July 15, 2021

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:

	Jun. 2021	Year-to-date
Hong Kong Partners LP*	-3.7%	14.0%
Hang Seng Index**	-1.1%	5.9%
Hang Seng Small Cap Index	0.4%	16.5%
MSCI HK Small Cap Index	1.3%	22.5%
HS Mid Cap Index	-1.6%	9.2%

Partners' NAV $2.6591 after management fee and provisions, but before annual incentive fees of 15% on appreciation.
Please refer to footnotes at the end of this commentary for descriptions of the Fund's indexes and Fund risk disclosures.

"*So these are the areas you want to look at. The things that are* ***downtrodden****. You want to get the ones... that will recover, not the ones that won't. You want to look into the emerging markets and maybe China certainly...*"

-Latest interview with Bloomberg, Howard Marks, June 16th, 2021

South Ocean Management Ltd.'s Limited Partnership fund, Hong Kong Partners LP, founded 28 years ago, has been investing in the growth of China through fundamentally strong companies listed in Hong Kong since its beginning.

Hong Kong Partners LP outperformed in the first half of this year, gaining 14.0% (net). The Morningstar average Hong Kong equities mutual fund year-to-date results (of 49 funds) was +4.96%.

During June, certain areas of the Hong Kong stock market were volatile. Lumber prices, for instance, were off more than 40% in June, affecting paper stocks. Hog/Pork names were lower as pork prices have dropped 42% since mid-February. Small cap stocks were flat but the Hang Seng Material stock index was weak (down 13% in June alone). Several tech and material constituent stocks are off 30-50% from recent highs. We added to a few of our positions on the sharp declines.

Though our disciplined approach may be out-of-favor at times, we seek fundamentally strong companies, with stable earnings and avoid yet-profitable companies such as popular technology stocks. Our holdings in leading down apparel maker Bosideng International (code 3998hk, HK$60.5 billion market cap, US$7.8 billion) and leading glass manufacturer, Xinyi Glass (code 868hk, HK$128.5 billion market cap, US$16.5 billion) both reported solid outlooks and were outstanding performers in our portfolios in the first half.

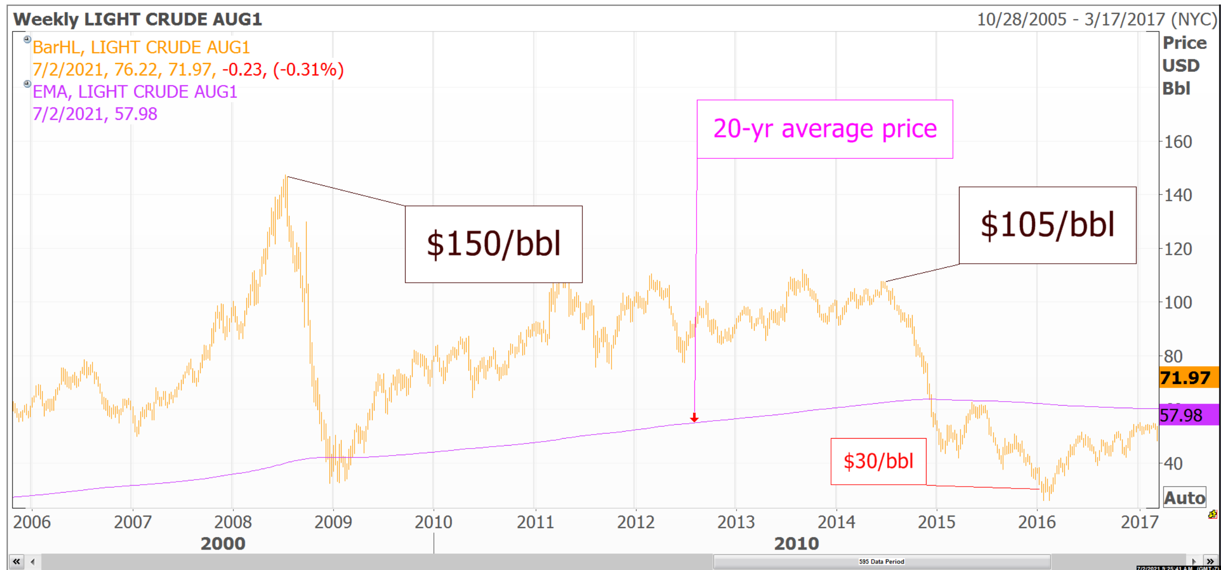
In the middle of last month, our holding in China Gas (code 384hk, HK$131 billion market capitalization, US$16.8 billion) was adversely affected by an unfortunate gas explosion in Hubei Province. China Gas is involved in city piped gas projects, in urban and rural gas projects, throughout the PRC. China has committed to the peaking of carbon emissions by 2030 and becoming carbon neutral by 2060. The country is promoting the 'replacement of coal with gas' in industrial and commercial sectors.

