January 18, 2013

Dear Clients, Partners, and Friends,

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

	Dec 2012	Year-to-Date
Hong Kong Partners LP *	3.2%	6.6%
Hang Seng Index **	2.8%	22.9%
MSCI HK Small Cap Index	1.0%	18.6%

Partnersø NAV for Dec $2.5084 after management fee, but before annual incentive fees of 15% on appreciation.

õThere seems to be some perverse human characteristic that likes to make easy things difficult.ö Warren Buffet

In December, our holdings of Hong Kong-listed companies with earnings geared toward Chinaøs growth, performed better.

Last year, more than 75% of the Hang Seng Indexøs gains came after the USøs Federal Reserve QE3 announcement in September. Property stocks (up over 40%), along with interest-rate sensitive banks and finance stocks, dominate the Index and were not sectors we were exposed in our portfolios.

Economic uncertainty and the potential for external shocks from the Middle East, a potential large EU bank (or country) failure, or a crisis in Chinaøs financial sector, kept us cautious through much of the year. In fact, value investing, along with arbitrage strategies such as relative-value trading, long-short equity or equity pairs trading, have all performed poorly since 2008. The disappointing results reflect uncertainty about accurate values, risk-on/risk-off trading, risk aversion, illiquidity and the lack of any convergence to theoretical values. Our risk-adverse stance kept our gains for the year below that of the major Index (see Reutersø article below).

In the global bestseller by Martin Jacques, ***When China Rules the World***, the author makes an almost frightening case for China: he contends, with mountains of historical data and facts, that as China ascends, both economically and culturally, the impact will be huge and the global dominance of the Western nation-state will soon end. And the rise of China will herald the birth of a new international order. This is an important book, and, as I stressed in a recent presentation, it is an event that is not too far out or too far off.

Weøve developed a new system to analyze and buy great companies here in Hong Kong at (very) reasonable prices.

This systematic investment process is an extension of our 20 year investment program here at South Ocean, and is akin to Warren Buffettøs* investment strategy, which is conservative and long term oriented.

For many years, ever since first arriving in Hong Kong twenty years ago, I have endeavored to create a simple to use/understand, fundamental/quantitative ranking scheme to analyze stocks (like the one used by my Dadøs previous investment management firm in Greenwich, Connecticut). Our new system, which I started working on with a Reutersø computer software programmer last spring, is a method that identifies great businesses, helps determine a practical long term value (intrinsic value) for those businesses and establishes a reasonable price to pay for the shares. The database-driven system screens all Hong Kong stocks, and ranks their attractiveness. The system is a huge help to our investment decision making process. We, additionally, created an individual stock worksheet to help drill down into analyzing a stock, that incorporates a fundamental ranking on the business of the company and a maximum price to pay for the shares (based on expected earnings and dividend growth of each company). This automated process should also help reduce portfolio volatility.

The systematic analysis concentrates on four factors: first, a company's economic moat, or its competitive advantage. Second, a rating on the company (top rating of A, then B, and then C, using ROE, Income Growth, Cash flow growth and amount of debt). Third, a long term estimated growth in both the dividend and earnings per share (if the company pays a dividend, then we take just ½ that amount, to be extra conservative in case the company should cut its dividend down the road).

We can further override the marketøs expected growth rate with a more conservative estimate, utilizing a unique analysis in our Reuters service called StarMine Estimates (which essentially discounts overly optimistic estimates).

Lastly, taking the lowest annual price earnings ratio for the company over the past five years to compute a long term value for the shares, the system calculates the maximum price to pay today for a minimum 20% annual return. This extra buffer (margin of safety) helps protect losses/downside in case we make an analytical error or if our analysis is incorrect, by being either too positive or optimistic.

Basically, these four fundamentals are elements weøve always been using in our investment strategy. Now (finally), it is fortified by a systematic common-sense, business-like approach. The strategy is an inherently conservative approach, as we are forced not to pay too much for expected growth (no matter how exciting that may seem).

Though this value approach to investing makes perfectly sound sense to us, youød think everyone would be using a similar system. But, thatøs not human nature.

