January 14, 2016

Dear Clients, Partners, and Friends,

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

	Dec 2015	Year-to-date
Hong Kong Partners LP*	-2.2%	6.2%
Hang Seng Index **	-0.2%	-7.2%
Hang Seng Small Cap Index	-1.3%	-7.4%
MSCI HK Small Cap Index	-1.4%	-16.2%

Partnersø NAV $3.0076 after management fees, but before annual incentive fees of 15% on appreciation.

Our portfolios of small/mid-cap stocks of Hong Kong-listed companies with earnings geared towards China, ended a roller coaster year with a net gain.

South Ocean Management Ltd. was established as a Hong Kong-based, discretionary investment management firm in 1992 (23 years ago). We have traditionally used a fundamental, price to expected growth (PEG) approach of buying shares where the price-earnings ratio was 1/2 or less than expected growth of earnings per share. Four years ago, we began testing an enhanced version of this approach, developing an in-house, proprietary software screen based on Warren Buffettøs fundamental approach.

Since the launch of the system in Dec 2012, the three year results (after expenses) were are as follows:

	Hong Kong Partners L.P.	Hang Seng Index	Hang Seng small cap index
2013	10.7% (after 12% write-downs)	+5.4%	+12.6%
2014	+2.0%	-1.2%	-7.9%
2015	+6.2%	-7.2%	-7.4%
Cumulative	**+20.0%%**	**-3.3%**	**-3.9%**

Our discipline screens for quality businesses, calculating an intrinsic value for each and, importantly, a maximum price to pay based upon StarMineøs reasonable (below consensus) expected growth rates. As we demand a minimum 20% annual return for each purchase, we are not caught ÷chasing growthø with this mechanism-of-safety feature built in.

All our holdings were selected on these principles, resulting in a concentrated portfolio of high conviction ideas that we expect to deliver strong risk-adjusted returns.

Our largest holding, smartphone casing manufacturer, Tongda Group (code 698HK, 7.6% holding, US$983million market cap) gained 46.4% in price last year. Tongda is one of the largest manufacturers in the production of handset casings for mobile phone companies, producing more than 100 million units a year. Clients include top brands, such as Huawei, Xiaomi, Asus, ZTE and Lenovo. The group, a global leader in the use of in-mould lamination (IML) technology, also makes panels and parts for notebook computers, electrical appliances, and decorative panels for cars.

I was impressed with the people and manufacturing facilities I saw when visiting the companyøs operations in Fujian Province, China several years ago.

Today, the group has six factories in Shenzhen, Xiamen, Shanghai and Suzhou, employing around 19,000 people.

The Chairman and founder, Wang Yanan, set up Tongda in 1988 and went public on the Hong Kong stock exchange in November 2000. The Chairman started with a small family-run factory in 1978 making metal and plastic parts for electrical appliances such as DVDs and VCDs. As China opened up in the early 1980s, there was burgeoning demand for electrical appliances such as refrigerators, washing machines and air conditioners. The Company began working with giant electrical appliance makers such as Haier, Changhong and Konka for different products.

Handset casings now account for 65 to 70% of the group's revenues. There are hundreds of different casing designs which Tongda manufactures as most mobile phones have the same software, but different look and designs of the hardware.

While the company will focus on its handset casing business in the coming years (with next year looking particularly strong), it envisions the car market, which it entered two years ago, as potentially its next growth driver.

Last yearøs revenues are projected at HK$6.2 billion (US$800 million), a gain of 29% over 2014øs HK$4.8 billion (US$620 million) in sales. The shares sell at 10.8 times December 2015øs estimated earnings.

Tongda remains a long term, core holding.