Though China Gas reported a 14% year-over-year increase in profits later in the month (and predicted solid prospects for the year ahead), we wait for the results of the investigation into the gas explosion before we would add to our position.

Mean reversion is a financial term that assumes an asset's price will tend to converge to the average price over time. As one of my investor friends once stated:

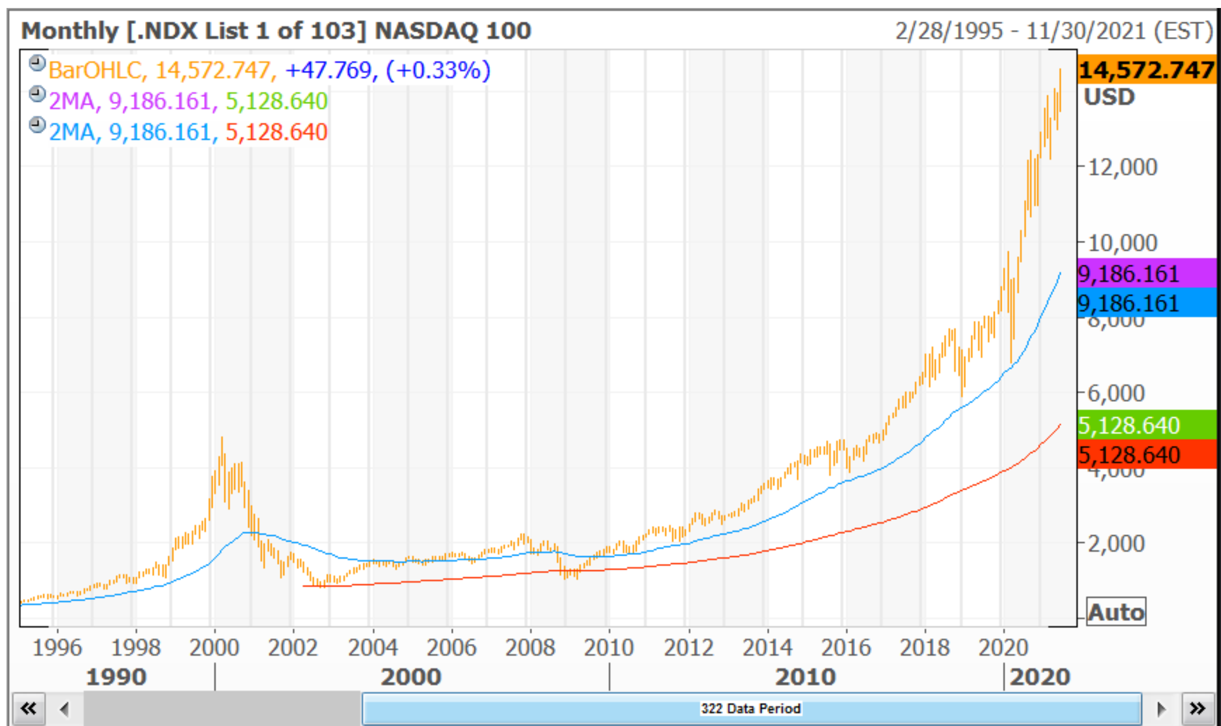
> When people talk of mean reversion, they usually forget to mention that this does as a rule does not just mean 'return to some average'. If one looks at such data series, they seem to have a strong tendency to move from one extreme to another. The bigger the extreme in one direction, the more likely the pendulum is eventually going to swing all the way in the other. What we don't know is when it will happen...

