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

December 8, 2010

Dear Clients, Partners, and Friends,

The results for the South Ocean Management composite and Hong Kong Partner's L.P. before management fees, were as follows:

	Nov 2010	Year-to-Date
Hong Kong Partners *	4.1%	24.9%
Hang Seng Index**	-0.4%	5.2%
BNP Peregrine Greater China Index	-1.9%	2.7%
MSCI HK Small Cap Index	3.4%	31.0%

Partnersô NAV for Aug was 3.5712 after management fee, but before annual incentive fees of 15% on appreciation.

Our portfolios of smaller capitalized, Hong Kong-listed companies with earnings geared towards China, continued to gain in November, despite turbulence in the overall market. In mid- month, Irelandôs bailout and Chinaôs inflation concerns simultaneously shook investors. The following week, nerves were rattled with the bombs in Korea. Itôs a demonstration of the cheapness of our holdings that large declines didnôt come to pass during this mayhem.

The developing themes we have been observing and pointing out in our monthly letters over the past 15 years are becoming more prevalent in main-stream media today. The following article, in the Wall Street Journal, written by a Harvard professor, depicts some compelling statistical comparisons on China.

Sincerely,

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THE SATURDAY ESSAY NOVEMBER 18, 2010

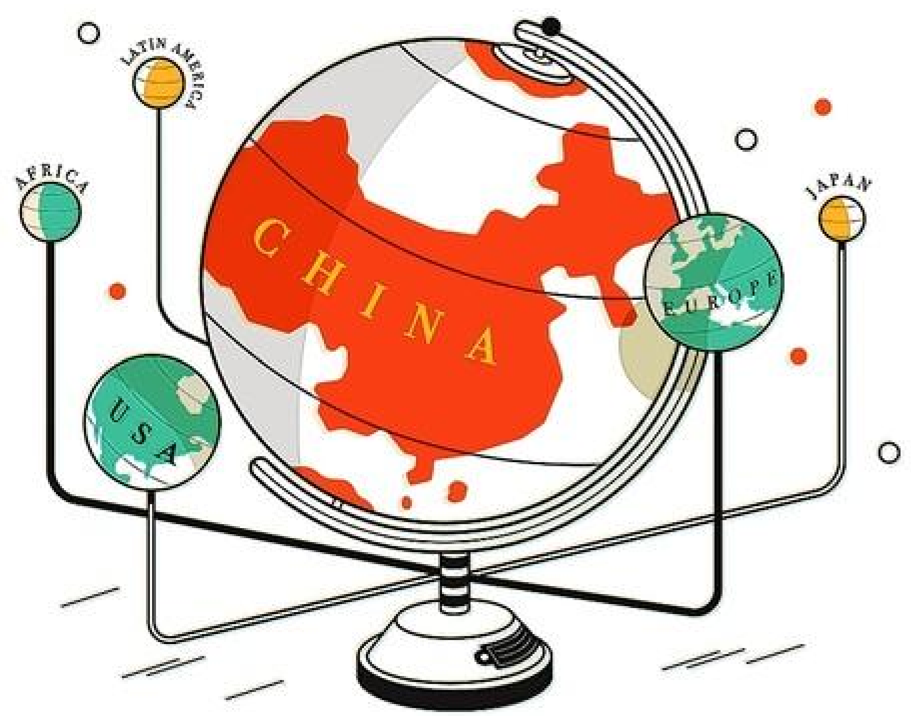
In China's Orbit

After 500 years of Western predominance, Niall Ferguson argues, the world is tilting back to the East.

By NIALL FERGUSON

"We are the masters now." I wonder if President Barack Obama saw those words in the thought bubble over the head of his Chinese counterpart, Hu Jintao, at the G20 summit in Seoul last week. If the president was hoping for change he could believe inð in China's currency policy, that isð all he got was small change. Maybe Treasury Secretary Timothy Geithner also heard "We are the masters now" as the Chinese shot down his proposal for capping imbalances in global current accounts. Federal Reserve Chairman Ben Bernanke got the same treatment when he announced a new round of "quantitative easing" to try to jump start the U.S. economy, a move described by one leading Chinese commentator as "uncontrolled" and "irresponsible."

Illustration by Harry Camp



"We are the masters now." That was certainly the refrain that I kept hearing in my head when I was in China two weeks ago. It wasn't so much the glitzy, Olympic-quality party I attended in the Tai Miao Temple, next to the Forbidden City, that made this impression. The displays of bell ringing, martial arts and all-girl drumming are the kind of thing that Western visitors expect. It was the understated but unmistakable self-confidence of the economists I met that told me something had changed in relations between China and the West.

One of them, Cheng Siwei, explained over dinner China's plan to become a leader in green energy technology. Between swigs of rice wine, Xia Bin, an adviser to the People's Bank of China, outlined the need for a thorough privatization program, "including even the Great

Hall of the People." And in faultless English, David Li of Tsinghua University confessed his dissatisfaction with the quality of Chinese Ph.D.s.