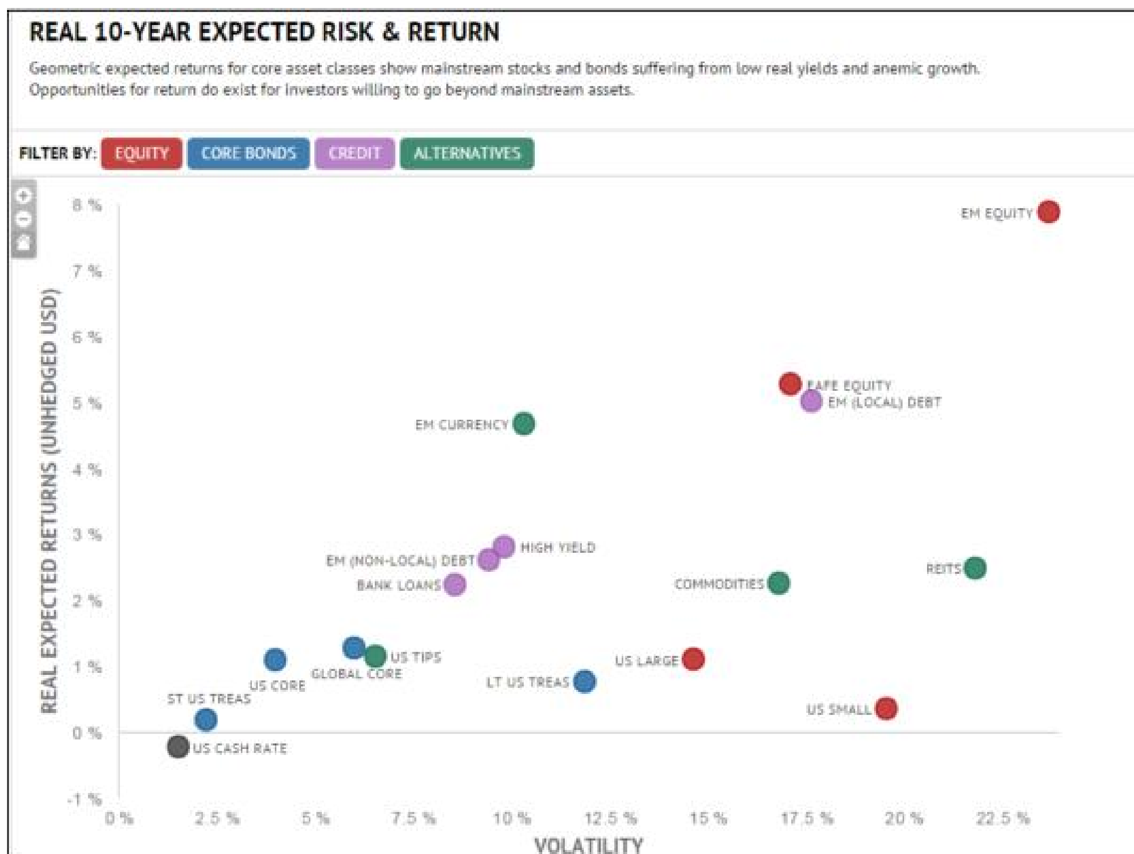
Many of our positions have come down with the general market to attractive levels again. For example, our holding in a leading wire and cable producer for power transmission in the PRC has seen earnings per share grow 30.1% compounded over the past 5 years. We have a 3.4% position in this HK$5.2 billion (US$670 million) market capitalized share. First half revenues last year gain 17% to RMB3.9 billion (US$600 million), with net profit gaining 16% to RMB288mn (US$44 million). The depressed shares trade today at just 5.5 estimated 2015 earnings and a dividend yield of 4.9%.

Our holding in Haudian Power (code 1071hk, 2.9% holding, US$9.8billion market cap), a major electric/wind power utility in China, lagged in the second half last year. Last yearøs slowing of electric power usage on the mainland (especially from depressed sectors such as mining and heavy industry) was greater than anticipated. Shares now sell at a single digit P/E (5.4 times), 1.9 times book value per share, and a dividend yield of 6.5%. Even after our gain of 44.7% since purchase two years ago, we remain holders of the position.

