators will put a stop to it. Long-term investors would do well to invest in companies that help China become a "better" society, rather simply betting on "highly profitable" companies.

~ End ~

[9] *Tencent vows fresh gaming curbs after 'spiritual opium' attack zaps $60 billion*, **Reuters**, 4 August 2021

Annex I

NAV in USD (Official)

	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	82.57	78.45	76.52	77.82	78.75	82.80	**-4.5%**
2020	78.58	75.37	67.15	71.23	70.50	77.22	82.23	88.36	84.97	86.77	90.34	93.20	**12.6%**
2021	99.54	99.36	94.98	99.37	96.76	96.86							**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.

The following data is for the convenience of SGD-based investors and is for reference only.

NAV in SGD (for reference only)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2008										50.68	50.69	51.20	**2.4%**
2009	52.22	51.91	50.74	54.21	66.70	66.59	72.06	71.60	74.19	75.67	78.50	84.15	**64.4%**
2010	83.11	85.83	91.17	93.55	89.79	91.72	96.10	97.84	106.70	108.12	112.34	115.86	**37.7%**
2011	111.57	109.76	111.06	113.64	112.11	112.14	109.75	100.70	89.85	97.91	93.64	94.48	**-18.5%**
2012	97.39	103.46	103.79	103.05	98.44	97.76	96.12	97.20	98.89	96.95	100.95	103.74	**9.8%**
2013	113.19	120.44	124.03	123.50	125.34	120.54	125.55	127.49	126.57	126.83	128.86	127.81	**23.2%**
2014	124.51	128.55	125.58	127.84	132.26	132.85	135.95	135.58	132.14	133.61	132.91	132.34	**3.5%**
2015	132.68	133.74	134.11	137.66	139.74	136.08	131.71	121.30	119.78	124.68	121.53	122.26	**-7.6%**
2016	116.13	117.82	119.59	123.86	126.08	123.36	126.71	129.30	129.32	129.95	131.79	130.54	**6.8%**
2017	131.35	135.81	141.22	141.04	146.29	147.44	148.75	147.28	149.30	153.38	146.00	146.32	**12.1%**
2018	148.13	145.04	142.95	139.64	146.74	142.24	137.76	128.59	128.83	117.98	119.13	118.06	**-19.3%**
2019	123.77	124.86	123.01	122.81	113.88	113.93	113.02	108.85	105.83	105.92	107.71	111.33	**-5.7%**
2020	107.23	105.02	95.47	100.41	99.64	107.68	112.93	120.15	116.02	118.55	121.20	123.14	**10.5%**
2021	132.30	132.32	127.74	132.16	127.85	130.26							**5.8%**