August 13, 2013

Dear Clients, Partners, and Friends,

The results for South Ocean Managementôs Delaware LP, Kong Partnersô L.P., before incentive fees, were as follows:

	Jul 2013	Year-to-Date
Hong Kong Partners LP	1.8 %	-2.6%*
Hang Seng Index	5.2%	-7.8%
MSCI HK Small Cap Index	1.7%	-8.9%

Partnersô NAV $2.5327 after management fee and provisions March 2013*, but before annual incentive fees of 15% on appreciation.

In July, the Hang Seng benchmark had its best month since September. Mainland property stocks, a sector we largely avoid, lifted the large cap index after comments from China's politburo were seen affirming greater official *tolerance* for home price increases.

Trading volumes slumped as the summer doldrums arrived. We made almost no changes in July to our portfolios of Hong Kong-listed companies with earnings geared towards China.

Our suspended holding, Chaoda Modern Agriculture, made an announcement that its new auditors were preparing the final audit figures by next month. The company rebutted accusations made by Anonymous Analytics on 26 September 2011, one of the three conditions imposed by the stock exchange before share trading can be resumed. A schedule was provided to shareholders by the company in the stock exchange announcement, found here:

Chaoda announcement:
http://www.hkexnews.hk/listedco/listconews/SEHK/2013/0719/LTN20130719464.pdf

The month of August is jam-packed with companies announcing June earnings publications. We shall be busy following these results.

Much consternation is bantered in the financial press these days concerning Chinaôs economic health. The article below addresses some of those issues.

Sincerely,

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Some interesting comments from Kiril Sokoloffôs 13D Research:

What I Learned This Week ® Excerpt from 5/30/13

3. **Beijing moves to a market-oriented economy. Buy China (continued).**

After meeting with Chinese officials in Beijing two weeks ago, we learned that **China's new leadership is serious about introducing and enforcing market oriented reforms. In the financial sector, this implies opening-up the country's capital account, liberalizing interest rates and allowing the currency to float freely.**

This shift has been largely confirmed by news reports after our visit. Professor Chen Yulu, who is the president of Renmin University and also a member of the central bank's Monetary Policy Committee, recently delivered a lengthy report on the proposed reforms, which targets **interest-rate liberalization by 2017 and convertibility on the capital account by 2020**.

Despite the fact that Chinese exporters are struggling with an appreciating yuan and rising interest rates, the new Chinese leadership thus far has largely refrained from delivering a large fiscal stimulus, instead, allowing the market mechanism to solve domestic overcapacity issues. In his first press conference after taking the post of Premier, which was held in March, Li Keqiang reportedly commented on the market-oriented reforms as follows: "**It's about cutting power, it's a self-imposed revolution…It will be very painful and even feel like cutting one's wrist.**"

However, he remains positive on the likely outcomes and sees the coming reforms as **the "biggest dividend" for China**. Premier Li holds a Master's degree in Law and a Ph.D. degree in Economics, having studied under Professor Li Yining, who is a well-known advocate of market reforms.

According to Huang Yiping, Chief Economist at Barclays, *seven working groups under direct leadership of China's President, Xi Jinping, are drafting proposals to reform the financial sector, the fiscal system, land tenure, prices, the bureaucracy, income distribution and household registration reporting.* This coming fall, President Xi is expected to deliver the proposed reforms to the third plenum of the 18th Communist Party's Central Committee for its approval…

Notably, the bull market for Chinese equities during the mid-1990s came after the former Chinese Premier, Zhu Rongji—who was in charge of finance and economics matters at the time—**ushered-in a series of measures to reform the state-owned enterprises (SOEs) and the banking sector**. Zhu also overhauled the central government's tax collection and fiscal system, as well as serving as governor of the central bank—the People's Bank of China (PBoC)—from 1993 to 1995. He played a large role in establishing the central bank's independence by establishing the Law of the PBoC, which was passed by the People's Congress on March 18, 1995. It was Premier Zhu's tough measures that ultimately tamed inflation and kept banking loans under control during the mid-1990s.

In our view, **President Xi's and Premier Li's determination to deliver market-oriented reforms resembles Premier Zhu's determination when he was called-upon to carry out the reforms of the 1990s.** *Coincidentally, the "third plenum" has played a significant role in major government reform programs in the past.* For instance, the third plenum of the 14th Central Committee, which was held in November 1993 and endorsed the "socialist market economy," paved the way for Premier Zhu Rongji to move ahead with his aggressive reforms. Moreover, the third plenum of the 11th Central Committee, which was held in November 1978 and was chaired by Deng Xiaoping, the legendary leader of modern China, established China's "Open Door Policy," which kicked off more than three decades of prosperity in the world's most populous country. *Will history repeat with the upcoming third plenum? Will the coming reforms help China unleash its true potential, perhaps becoming the country's "biggest dividend"?* Only time will tell, but given China's history, we would not bet against it.

Though this ðbiggest dividendô is very bullish, there are, of course, problems needing to be addressed in China.

13D recently added:

> "…Local governments are still addicted to land sale revenues to fund their daily operations and the central government has not figured out a way to generate other sources of tax revenue as local governments try to diversify their income streams. When economic growth is trending down, it is very hard to generate more taxes without hurting the private sector. **The Chinese yuan has gained 2% versus the U.S. dollar so far this year,** making it one of the best-performing currencies in the world. Exports, the primary driver of the last China boom, have been struggling. If Beijing eases by giving out more bank credit, **that will make China even more dependent on domestic investment.** And consumption will once again be "crowded out", as it was during the four trillion yuan stimulus under Wen Jiabao's Administration (late 2008). That will make the Chinese economy even more unbalanced and, in the absence of a depreciating yuan, the only way out for China could be very painful and lone journey."

Our portfolios have holdings geared towards the essential requirements of China, such as water, food, energy and electricity. These 'boring' sectors actually have quite dynamic and exciting growth trajectories.

Brook McConnell
Hong Kong