SOUTH OCEAN 南海管理有限公司
MANAGEMENT, LTD.
HONG KONG

September 19, 2017

Dear Clients, Partners, and Friends,

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

	Aug 2017	Year-to-date
Hong Kong Partners LP	-1.1%	2.6%
Hang Seng Index	2.4%	27.1%
Hang Seng Small Cap Index	0.7%	8.9%
MSCI HK Small Cap Index	0.1%	7.7%

Partners' NAV $3.0618 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

Last month, our holdings of small/mid cap, Hong Kong-listed companies reported interim results mostly in line with expectations. Yet, as we cited in our July monthly letter, there has been a striking divergence in the performance of small caps versus (a select few) large capitalized stocks in Hong Kong.

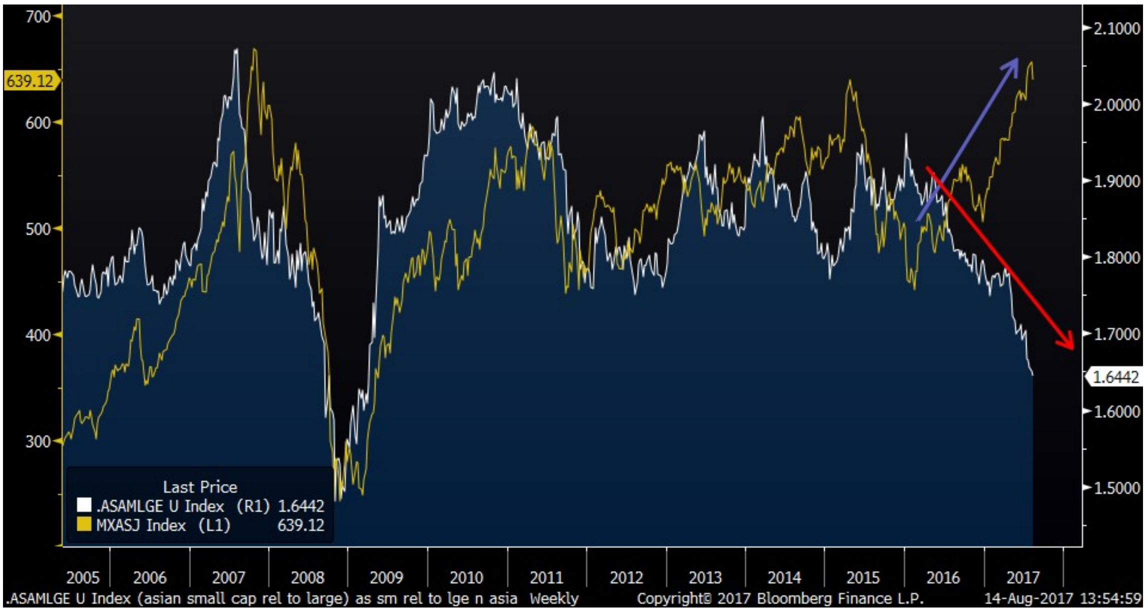
There are several observations we can make for this dichotomy.

To start, the US markets have witnessed a similar situation where a select few stock sectors garner most of the investor interest. The digital technology boom, for instance, has propelled shares of companies with advanced digital capabilities. This group, with higher profit margins and faster growth, is also eating into the returns of other sectors (e.g. Amazon disrupting the retail sector).

One research house reported that, according to FactSet, just three sectors – information technology, energy and financial services – accounted for 70% of all earnings growth for S&P 500 companies in 2Q 2017. Further, overall second quarter earnings for the small cap S&P 600 came in somewhere between flat and negative 2.5% (according to Jefferies).

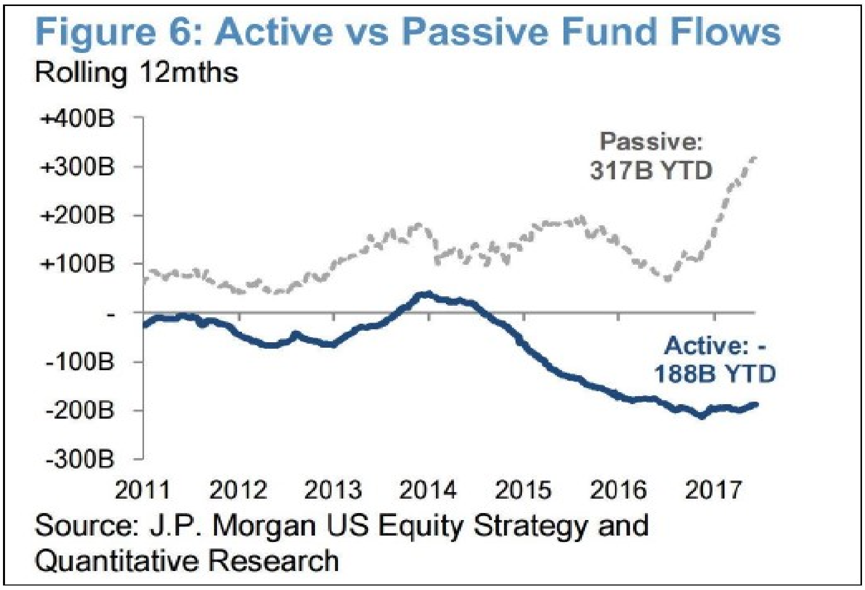
Consequently, the Russell 2000 Small Cap Index has lagged the larger S&P 500 Index year-to-date:

