July 9, 2015

Dear Clients, Partners, and Friends,

As tropical typhoon LINFA bears down on Hong Kong later today, we send the following before it hits:

NOTE . What began as a volatile correction to stock prices late last month, but which has turned into a massive flood of selling currently, precipitates this pre-amble to my June letter:

The China stock markets have witnessed, almost overnight, a melt-down due to panic selling. Government interventionist measures to contain the speculative rise in prices in early June, by tightening margin requirements, touched off forced selling. Like an invisible hand that wiped bids all off the table, stock prices declined precipitously as even further measures by the government were implemented to stem the declines. As the selling became unremitting, listed companies in China on July 6, through a securities law loophole, closed trading in their shares (50% of China's stocks today are closed).

This, then, unleashed a flash flood of selling into Hong Kong.

Over the past year China shares have risen sharply. In the previous six years, China's economy had been growing at a rapid clip, yet stock prices had gone nowhere. As the economy slowed last year, stock prices started rising. This un-coupling of the stock market and the economy is not without precedent as we outlined in our remarks on the 1982 USA stock market bottom amidst a deteriorating economy.

In China there are 90,000,000 retail investors out of a population of roughly 1.3 billion. Most of these investors are new to the vagaries of equity investments. For the most part, Chinese citizens' main wealth is held in property, by a large margin.

The panic selling has swept everything in its path. In Hong Kong, small and mid-cap shares witnessed the brunt of selling as the two indexes declined by almost 50% from recent highs.

Yet, in times of crisis like this, vast fortunes have been made. Yesterday, we invested 1/3rd of sidelined cash into Hong Kong stocks for one of our portfolios. Though I expect further turbulence, we will commit further cash into good quality Hong Kong listed shares on any deepening of this correction.

Please consider your appropriate allocations to Hong Kong and let me hear from you (As Buffett is fond of saying: %Be fearful when others are greedy, be greedy when others are fearful+). Brook McConnell

China stock markets corrected sharply in June, with selling spilling over into Hong Kong. Amidst the concerns on Greece, our holdings of small/mid cap stocks listed in Hong Kong were not immune and were dragged down along with the China sell-off.

We invest in quality small/mid cap shares listed in Hong Kong, and not in China domestic A-shares. When the media denotes the ÷frothyøChinese market, it is referring to the A-shares, which are traded in Yuan or RMB on the Shanghai and Shenzhen stock exchanges. The Hong Kong exchange is older, and is conducted along western rules and regulations. The Hang Seng Index has risen just 13% this year, well below frothy levels, and trades today at 9.9 times earnings. In many ways, the Shanghai and Shenzhen markets can be likened to õThe Curbö (the market outside on the *curb of* the New York Stock Exchange), which was dominated by individuals (later to became known as the American Stock Exchange).

Chinese regulators initiated additional market opening measures in June, lowering trading costs and allowing the countryøs pension funds to invest in equities for the first time. This should help stabilize share price volatility going forward.

Chinaøs stock market capitalization is the second largest in the world, and though China accounts for 15% of global GDP, its stock markets account for only 2.7% of the MSCI All Countries World Index. As Chinaøs capital markets are more fully opened to foreign institutional investors, there are important fundamentals justifying higher stock prices: real income growth was 8% the past 12 months (the labor market is tight), household savings deposits are near US$9 trillion. Real interest rates are positive (Chinaøs central bank has plenty of room to ease) and ongoing reforms (moving from a centrally planned to a market economy and major State-Owned Enterprise reforms) along with the anti-corruption clampdown, are constructive supports.

During the past quarter, we added 7 new positions to our portfolios and trimmed, or sold completely, 7 holdings which had risen sharply. Our weighted price earnings ratio on this yearøs expected earnings is 7.7 times. We have cash of about 10% of total portfolio value.

The China market correction has subjected downward pressure to many small Hong Kong capitalized stocks. The Hang Seng Small Cap Index, a 198 stock index with many speculative, lower quality names that had advanced sharply during the second quarter, fell 15% in June, before recovering in the last hours. We own just 3 stocks that are included in that index. Our holdings are quality-rated businesses, as measured by ROE, net income and cashflow growth over five years, elevated profit margins and balance sheet strength. Our system provides a maximum price to pay, thereby mitigating risk.