In the appendix to Ben Grahamøs book, The Intelligent Investor, fourth revised edition, Buffett, in explaining the value approach, wrote:

> "One sidelight here: it is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately with people or it doesn't take at all. It's like an inoculation. If it doesn't grab a person right away, I find that you can talk to him for years and show him records, and it doesn't make any difference. They just don't seem able to grasp the concept, simple as it is. A fellow like Rick Guerin, who had no formal education in business, understands immediately the value approach to investing and he's applying it five minutes later. I've never seen anyone who became a gradual convert over a ten-year period to this approach. It doesn't seem to be a matter of IQ or academic training. It's instant recognition, or it is nothing…Very, very few pension funds are managed from a value standpoint."

He explained again recently,

> **I don't know!** I am also puzzled by why value investing hasn't caught on. I mean, what other type of investing is there? You want something other than value? But the thing is, people just don't want to believe. They elect things that are emotionally satisfying. Even if you show them the results, they still don't believe you. However, eventually proof comes through results..

We have included in our portfolios a few larger capitalized names last year, such as Li and Fung (code 0494, market cap US$12.6 billion) and Digital China (code 0861, market cap US$1.8 billion, see September client letter). We shall use sidelined cash to invest further (cash is 22% of total portfolio value) as and when stocks sell at our value propositions dictated by our system.

Today, there arenøt too many large cap, attractive values around. Accordingly, we wait patiently and continue to analyze all companies and the maximum share prices weød pay for them.

As we have mentioned in previous letters, though we generally view larger cap stocks in Hong Kong as uninteresting values, we have owned them at certain junctures over the past 20 years; like during Sars in 2003, when the price declines in larger cap shares became quite attractive. In fact, back then, we put together and originated a *Sars portfolio of Hong Kong large caps*, but nobody seemed interested. Because there are sometimes up to 40 institutional analysts following and recommending individual stocks in this small group of blue chips and large China SOE stocks, we feel we add little value to these investments (except when they become out of favor, as with our Mengniu Dairy purchase during the China baby milk scandal in September 2008). Most over-researched large caps are fully

valued and, as a result, in our opinion, they have much less a margin of safety should a company ever disappoint.

Consequently, we tend to generally find much better values in the less followed, smaller cap stocks. We focus in these fast growing companies.

For example, last year we re-visited a quality manufacturer, small cap clothing manufacturer Luen Thai. As we mentioned in our June letter, Luen Thai, with retailers Polo and Coach as major clients, was expanding its production overseas. At the time we began purchasing, the total market cap of the shares was HK$850 million or US$110 million with reported trailing net profits amounting to HK$266 million or US$34.3 million.

Last week, the cash-rich company announced a US$55 million acquisition (all cash) of a clothing manufacturer that should be complimentary to Luen Thaiøs other operations. The new company will not only bring in another large client to Luen Thaiøs portfolio (The Gap), but supplement its offshore-China factories with additional lower cost production facilities (Cambodia) as well. Todayøs market cap stands at HK$1.67 billion or US$215 million and the shares sell at just 4.6 times our estimate of this yearøs earnings.

We head out regularly to inspect these types of un-loved values (last year, we visited about a 100 companies). Hong Kongøs stock market is a treasure trove of remarkable values today, especially in smaller cap names. Hong Kongøs close proximity is an ideal setting and terrific location to gather information on business operations of listed companies growing in China. We concentrate our daily efforts in arranging first hand meetings with managers/executive directors and founders of listed companies in the territory, and try to visit their China operations as much as possible (importantly, first hand meetings with small cap company managers are an absolute must for inclusion to our portfolios).

Of note, we attended the year-end shareholder meeting of suspended holding, vegetable producer Chaoda Modern Agriculture. Encouragingly, the Chairman announced that the election of a new auditor for the Company was 'imminent' (a prerequisite to the Hong Kong stock exchange lifting of the share suspension is the release of audited financial reports on the company). Importantly, I saw that all directors and company managers I had known previously were in attendance at the meeting (an important sign, as there have been instances of fraudulent Chinese companies where all those execs had disappeared into the hills, never to be seen again).

We estimate that it should take up to 10 weeks for the new auditors to issue financials. Therefore, even though all other conditions set by the HK stock exchange have been met by the company, the stock will remain suspended until the financials are released.