The divergence between small caps and large cap shares can also be seen in Emerging Markets as well. The Asia ex Japan Index has witnessed a marked deviation in returns of the two sectors for the last nine months;



Another observation for these divergences, and one we suspect is a powerful driving force, is the massive inflows into passive investing (a strategy widely advocated by Jack Bogle, Warren Buffett and Tony Robbins). As one hedge fund manager put it, there has been a '…tectonic shift in capital from active to passive' investing.

We suspect passive, ETF fund flows account for much of this market distortion.



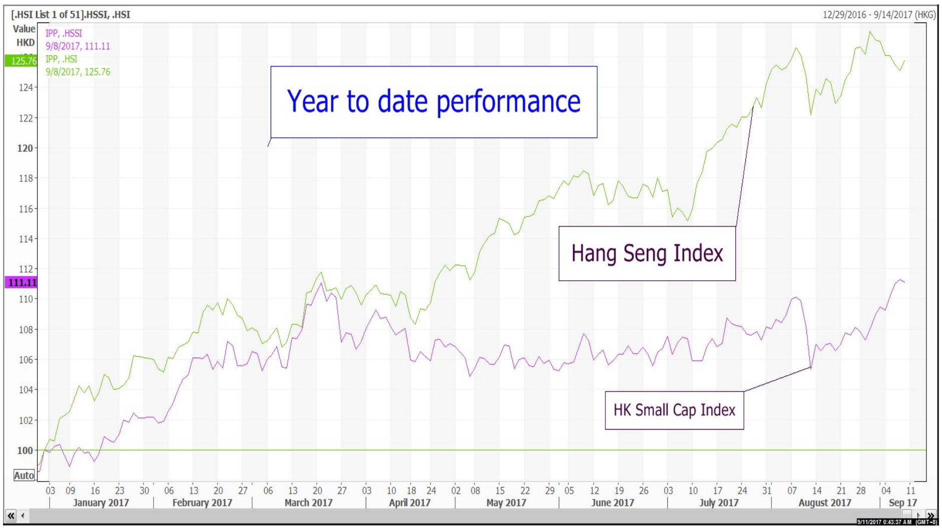
This dynamic growth raises several questions and concerns:

> *… Critics say that by owning every company in an index, passive investors don't care if company A does better than company B, or whether sector C does better than sector D. This lack of discrimination could lead to inefficient capital allocation, with money flowing into companies that don't deserve it.*
>
> *Another factor fueling the behavior change of passive fund managers is the tremendous growth of the assets they manage. Assets in traditional index funds and exchange-traded funds, or ETFs, have grown four-fold since the financial crisis, and nowadays represent nearly a quarter of total fund assets globally, according to Morningstar data.*

http://hk.morningstar.com/ap/news/ETF-Education/160810/Passive-Fund-Providers-Taking-an-Active-Interest-in-ESG.aspx

Financial powerhouse, BlackRock, leader in Exchange Traded Funds (ETFs), daily reports greater than 5% ownership in many Hong Kong large caps, according to the HSI Services website.

As can be seen in Hong Kong, small caps have generally way underperformed the passive investing that is governing large caps;



The Hang Seng Index is dominated by financial/interest rate sensitive companies, such as banks, insurance and real estate, sectors that we have no exposure in our portfolios. Tencent, the PRC Internet giant, is the exception in the blue-chip index: it has risen 70% year-to-date and accounts for roughly ¼ of the index's gains this year. Actually, the gains to date for the large cap index have been concentrated in just a handful of stocks.

We shall advance these observations further next month and explain how our system is working in today's markets. On a fundamental basis, our small/mid cap stock portfolio of 23 holdings sells at a weighted average P/E of 9.9x '17 estimated earnings vs the Hang Seng at 12.4x.

Sincerely,

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