



October 15, 2013

Dear Clients, Partners, and Friends,

The results for South Ocean Management's Delaware LP, Kong Partners L.P., before incentive fees, were as follows:

| | <u>Sep. 2013</u> | <u>Year-to-Date</u> |
|---------------------------|------------------|---------------------|
| Hong Kong Partners LP | 0.3% | 6.3%* |
| Hang Seng Index | 5.2% | 0.9% |
| Hang Seng Small Cap Index | 5.7% | 5.5% |

Partners' NAV \$2.6668 after management fee and provisions March 2013*, but before annual incentive fees of 15% on appreciation.

Our portfolios of Hong Kong-listed, China-oriented small/mid cap stocks rose 7.2 % for the quarter ending September. Year-to-date, our net gain is 6.3% (after provisions in March). In early September, an uptick in China's manufacturing index surprised market participants (the August HSBC/Markit PMI for manufacturing was reported at 50.1, the first time in four months this gauge registered above the key threshold of 50). The improvement, together with the surprise Fed announcement of no imminent tapering, triggered a sharp short covering rally in the large caps.

Your fund is invested along two themes; roughly half the holdings are in turnaround situations and the other half in growth-oriented stocks. With our proprietary software screen, we analyze undervalued stocks, using a similar approach as Warren Buffet, to determine intrinsic values.

To illustrate, we recently purchased shares in a garment manufacturer and retailer of casual wear apparel. The company listed in 1996, but trades now just above its IPO price of HK\$1.60/share (when it was 10 times smaller). This conservatively run company has no debt, ~HK\$1.00/share in cash and trades below book value. A money losing division is being jettisoned which will benefit the bottom line, especially as markets in US and China improve (China retailers have suffered inventory difficulties since the 2008 financial crisis). The stock's dividend yield is close to 7%.

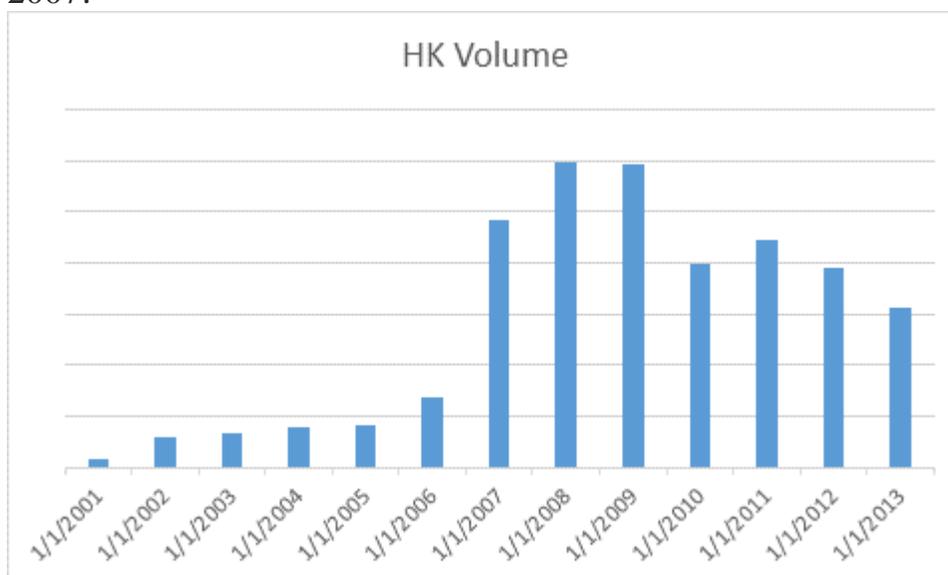
We believe the intrinsic value for the entire company is over HK\$8 per share which provides a margin of safety should our analysis of projected earnings fall short.

We are finding exceptional values nowadays and see the overall stock market as significantly undervalued. We outline several reasons to consider.

Traditionally, the Hong Kong stock market has closely followed the US stock market returns. Hong Kong's currency is pegged to the US\$ and many listed companies in Hong Kong have long enjoyed business alliances with the west.

But that close correlation broke down over recent years.

Hong Kong's Hang Seng Index trades significantly below its 2007 high (the S&P 500, conversely, trades 7 % above its pre-financial crisis high). There have been yearly outflow of funds, as evident in declining volumes since 2007:



This anomaly is an opportunity, in our view.

We can point to one contributing factor for the recent relative underperformance; China bank stocks.