Overall, our portfolioøs weighted average estimated P/E for 2015 is 9.7x and 8.7x for 2016, with a weighted average dividend yield of 5.0%.

Recent volatility in Chinaøs financial markets (with foreign media uniformly negative for the past five years on the PRC) has created uncertainty, keeping most players out of the markets. In fact, global investors are under-invested in all Emerging Market equities.

The following chart from Newport Beach-based Research Affiliates shows the 10-year expected rates of risk and return from all asset classes, with EM Equities (Emerging Markets) in the top right quadrant (highest returns) and the US forecast to have the lowest returns (negative returns from cash!):



Research Affiliates forecast of the 10-year real return for U.S. equities is 1% compared to that of EM equities at 8%, with EM now valued at less than half the U.S. CAPE (cyclically adjusted price-to-earnings ratio).

This illustrates vividly typical investor short-term, rear-view behavior today.

Moreover, fund managers surveyed by Merrill Lynch demonstrates further the underweighting of Emerging Markets in the next chart - the largest manager underweighting since the survey started 15 years ago:

CHART 3: Bank of America Merrill Lynch, FMS Relative Positioning

Extreme EM underweight in our equity fund manager survey

Source: BoA Merrill Lynch Global Researsrch, Global Fund Survey

This positioning underpins our contention the extreme pessimism towards China which, though classified as an emerging market, is ranked by investors and the media more a Zimbabwe-like, imploding country.

Our observations suggest otherwise.

For instance, Hong Kongøs South China Morning Post carried an article this summer that was eye-opening. China is, by most measures, the worldøs 2nd largest economy just behind the US, but is awash in assetsí even greater now than the US;

> China has overtaken the U.S. as the world's wealthiest nation in terms of built assets in 2014, and is likely to double that of the U.S. by 2025, according to the Arcadis Global Built Asset Wealth Index.
>
> China has the largest stock of built assets at $47.6 trillion in 2014 and the U.S. came in second at $36.8 trillion…The study compares 32 countries in terms of their buildings and

infrastructure – homes, schools, roads, airports, power plants, malls, rail tracks and other structures.
In fact, China's stock of built assets will exceed the next four economies combined in the next 10 years…

China's built asset wealth per person stood at $34,100, which ranks it No. 24 worldwide… The latest figure is slightly less than a third of the U.S. per capita figure of $114,100. In per capita terms, however, populous China appears far from being overbuilt.

With its net assets having surpassed those of the United States, China is **well positioned to deal with any major financial crisis**…

Awash in assets, China well-placed to ride out any financial crisis, top academy says

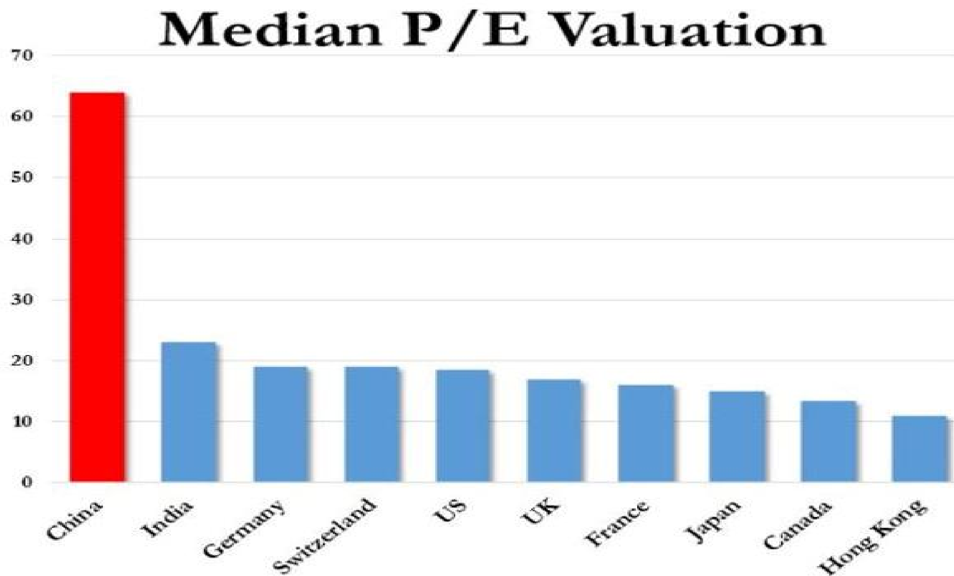
Chinaøs massive restructuring and reform efforts, to migrate its economy from a predominately export-related to a service economy, is in full progress. The successful inclusion of the yuan in the International Monetary Fund's (IMF) reserve currency basket sets the stage for further opening of the country's financial markets. This is significant as it places the renminbi on par with the major global currencies (the U.S. dollar, the euro, the British pound and the Japanese yen). It will enhance public- and private-sector acceptance of Chinaøs currency in the international monetary system.