Even though it 'seems different this time,' markets inevitably mean-revert. A classic example was the price of oil from 2005 to 2017. West Texas Intermediate Light Crude moved to an extreme in 2008 of $150/barrel (when Goldman Sachs famously forecast a $200/bbl price target) and again in 2014, (which the price then proceeded to revert below its 20-year historic average):

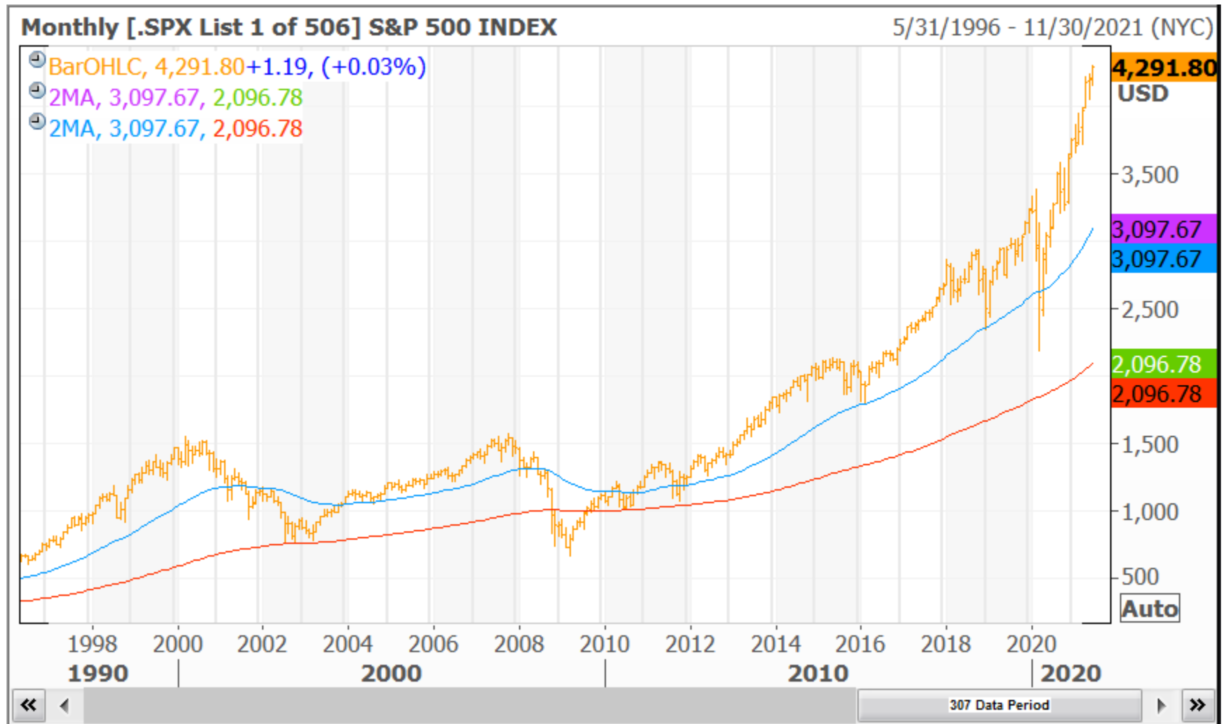


Today, though, the US and Hong Kong markets have dissimilar comparisons.

The Nasdaq 100 Index trades 60% above its long-term trend (blue line):