In a nutshell, when China instituted a gigantic (4 trillion Yuan) stimulus package soon after the credit crisis of 2008, much of the credit flowed into unsure ventures, especially real estate. The financial media continuously harped on about this concern, using dire adjectives to describe the probability

for bad bank loans. Consequently, investors balked. Consider the following year-to-date returns of financial stocks:

| Name | YTD (%) |
|---|----------------|
| HSCI-FINANCIALS INDEX | 1.20 |
| China Everbright Ltd | -31.99 |
| China Taiping Insurance Holdings Co Ltd | -28.54 |
| New China Life Insurance Co Ltd | -22.92 |
| China Life Insurance Co Ltd | -18.58 |
| CITIC Securities Co Ltd | -18.16 |
| Far East Horizon Ltd | -17.79 |
| China Merchants Bank Co Ltd | -12.63 |
| Chongqing Rural Commercial Bank Co Ltd | -11.32 |
| China Citic Bank Corp Ltd | -11.09 |
| Haitong Securities Co Ltd | -9.62 |
| Ping An Insurance Group Co of China Ltd | -9.32 |
| Value Partners Group Ltd | -7.81 |
| Agricultural Bank of China Ltd | -4.96 |
| People's Insurance Group of China Co Ltd | -4.60 |
| Hong Kong Exchanges and Clearing Ltd | -4.40 |
| China Construction Bank Corp | -2.57 |
| Bank of Communications Co Ltd | -1.03 |
| Industrial and Commercial Bank of China Ltd | 0.00 |

As of Oct. 4

While we do not own shares in this sector, it illustrates where sentiment resides today. Should those dire forecasts overhanging the marketplace turn out not to be as calamitous as feared, Hong Kong's market may catapult.

This excellent analysis from BCA Research's Chief China Investment Strategist, regarding China's "debt bubble", further explains this point. China has thoroughly deliberated the credit issues, which carries several important implications:

The first is from policymakers' point of view. Alerted by heightened concerns on the leverage issue, the Chinese authorities have been taking precautionary measures. In recent years, the authorities have been trying to cool off the housing sector, restrict local government borrowing and tighten scrutiny on "shadow" banking. Most importantly, regulators have mandated banks to dramatically increase the provision coverage ratio of non-performing loans. The provision coverage ratio of banks has increased from a mere 40% in 2007 prior to the financial crisis to about 300% currently, a massive buffer to protect banks' capital

base (Chart 3). In fact, preventing regional or national financial crises is among the top priorities of regulators in recent years.

From investors' perspective, Chinese bank stocks have essentially been abandoned amid the overwhelming concern over the leverage issue, in stark contrast to U.S. bank stocks prior to the global financial crisis. Chart 4 shows that U.S. banks were still trading at two-times book value in the second half of 2007, when the economy was already slipping into recession and banks' profitability was declining and asset quality was deteriorating. The price-to-book ratio of U.S. banks dropped to 1 in the first half of 2008 when financial stress intensified dramatically. The P/B ratio dropped even further when the situation degenerated into a full-blown crisis.

In China's case, however, bank stocks' price-to-book ratio has already dropped to levels comparable to those in the U.S. in the first half of 2008, even though all the performance indicators of Chinese banks have barely deteriorated. It is almost a sure bet that Chinese banks' asset quality will deteriorate going forward after a lending binge. However, it is equally worth noting that a lot of potential bad news has been priced into the market.

Next month's Chinese Communist party's Third Plenary Session major focus could be a breakthrough on fiscal reforms. These reforms will address concerns over China's financial system risks. Premier Li Keqiang said last month the government was taking "targeted measures" to address the issue of local debt. [Shanghai's Free Trade Zone](#) exemplifies China's gathering pace of reforms.

Something that is generally not known is mainland bank managers that underwrite a poor-performing loan are unceremoniously demoted from their positions and held personally responsible for remedying the bad loan before being reinstated to their former positions (wouldn't that be a welcomed regulatory edict by many in the west today!)

This brings up an interesting comparison between Hong Kong and Spain.

Both countries have "pegged" currencies: Hong Kong to the US\$, Spain to the Euro. There is no possibility to adjust the "attractiveness" of their currencies.

Spain has undergone a significant deflationary phase with high unemployment, falling real estate values and rising debt ratios.

Spain's equities are 25% below July 2008 highs.

Likewise, Hong Kong equities are depressed and sell 25% below previous highs of 2007. Yet, Hong Kong has gone through no deflationary collapse as Spain has endured. Unemployment is less than 3% and real estate values have soared over the past five years.