Notably, as the following article confirms, owning quality small company portfolios (minus the junk) can substantially enhance returns. We are confident in holding these sound businesses.

Sincerely,

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If you want to make big bucks, go small

3-16-15 7:08 PM EDT By Brett Arends, MarketWatch

Investors should buy high-quality small cap stocks.

What if there was no great mystery to beating the stock market?

What if building an investment portfolio of great stocks was easier than you think -- and something so straightforward pretty much anyone could do it?

It sounds ridiculous -- something pitched by a charlatan or a huckster offering a dubious advisory service. But according to new research it might be reality.

Five independent stock-market experts, including three hedge-fund managers, and two business-school professors, have just published the first draft of an absolutely fascinating research paper that may turn out to be pure gold for ordinary investors (or, given the disastrous performance of gold bullion recently, better than gold).

"Size Matters, If You Control for Junk" (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2553889) has been written by Cliff Asness, Andrea Frazzini and Ronan Israel of AQR Capital, a Greenwich, Conn.,-based hedge-fund company; Tobias Moskowitz, a professor at the University of Chicago's Booth School of Business; and Lasse Pederson at the Copenhagen School of Business in Denmark.

They've conducted fresh analyses of over 50 years of U.S. stock market data, and over 30 years of data for overseas stock markets, and they've reached a startlingly simple conclusion.

If you had wanted to beat pretty much any stock market over time, at any point, all you had to do was buy the stocks of companies that were both small and "high quality" when measured by things like balance-sheet strength, profitability, stability and growth.

Indeed, according to their analysis, the broad portfolio of such "small cap, high quality" stocks have beaten the overall market by just under five percentage points a year -- which, for the uninitiated, is an absolutely stunning performance.

How did they get there?

Academics and stock market experts have long debated something called the "small-cap effect" -- the question of whether small-company stocks have outperformed large-company stocks over time. Lots of financial advisers and commentators claim airily that small-cap stocks do indeed "outperform," but with "more volatility."

But as Asness and his associates point out, the truth is much more complex. Most of that historic outperformance came in the 1960s and 1970s. During the 1980s and 1990s, for example, small caps did not outperform the wider market. Furthermore, they point out that most small-cap outperformance came during January each year -- during the other 11 months the extra gains from small-cap stocks was minimal.

And when you take into account other things, such as the higher costs typically involved in running small-cap funds, and the greater volatility, the actual benefits from small caps were pretty slight. They weren't a free lunch. They might not even be a free canapé.

But according to the new research, the biggest drag on small-cap performance has been something simple but widely overlooked: Small-cap stocks, overall, tend to be of lower quality than bigger blue chips. Smaller companies, on average, tend to have weaker balance sheets, more volatile businesses, and lower levels of profitability than their bigger peers.

And in recent years researchers -- including the same five experts who have produced the latest paper -- have increasingly demonstrated that, when all other things are equal, the stocks of "quality" companies have beaten "junk" companies by a country mile.

What this means: If you had only invested in small cap, high quality stocks over time then you would have ended up eating two free lunches -- one because they were small, and another because they were high quality. Your portfolio would be stuffed to the gills with profits.

There are some important caveats. None of this addresses the key investment questions of, say, whether this is a good time to invest a lot in stocks at all, or how much of your portfolio you should invest in stocks as opposed to other assets, such as real estate, bonds, or commodities. Both questions are complex.

The only question this research tries to answer is, "If I am going to invest a certain amount in stocks right now, which stocks should I buy?"

Furthermore, a stock is only a claim on future cash flows, and how much you pay for it is going to have a huge influence on your subsequent investment returns. Any investment strategy becomes self-defeating if everyone starts following it, because they will drive up the price. Small-company stocks, and high-quality stocks, have outperformed substantially in recent years. That may -- repeat: may -- be followed by weaker gains.

Nonetheless, the advantage of "small cap, high quality" seems to have been persistent over a long period of time, and in almost every developed overseas market as well (with the odd exception, apparently, of Ireland). Could it really be this easy?

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*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.