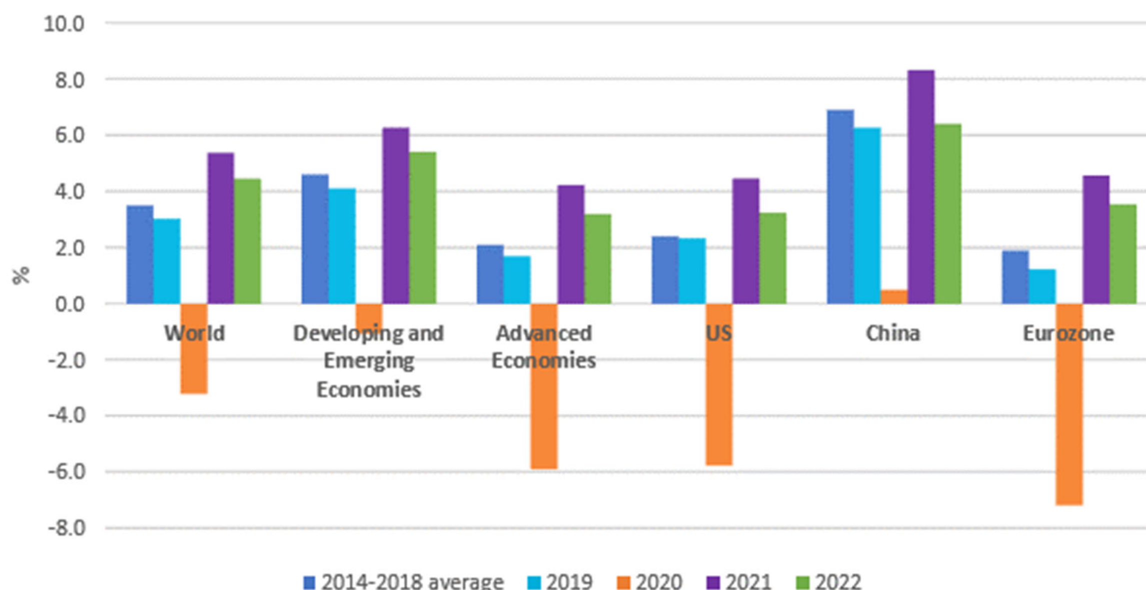


A similar rise above the long-term average is evident with the US S&P 500 Index:



The Hang Seng Index, however, trades much closer (just 9% above) to its long-term price trend:

In other words, Hong Kong stocks don't incur the extreme mean-reversion risks inherent in the US markets. With China having controlled the 2020 pandemic (it was the only country to witness economic growth for the year):



...The Middle Kingdom has a first mover advantage and head start to reinvigorate its economy.

With its financial health powering ahead, coupled with a global resurgence, it's not unreasonable to assume things are looking up for Chinese investments.

And, **downtrodden** Hong Kong shares stand to benefit. More on the strength of this outlook in the article copied below.

Sincerely,

Brook McConnell

President – South Ocean Management, Ltd. Hong Kong

Email: brook@south-ocean.com Website: www.south-ocean.com

"Americans Don't Know How Capitalist China Is"

An interview with Weijian Shan
by
- Adi Ignatius

From the Magazine (May–June 2021)

Jun Cen

Spotlight Series / **Understanding China**

Summary. Weijian Shan was born in China and had his life upended by the Cultural Revolution. Educated in the United States, he worked for the World Bank and J.P. Morgan and taught at the Wharton School. Today he is the CEO of PAG, a $40 billion private equity firm based in...more

Weijian Shan understands the delicate U.S.-China dynamic as well as anyone. He was born in China, and his life was upended during the Cultural Revolution, when he was sent off to do farm labor in the Gobi Desert. Eventually he came to the United States, where he earned a master's and a PhD at UC Berkeley, worked for the World Bank and J.P. Morgan, and taught at the Wharton School. A candid observer of Asian society and business, Shan is the author of Out of the Gobi: My Story of China and America and the newly published Money Games: The Inside Story of How American Dealmakers Saved Korea's Most Iconic Bank. Now CEO of the Hong Kong–based $40 billion private-equity firm PAG, Shan spoke with HBR Editor in Chief Adi Ignatius about the economic prospects for China and the United States.

HBR: China's economy seems to be the healthiest in the world at the moment. Does that create new investment opportunities?

Shan: Despite initial blunders, China has handled the coronavirus pandemic well through strict lockdowns and mass testing. Its GDP dropped 6.8% in the first quarter of 2020, but resumed growth from the second quarter onward. China has been shifting away from an investment-driven growth model to one led by private consumption. A decade ago its retail-goods market was about $1.8 trillion—less than half that of the United States. In 2019 that market reached $6 trillion, surpassing the U.S. level of $5.5 trillion. Even now China's private consumption represents only about 39% of its GDP—way below the U.S. level of 68% and the world average of 63%. That leaves much room for growth and many opportunities for investors, particularly in businesses that cater to consumers.

Investors have always been enticed by China's vast market. How accessible is it these days?

Our firm, PAG, invests throughout Asia and occasionally beyond. China's is the only major economy that requires no special approval for foreign direct investments, although some sectors, such as Lived Change media and the internet, are on a "negative list" that restricts them. However, there are usually lawful ways to get around that. PAG invested about $100 million in a digital music business in China a few years back which subsequently merged with a similar business and changed its name to Tencent Music Entertainment. Today it's traded on the New York Stock Exchange with a market cap of about $45 billion and has more than 800 million unique active users. The name of the game in China is scale. If a business is

successful, it's usually open to taking outside capital so that it can quickly expand nationwide. That's why China is the most active private-equity market in Asia.