You could not ask for smarter people with whom to discuss the two most interesting questions in economic history today: Why did the West come to dominate not only China but the rest of the world in the five centuries after the Forbidden City was built? And is that period of Western dominance now finally coming to an end?

In a brilliant paper that has yet to be published in English, Mr. Li and his co-author Guan Hanhui demolish the fashionable view that China was economically neck-and-neck with the West until as recently as 1800. Per capita gross domestic product, they show, stagnated in the Ming era (1402-1626) and was significantly lower than that of pre-industrial Britain. China still had an overwhelmingly agricultural economy, with low-productivity cultivation accounting for 90% of GDP. And for a century after 1520, the Chinese national savings rate was actually negative. There was no capital accumulation in late Ming China; rather the opposite.

The story of what Kenneth Pomeranz, a history professor at the University of California, Irvine, has called "the Great Divergence" between East and West began much earlier. Even the late economist Angus Maddison may have been over-optimistic when he argued that in 1700 the average inhabitant of China was probably slightly better off than the average inhabitant of the future United States. Mr. Maddison was closer to the mark when he estimated that, in 1600, per capita GDP in Britain was already 60% higher than in China.

For the next several hundred years, China continued to stagnate and, in the 20th century, even to retreat, while the English-speaking world, closely followed by northwestern Europe, surged ahead. By 1820 U.S. per capita GDP was twice that of China; by 1870 it was nearly five times greater; by 1913 the ratio was nearly 10 to one.

Despite the painful interruption of the Great Depression, the U.S. suffered nothing so devastating as China's wretched mid-20th century ordeal of revolution, civil war, Japanese invasion, more revolution, man-made famine and yet more ("cultural") revolution. In 1968 the average American was 33 times richer than the average Chinese, using figures calculated on the basis of purchasing power parity (allowing for the different costs of living in the two countries).

Calculated in current dollar terms, the differential at its peak was more like 70 to 1.

This was the ultimate global imbalance, the result of centuries of economic and political divergence. How did it come about? And is it over?

As I've researched my forthcoming book over the past two years, I've concluded that the West developed six "killer applications" that "the Rest" lacked. These were:

ÅCompetition: Europe was politically fragmented, and within each monarchy or republic there were multiple competing corporate entities.

ÅThe Scientific Revolution: All the major 17th-century breakthroughs in mathematics, astronomy, physics, chemistry and biology happened in Western Europe.

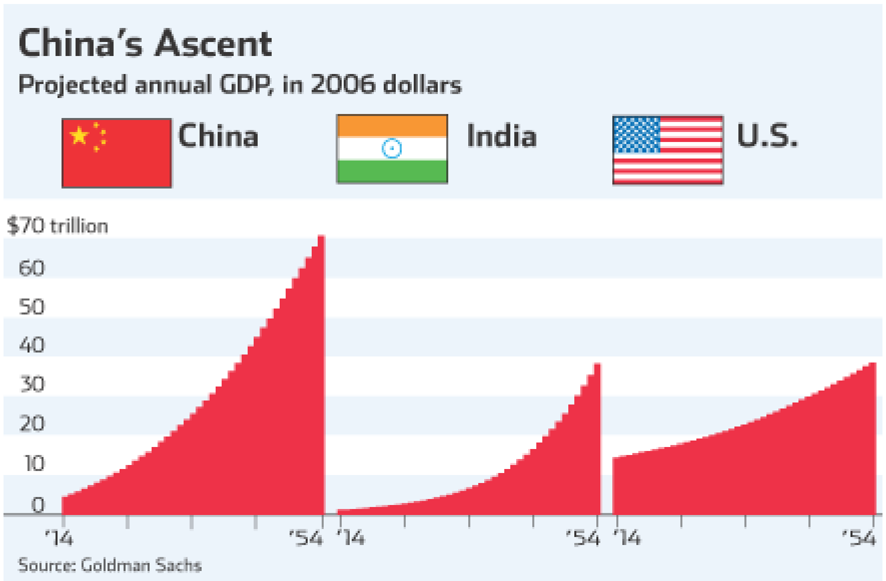
ÅThe rule of law and representative government: This optimal system of social and political order emerged in the English-speaking world, based on property rights and the representation of property owners in elected legislatures.

ÅModern medicine: All the major 19th- and 20th-century advances in health care, including the control of tropical diseases, were made by Western Europeans and North Americans.

ÅThe consumer society: The Industrial Revolution took place where there was both a supply of productivity-enhancing technologies and a demand for more, better and cheaper goods, beginning with cotton garments.

ÅThe work ethic: Westerners were the first people in the world to combine more extensive and intensive labor with higher savings rates, permitting sustained capital accumulation.