Having already suffered through the Asian Financial Crisis of 07, Hong Kong's stock market today doesn't reflect the same economic dynamics as Spain's depressed situation.

Further, this aberration is indeed not the norm as the Hang Seng Index (HSI) has outperformed over the last 44 years:

Exhibit 2

HSI has outperformed MSCI World over the cycle with an excess return of 5.3% per annum: price performance since index inception (in US\$)



Source: HSI Company, MSCI, Datastream, Morgan Stanley Research, data as of March 14, 2013

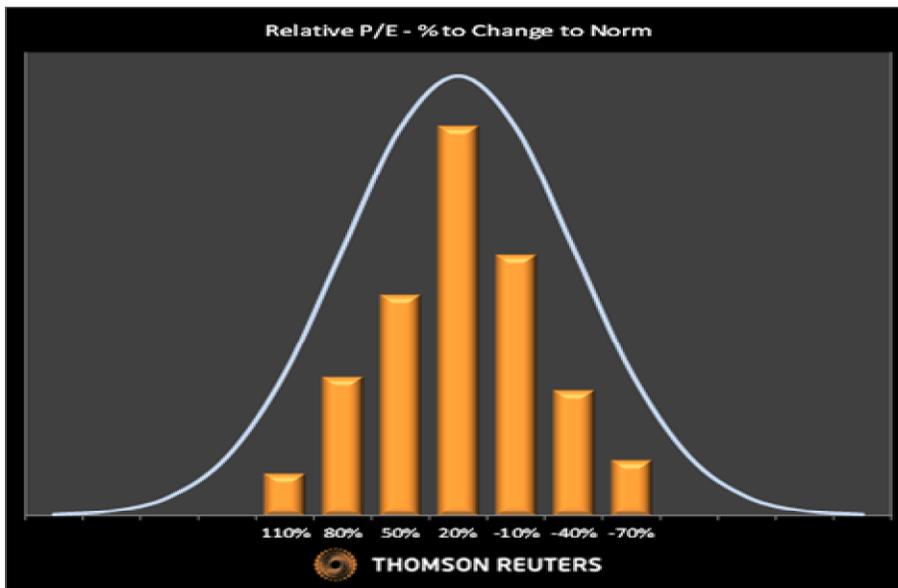
Apropos to the alternatives, Warren Buffett noted US stocks have "moved a long way" in the past five years, going from "ridiculously cheap" to "more of less fairly priced now."

"We don't find bargains around but we don't think things are way overvalued either. We're having a hard time finding things to buy."

<http://www.cnbc.com/id/101048419>

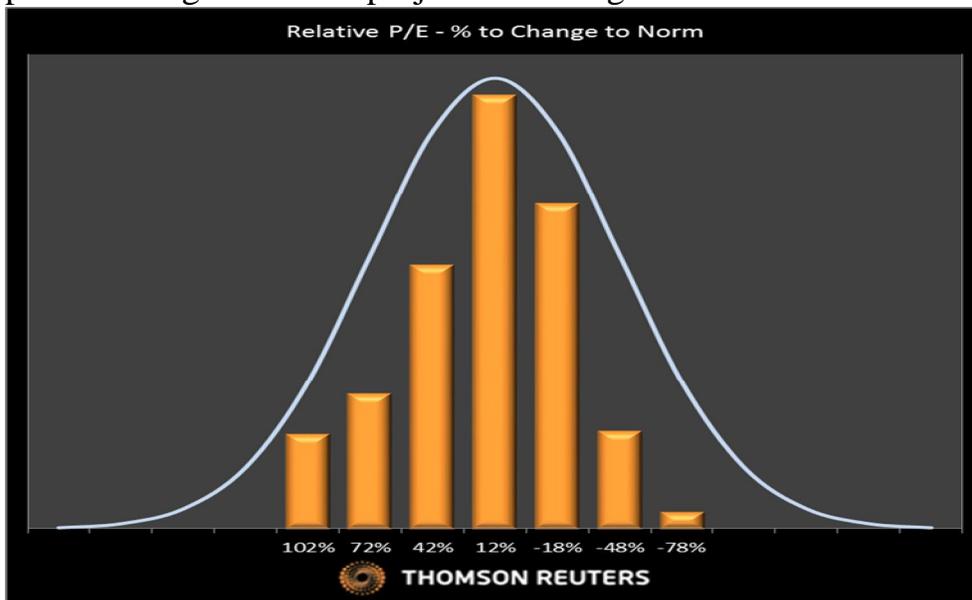
Contrariwise, global investors may well turn to the cheap values in Hong Kong for better returns.