(Regarding the fright instilled in the markets regarding Chinaøs Yuan currency moves this year, David Bloom, HSBC Global Head of FX Strategy gave a terrific 3 minute synopsis here on Bloomberg TV today).

Although the Chinese economy may produce *only* 6% or 7% sustainable growth over the intermediate term, it would certainly be one of the few major producing regions capable of delivering high real growth rates over the next five years.

The PRCøs reduced economic growth outlook is still compelling especially relative to the slow-growing developed world. Value investors are more and more looking into owning China-related investments (see our comments last year regarding remarks from contrarian investors Wilbur Ross and Howard Marks).

Notably, Hong Kongøs stock market, a major beneficiary of Chinaøs growth, is one of the cheapest major stock exchanges (if not the cheapest):



(As indicated before, we own no China domestic shares, just Hong Kong-listed companies).

We have postulated in these letters that global investors are incredibly underweight China-related equities and will have to buy an insane amount of shares in the region just to meet global index benchmarks. According to Morningstar data and a sample of over 200 international (ex-USA) funds managed in the USA, even though the MSCI ACWI ex-USA benchmark has a 4.98% weighting in China (which will surely be increased in the future), the median manager has an investment of just 1.7%, less than half the index weighting.

China today, with the second largest stock market in the world, has almost no foreign exposure. As one analyst opined:

1. **China is the world's second-largest economy**.
2. **NOBODY owns its stocks**.
3. **NOBODY holds its currency**.

Think about the insanity of that...

We have held 15+% cash levels since early last summer, not committing these funds until the height of last weekøs panic sell-off when we deployed about

1/3rd into various undervalued, beaten down stocks (from the highs in May, the Hang Seng Index has declined ~30%).

We will continue to take advantage of short-term volatility in these turbulent markets, paying close attention to risk management.

Below is a review on further thoughts on China.

Sincerely,

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Hong Kong

Over the holidays, I read a richly analytical and fascinating book, The Fourth Revolution: The Global Race to Reinvent the State by John Micklethwait (editor-in-chief of Bloomberg News) and Adrian Wooldridge, (managing editor of The Economist). They argue there have been three õsciences of politicsö since the dawn of the modern era that have proven indispensable to mankindøs advancement.

The authors believe that the fourth great revolution of government is now underway and China is in the vanguard.

The implications are immensely positive for the outlook of the Middle Kingdom.

Though the book cites the common opinion that the U.S government is in a declining stage - inefficient, bloated, entitlement-driven and dysfunctional (describing the State of California as an example of what ails western democracies in general) - the two authors are upbeat and explore resourceful new ideas that result in increased efficiencies in the State.