Those six killer apps were the key to Western ascendancy. The story of our time, which can be traced back to the reign of the Meiji Emperor in Japan (1867-1912), is that the Rest finally began to download them. It was far from a smooth process. The Japanese had no idea which elements of Western culture were the crucial ones, so they ended up copying everything, from Western clothes and hairstyles to the practice of colonizing foreign peoples. Unfortunately, they took up empirebuilding at precisely the moment when the costs of imperialism began to exceed the benefits. Other Asian powersð notably Indiað wasted decades on the erroneous premise that the socialist institutions pioneered in the Soviet Union were superior to the market-based institutions of the West.



Beginning in the 1950s, however, a growing band of East Asian countries followed Japan in mimicking the West's industrial model, beginning with textiles and steel and moving up the value chain from there. The downloading of Western applications was now more selective. Competition and representative government did not figure much in Asian development, which instead focused on science, medicine, the consumer society and the work ethic (less Protestant than Max Weber had thought). Today Singapore is ranked third in the World Economic Forum's assessment of competitiveness. Hong Kong is 11th, followed by Taiwan (13th), South Korea (22nd) and China (27th). This is roughly the order, historically, in which these countries Westernized their economies.

Today per capita GDP in China is 19% that of the U.S., compared with 4% when economic reform began just over 30 years ago. Hong Kong, Japan and Singapore were already there as early as 1950; Taiwan got there in 1970, and South Korea got there in 1975. According to the Conference Board, Singapore's per capita GDP is now 21% higher than that of the U.S., Hong Kong's is about the same, Japan's and Taiwan's are about 25% lower, and South Korea's 36% lower. Only a foolhardy man would bet against China's following the same trajectory in the decades ahead.

China's has been the biggest and fastest of all the industrialization revolutions. In the space of 26 years, China's GDP grew by a factor of 10. It took the U.K. 70 years after 1830 to grow by a factor of four. According to the International Monetary Fund, China's share of global GDP (measured in current prices) will pass the 10% mark in 2013. Goldman Sachs continues to forecast that China will overtake the U.S. in terms of GDP in 2027, just as it recently overtook Japan.

But in some ways the Asian century has already arrived. China is on the brink of surpassing the American share of global manufacturing, having overtaken Germany and Japan in the past 10 years. China's biggest city, Shanghai, already sits atop the ranks of the world's megacities, with Mumbai right behind; no American city comes close.

Nothing is more certain to accelerate the shift of global economic power from West to East than the looming U.S. fiscal crisis. With a debt-to-revenue ratio of 312%, Greece is in dire straits already. But the debt-to-revenue ratio of the U.S. is 358%, according to Morgan Stanley. The Congressional Budget Office estimates that interest payments on the federal debt will rise from 9% of federal tax revenues to 20% in 2020, 36% in 2030 and 58% in 2040. Only America's "exorbitant privilege" of being able to print the world's premier reserve currency gives it breathing space. Yet this very privilege is under mounting attack from the Chinese government.

For many commentators, the resumption of quantitative easing by the Federal Reserve has appeared to spark a currency war between the U.S. and China. If the "Chinese don't take actions" to end the manipulation of their currency, President Obama declared in New York in September, "we have other means of protecting U.S. interests." The Chinese premier Wen Jiabao was quick to respond: "Do not work to pressure us on the renminbi rateé . Many of our exporting companies would have to close down, migrant workers would have to return to their villages. If China saw social and economic turbulence, then it would be a disaster for the world."

Such exchanges are a form of *pi ying xi*, China's traditional shadow puppet theater. In reality, today's currency war is between "Chimerica"ð as I've called the united economies of China and Americað and the rest of the world. If the U.S. prints money while China effectively still pegs its currency to the dollar, both parties benefit. The losers are countries like Indonesia and Brazil, whose real trade-weighted exchange rates have appreciated since January 2008 by 18% and 17%, respectively.

But who now gains more from this partnership? With China's output currently 20% above its pre-crisis level and that of the U.S. still 2% below, the answer seems clear. American policy-makers may utter the mantra that "they need us as much as we need them" and refer ominously to Lawrence Summers's famous phrase about "mutually assured financial destruction." But the Chinese already have a plan to reduce their dependence on dollar reserve accumulation and subsidized exports. It is a strategy not so much for world domination on the model of Western imperialism as for reestablishing China as the Middle Kingdomð the dominant tributary state in the Asia-Pacific region.

If I had to summarize China's new grand strategy, I would do it, Chinese-style, as the Four "Mores": Consume more, import more, invest abroad more and innovate more. In each case, a change of economic strategy pays a handsome geopolitical dividend.

By consuming more, China can reduce its trade surplus and, in the process, endear itself to its major trading partners, especially the other emerging markets. China recently overtook the U.S. as the world's biggest automobile market (14 million sales a year, compared to 11 million), and its demand is projected to rise tenfold in the years ahead.