Last, a big thank you to the Palm Beach Florida chapter of the Young Presidentsø Organization-YPO for having me in to talk about South Oceanøs outlook for China last month. It was a pleasure meeting everyone there (many thanks again, Stan, for the kind invite). Please get in touch with our Joyce Yip here (joyce@south-ocean.com) if youød like a copy of the slides I presented.

A very Happy New Year to all our patient friends and clients.

Sincerely,

Brook McConnell
President
Email: brook@south-ocean.com Website: www.south-ocean.com
Hong Kong

Bad China bets ruin 2012 for Asia's star fund managers

By Nishant Kumar

HONG KONG, Dec 31 (Reuters) - The Warren Buffetts of the East failed to live up their reputations in 2012, when big-name investment gurus made the wrong calls on China while markets in India and Southeast Asia raced ahead to rank among the top performers globally.

Between January and November this year, Franklin Templeton's Mark Mobius and Value Partners' Cheah Cheng-hye fell short of their benchmarks by the widest margins in more than a decade, data from Thomson Reuters Lipper showed.

Sustained underperformance by the top names could push investors towards cheaper, passively managed index and exchange traded funds (ETFs), a trend that has taken hold in Europe and the United States where active funds find it tougher to exceed benchmarks.

"The (Chinese) economic slowdown in 2012 certainly had a negative impact on the consumer sector, an area I am overweight," Fidelity's Anthony Bolton, another star portfolio manager who failed to beat his benchmark during the period, told Reuters in an email.

"The fund's focus on small and mid-caps also hurt performance," said Bolton, who returned three years ago amid much fanfare to chance his arm in China.

All three A-listers were undermined by their bets on China, whose stock market, measured by top Shanghai and Shenzhen listings CSI300, fell 8.8 percent through November on fears of economic slowdown, and as a once-a-decade political leadership change was completed in that month. The index has since rebounded and is now up 4.5 percent for 2012.

By contrast, share markets in the resilient Southeast Asian economies have rallied, and Indian shares have risen by a quarter so far this year, helped by $24 billion foreign portfolio inflows.

Bolton's Fidelity China Special Situations was up 5.8 percent in the 11 months to end-November, 8 percentage points behind its benchmark MSCI China index. That came after missing its gauge by nearly 18 percentage points last year.

His play on China consumer stocks backfired, with sector shares falling 5 percent on average compared with an average 15 percent rise in consumer staple stocks in Asia Pacific, data from Thomson Reuters StarMine showed.

MOBIUS TRIPS

Mobius also paid a price for his heavy China exposure, with almost 30 percent of the $16.9 billion Templeton Asian Growth fund invested there. Those positions proved to be a drag on performance: the fund notched just 10.6 percent return, lagging the benchmark MSCI AC Asia ex Japan index by 8.3 percentage points and logging its biggest gap since 1999.

The fund suffered from its investment in some energy stocks, as the sector was impacted by swings in commodity prices, Mobius said, with poor show by automobiles also hurting performance.

His fund's top holding at end-September was PetroChina, the nation's dominant oil and gas producer, Lipper data showed, a stock that fell by 13 percent in the year to end-November.

Value Partners Classic Fund, managed by a team led by Cheah, was 16.6 percentage points behind Hang Seng index, its widest gap since 1999, data from Lipper showed.

"This macro-driven year has been a long winter for value investing, as investors have stayed on the sidelines remaining defensive," a spokeswoman for Value Partners said.

BAD NEWS FOR MONEY MANAGERS

The underperformance by stellar names highlights the struggles large, actively managed funds face in trying to beat their benchmarks in the West and now in Asia, a trend likely to push investors towards cheaper index and ETFs.

That would be a blow to active money managers who typically charge a fee of 1.5 percent of assets under management, nearly three times that of ETFs, Lipper data showed.

ETFs blindly track indices and require no management or research, making them cheaper than active funds run by teams of investment professionals.

To keep charging premium fees, active managers would have to show results. Expectations of outperformance are especially high in Asia due to the region's relatively under-researched and inefficient markets compared with more mature economies.

Otherwise, active managers risk losing business to passive investment funds, a firm trend in developed markets, as a result of their low cost and of the failure of actively-managed funds to consistently outperform.

This year U.S. investors embraced low-cost, passively managed index funds. For instance, customers ploughed $130.4 billion into Vanguard Group's mutual funds and ETFs in the first 11 months of 2012, setting a new record for annual inflows.