The introduction begins with the authorsø visit to an ÷academyø in the Shanghai suburb of Pudong to train Chinaøs upcoming leaders. The purport of the bookøs chief assessments were best described by research firm, 13D Research:

> Micklethwait and Wooldridge describe the amazing effectiveness of the China Executive Leadership Academy in Pudong (CELAP). They write that it is too disciplined and businesslike to be a university. Rather, it is õan organization bent on world domination.ö The students at the

academy are Chinaøs future rulers. About 10,000 people a year attend courses at CELAP. Every Chinese civil servant is expected to have three months of training every five years at CELAPô or 133 hours a year. The two central questions driving the schooløs mission and curriculum: õWhat works best?ö and õCan it be applied here?ö

For a Western politician visiting CELAP, the response is not dissimilar from that of a Western manufacturer visiting a Shanghai factory two decades ago: awe, and perhaps a degree of fear. As the authors note, CELAPøs ambitions are broad but clear: õJust as China deliberately set out to remaster the art of capitalism a couple of decades ago, it is now trying to remaster the art of government. The main difference is that the Chinese believe that nowadays there is far less to be gained from studying Western government than they did from studying Western capitalism.ö

Looking forward, a countryøs success will depend overwhelmingly on its ability to reinvent government. China appears to be leading the way. The West, not surprisingly, is lagging.

A noteworthy example in recent times was the plight of Nordic countries (Sweden, Denmark and Finland). Swedenøs socialistic government went bankrupt, which started new thinking. Perhaps serious bankruptcy in the US is needed to bring about similar efficiencies.

This fourth revolution is incredibly bullish for those countries striving to rethink their management.

Thirteen hundred years ago, China set up an imperial exam system to find the best young people to become civil servants. As the authors observe: õFor centuries these ÷mandarinsø ran the worldøs most advanced government, but in the nineteenth century the British and the French (and eventually the Americans) stole their systemô and improved it. Since then better government has been one of the Westøs great advantages. Now the Chinese want that advantage back.ö

That advantage will come in the form of a more efficient government. America is not CELAPøs model, but Singapore is. Singapore has plenty to emulateô its worldclass schools, hospitals, effective system of law and order, thoughtful industrial planning, and a lean public sector that is half the size proportionately of Americaøs.

> õFor the Chinese, Singapore is the Silicon Valley of government. Even the idea at the heart of CELAPô training an elite civil-service cadreô is based on a Singaporean model, though the Chinese boast that its requirements are more onerous.ö The authors point out that CELAP is not unique. Across much of the world, save Western Europe and America, politicians and bureaucrats are looking for new leadership ideas. õThe main political challenge of the next decade will be fixing governmentí A revolution is in the air, driven partly by the necessity of diminishing resources, partly by the logic of renewed competition among nationstates, and partly by the opportunity to do things better.ö
>
> There is far more deep thinking going on about how to improve government in Beijing than there is in Washingtonô and this raises serious questions about the efficiency and longevity of democracy.
>
> Such fears are not new. Micklethwait and Wooldridge quote John Adams, Americaøs second President and one of the founding fathers:
>
> *Democracy never lasts long…It soon wastes, exhausts and murders itself…There never was a democracy yet that did not commit suicide…It is in vain to say that democracy is less vain, less proud, less selfish, less ambitious, or less avaricious than aristocracy or monarchy. It is not true, in fact, and nowhere appears in history. Those passions are the same in all men, under all forms of simple government, and when unchecked, produce the same effects of fraud, violence, and cruelty.*

The authors note that today few people question the strengths and weaknesses of the democratic system.

> õOn the one hand, voters have scant respect for the governments that democracy has landed them with: To varying degrees, they loathe their leaders and regard them as corrupt and inefficient. On the other hand, they assume that democracy is beyond criticism, a permanent feature of political life. They hate the practice, but never question the theoryí [The problem is that] they continue to want a great deal [from government]. The result can be a toxic and unstable mixture: dependency on government on the one hand and disdain for government on the other. The dependency forces government to over-expand and overburden itself while the disdain robs government of its legitimacy and turns every setback into a crisis.ö

> Complacency, partisanship and entitlement have consumed leadership in much of the West. Governments from Beijing to New Delhi to Jakarta are eagerly seeking bold, new leadership formulas for the 21st century.

One cannot be bearish about China after reading this book.

Brook McConnell
Hong Kong

*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.