By 2035, according to the International Energy Agency, China will be using a fifth of all global energy, a 75% increase since 2008. It accounted for about 46% of global coal consumption in 2009, the World Coal Institute estimates, and consumes a similar share of the world's aluminum, copper, nickel and zinc production. Last year China used twice as much crude steel as the European Union, United States and Japan combined.

Such figures translate into major gains for the exporters of these and other commodities. China is already Australia's biggest export market, accounting for 22% of Australian exports in 2009. It buys 12% of Brazil's exports and 10% of South Africa's. It has also become a big purchaser of high-end manufactured goods from Japan and Germany. Once China was mainly an exporter of low-price manufactures. Now that it accounts for fully a fifth of global growth, it has become the most dynamic new market for other people's stuff. And that wins friends.

The Chinese are justifiably nervous, however, about the vagaries of world commodity prices. How could they feel otherwise after the huge price swings of the past few years? So it makes sense for them to invest abroad more. In January 2010 alone, the Chinese made direct investments worth a total of $2.4 billion in 420 overseas enterprises in 75 countries and regions. The overwhelming majority of these were in Asia and Africa. The biggest sectors were mining, transportation and petrochemicals. Across Africa, the Chinese mode of operation is now well established. Typical deals exchange highway and other infrastructure investments for long leases of mines or agricultural land, with no questions asked about human rights abuses or political corruption.

Growing overseas investment in natural resources not only makes sense as a diversification strategy to reduce China's exposure to the risk of dollar depreciation. It also allows China to increase its financial power, not least through its vast and influential sovereign wealth fund. And it justifies ambitious plans for naval expansion. In the words of Rear Admiral Zhang Huachen, deputy commander of the East Sea Fleet: "With the expansion of the country's economic interests, the navy wants to better protect the country's transportation routes and the safety of our major sea-lanes." The South China Sea has already been declared a "core national interest," and deep-water ports are projected in Pakistan, Burma and Sri Lanka.

Finally, and contrary to the view that China is condemned to remain an assembly line for products "designed in California," the country is innovating more, aiming to become, for example, the world's leading manufacturer of wind turbines and photovoltaic panels. In 2007 China overtook Germany in terms of new patent applications. This is part of a wider story of Eastern ascendancy. In 2008, for the first time, the number of patent applications from China, India, Japan and South Korea exceeded those from the West.

The dilemma posed to the "departing" power by the "arriving" power is always agonizing. The cost of resisting Germany's rise was heavy indeed for Britain; it was much easier to slide quietly into the role of junior partner to the U.S. Should America seek to contain China or to accommodate it? Opinion polls suggest that ordinary Americans are no more certain how to respond than the president. In a recent survey by the Pew Research Center, 49% of respondents said they did not expect China to "overtake the U.S. as the world's main superpower," but 46% took the opposite view.

Coming to terms with a new global order was hard enough after the collapse of the Soviet Union, which went to the heads of many Western commentators. (Who now remembers talk of American *hyperpuissance* without a wince?) But the Cold War lasted little more than four decades, and the Soviet Union never came close to overtaking the U.S. economically. What we are living through now is the end of 500 years of Western predominance. This time the Eastern challenger is for real, both economically and geopolitically.

The gentlemen in Beijing may not be the masters just yet. But one thing is certain: They are no longer the apprentices.

ð Niall Ferguson is a professor of history at Harvard University and a professor of business administration at the Harvard Business School. His next book, "Civilization: The West and the Rest," will be published in March.

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- The Fund invests in China-related companies which involve certain risks not typically associated with investment in more developed markets, such as greater political, tax, economic, foreign exchange, liquidity and regulatory risks.
- The Fund is also subject to concentration risk due to its concentration in Hong Kong, particularly China-related companies. The value of the Fund can be extremely volatile and could go down substantially within a short period of time. It is possible that a substantial value of your investment could be lost.
- You should not make investment decision on the basis of this material alone. Please read the explanatory private placement memorandum for details and risk factors.

**Index Descriptions: The Hang Seng Indexes are a widely recognized capitalization-weighted indexes that measures the performance of the three largest-capitalization sectors of the Hong Kong stock market in descending order. The Hang Seng Index measures the largest 52 market capitalized listed companies in Hong Kong’s stock market. The Hang Seng Mid Cap Index represents the next 193 largest capitalized listed companies, the Hang Seng Small Cap Index represents the next 187 largest capitalized listed companies in Hong Kong.

The MSCI HK Small Cap Index is a free float-adjusted market cap weighted index designed to measure the performance of small cap equity securities in the bottom 15% of equity market capitalization in Hong Kong. With 69 constituents, the index represents approximately 14% of the free float-adjusted market capitalization of the Hong Kong equity universe.

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