The trend has also benefited BlackRock's iShares ETF unit, while hurting more traditional firms like American Funds, Dodge & Cox and Janus Capital Group.

That shift is gaining momentum in Asia. Assets managed by ETFs to invest in Asia Pacific topped $150 billion by November, from around $34 billion a decade ago, Lipper data showed.

In contrast to the big beasts of the Asian investment world, more obscure funds like the $109 million Manulife Global Fund-Asian Small Cap Equity and $96 million Australian Leaders fund have beat benchmarks by more than 20 percentage points.

Manulife's fund delivered 35.3 percent return, nearly three times that generated by its benchmark FTSE World Asia Pacific Small Cap ex Japan index as of end-November.

Still, both Mobius and Bolton are positive on prospects for 2013. The nature of growth in China is changing as the country's export- and investment-driven model is gradually superseded by one driven by consumption, Bolton believes. This means the pace of growth will be slower, but more resilient.

"The economic cycle is now in its favour, as is the political process," Bolton said.

(Additional reporting by Sinead Cruise in London; Editing by Daniel Magnowski and Denny Thomas)
((nishant.kumar@thomsonreuters.com)(+852 28474064)(Reuters Messaging: nishant.kumar.reuters.com@reuters.net))

Here are some links to my pound-the-table buy on the Shanghai market on CNBC TV the end of November, when the Index that day closed at 1980.117. I was asked only several hours before the interview to come into the studios that day and commentí
http://archive.org/details/tv?q=brook mcconnell
http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2100/end/2130
http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2130/end/2160
http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2160/end/2190
http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2190/end/2220
http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2220/end/2250
http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2250/end/2280

http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2280/end/2310
http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2310/end/2340
http://archive.org/details/CNBC_20121128_090000_Worldwide_Exchange#start/2340/end/2370

*coincidently, Warren Buffetøs birthday is the same as mine; August 30th. He was born 1930, me, 1952. I have some catching up to doí ☺

*Hong Kong Partners LP risk disclaimer:

- Hong Kong Partners LP (The "Fund") primarily invests in the Hong Kong equity market with a Greater China focus.
- 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.
The Hong Kong Partners LP (HKP) is benchmark agnostic and its corresponding portfolio may have significant noncorrelation to any index. The portfolios may invest in all sectors (within and/or on other stock markets) and the composition of securities in the portfolio may change periodically depending on market conditions at the time. Securities in the portfolio will not match those in any index.
Index returns are generally provided as an overall market indicator. You cannot invest directly in an index. Although reinvestment of dividend and interest payments is assumed, no expenses are netted against an index's returns. Index performance information was furnished by sources deemed reliable and is believed to be accurate, however, no warranty or representation is made as to the accuracy thereof and the information is subject to correction.
Before investing you should carefully consider the Partnership's investment objectives, risks, charges and expenses. This and other information are in the prospectus, a copy for Accredited Investors may be obtained by inquiring to info@south-ocean.com. Please read the prospectus carefully before you invest.
The principal risks of investing in HKP: Equity Securities Risk. The value of the equity securities the Fund holds may fall due to general market and economic conditions. Foreign Securities Risk. Investments in the securities of foreign issuers involve risks beyond those associated with investments in U.S. securities. Industrials Sector Risk. Companies in the industrials sector may be adversely affected by changes in government regulation, world events, economic conditions, environmental damages, product liability claims and exchange rates. Consumer Discretionary Risk. Companies in this sector may be adversely impacted by changes in domestic/international economies, exchange/interest rates, social trends and consumer preferences. Information Technology Sector Risk. Information technology companies face intense competition, both domestically and internationally, which may have an adverse effect on profit margins. Detailed information regarding the specific risks of Hong Kong Partners LP can be found in the prospectus. Additional risks of investing in HKP include equity, market, management and non-diversification risks, as well as fluctuations in market value and NAV. An investment in a private limited partnership is subject to risks and you can lose money on your investment in the limited partnership.
There can be no assurance that HKP will achieve its investment objective. The LP's portfolio is more volatile than broad market averages. Shares of HKP cannot be bought or sold publicly, there is no active market in the Units and there are restrictions imposed on Limited Partnership unit transfers. Partnership redemptions are handled by Authorized Administrators of the Partnership.