Earlier in March this year, we presented this chart:



í noting a preponderance of stocks in Hong Kong today would increase 20% or more just to return to their typical/average price to earnings ratio/value on expected earnings.

Today, most stocks remain depressed and below their historic average 10 year price/earnings levels on projected earnings.



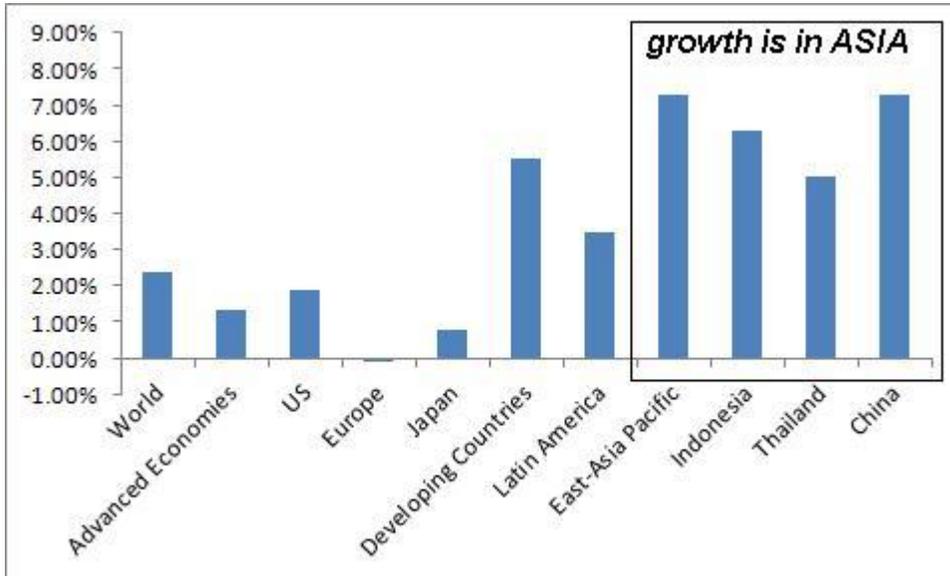
In New York on 26 Sep 2013, Carlyle's David Rubenstein said he is still very bullish on China (CARLYLE GROUP LP, has more than \$180 billion in assets under management across 118 funds).

Rubenstein said he thinks China is the second best place to invest in the world, after the U.S. and that Chinese growth may fall to 6 percent or 7 percent, but

that was still excellent compared to the rest of the world. "There are still a lot of opportunities there," he said.

There's little reason to believe China won't continue growing. As Mark Mobius of Templeton noted; "The new administration in China is just getting its game going, I think that growth engine will continue... Asia remains the world's engine of growth. And as such Asia will continue to outperform."

2013 GDP forecasts



In our view, Hong Kong stocks will likely rapidly catch up as investors are too pessimistic in their outlooks today.

Nonetheless, there is a caution: though the Hong Kong stock market is relatively undervalued, Hong Kong's residential property market is acutely overvalued.

The average flat size in Hong Kong is ~400 square feet. The average price per square foot (in USD) is calculated from the Ratings and Valuation Department (RVD) in the following chart:

| Square Feet | Average price per sq. f. (Hong Kong) |
|-------------|--------------------------------------|
| 431 | \$1,466 |
| 753-1,076 | \$1,863 |

1,076-
1,722 \$2,266

(and most luxury homes in Hong Kong, or those with 1,000 sf and above, have even crazier costs per square foot; impossible to accurately average).

In the USA, median home prices (using the Western region, which is the priciest) were \$287,500 in July this year. According to the latest (2012) new single-family house size data from the U.S. Census Bureau, the median was 2,306 square feet or, a price per square foot of about US\$124 for new homes.

The large discrepancy in residential property prices can partially be explained by Hong Kong's 16.5% flat salary tax, yet just a small portion of the distortion.

According to the [China Daily](#), just ½ of Hong Kong's 7 million residents own their own premises. Many residents are priced out of owning property, even with the median household income at US\$32,051.

Hong Kong's property market is vulnerable to any rise in US interest rates. Since the HK dollar is pegged to the US dollar, Hong Kong's adjustable rate mortgages (which account for 90% of all home mortgages) must follow US interest rates.

Nonetheless, we continue to focus on ferreting out attractive, long term values to own with operations benefiting from China's growth. Macro-economic issues don't govern our decisions on buying or selling. We remain optimistic and positive about the prospects of all our holdings, even in this slow trading environment.

Sincerely,

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