Trade wars, nationalism, and the pandemic have led many companies to question their supply chain strategy—in particular basing manufacturing in China, thousands of miles from their markets. Are you seeing a significant shift in supply chains out of China?

Some manufacturing has been relocated away from China since the trade war with the U.S. began in 2018, but that hasn't made a dent in either China's exports or America's trade deficit. In fact, the pandemic has made the world *more* dependent on Chinese exports, which grew 21% in November over the previous year. The point is that a China-based supply chain has proved a blessing, not a curse, in this pandemic. Any shift in supply chains will be gradual and partial, because it's very costly to move from the most efficient supplier to the second or third best. American companies will do so only if U.S. tariffs become more penalizing than moving would be. Also, while it's relatively easy to shift the sourcing of a low-value-added product from China to Vietnam or Mexico, how can you move an entire supply chain with many indigenous players? And what if the market itself is in China? GM sells more cars in China than in the U.S., Canada, and Mexico combined. Where can it move its production if the target market is China? China is also Apple's biggest market for iPhones: It has about twice as many iPhone users as the United States does.

The U.S. continues to vilify China, and China does itself no favors with its poor policy on human rights. How can outside investors ensure that they don't become collateral damage in a bigger political and economic war?

Both countries have human rights issues, although in different forms. Investors anywhere should invest in a socially responsible way to advance human rights, adhering to a high standard for labor practices, gender equality, investment in human capital, and charitable contributions. Wherever PAG operates, we adhere to the same environmental, social, and governance policies.

The Trump administration was determined to damage China's economy and businesses. Does the U.S. even have the power to hurt China economically?

Here and there, yes, but not in a meaningful way in general, and not without harm to itself. Trump's trade war was an abject failure. Its stated purpose was to reduce America's trade deficit. In November 2020 China's trade surplus with the U.S. was 70% greater than it had been in January 2017, when Donald Trump took office. Meanwhile, American consumers have paid for the higher tariffs, because the average prices of Chinese exports haven't decreased. China's GDP is forecast to grow 7% to 8% this year. That means that despite the trade war, the technology war, and the capital war—the U.S. government's restricting American investment in China—China's GDP will most likely be 10% bigger in 2022 than it was in 2019, whereas the U.S. economy probably will only recover to 2019 levels by 2022, according to the International Monetary Fund. It seems that the only country that can stifle China's growth is China itself—if it makes major policy mistakes. And only the U.S. can

threaten America's economic supremacy—by underinvesting in its own infrastructure and by limiting trade.

What are the dangers in America's continued demonization of China?

Much of Donald Trump's rhetoric and his actions on China were meant to deflect attention from his leadership failures at home, such as neglecting his duty to protect the public from the coronavirus. With less than a quarter of China's population, America has a death toll about 100 times China's and counting. Some real differences between the two countries do exist, but they have historically managed them without escalating tensions. The United States had maintained a fairly consistent foreign policy until Trump. The Biden administration is expected to restore that policy and to work within the rules of international institutions, which I expect will defuse tensions. When Nixon first visited China, in 1972, the differences between the two countries were vast, in political and economic systems and of course in ideology. Yet they found common ground to work in mutually beneficial ways. Today the differences are arguably a lot smaller, and there are many areas in which the two can benefit from cooperation. After all, each is the other's largest trading partner, and China has lent more than $1 trillion to the U.S. government by holding U.S. Treasury bills. Let's be honest: A rising China may be a threat to America's economic and technological supremacy, but not to its national security, because China doesn't export its ideology or political system and doesn't seek regime change anywhere in the world. But it won't back off from its territorial claims, all of which predate the People's Republic of China. The real danger is the Taiwan issue. If the U.S. abandons the one-China policy and supports Taiwan's independence, conflict will be inevitable, with unimaginable consequences for the world market.

Is a China-U.S. decoupling a real possibility?

Not completely and not without very high costs. The technology war waged by the Trump administration forced China to develop critical technologies, such as semiconductor chips, for which it has relied on U.S. suppliers. It will take years if not decades for China to catch up in some areas, at great cost. But the technology war also hurts U.S. suppliers. The top 10 American semiconductor chip makers sell about three times as much in China as in the United States. Losing the China market will be costly for American tech companies and deprive them of funds for further R&D.

What are the biggest risks for China's economy in the coming years?

The economy has grown 36-fold over the past three decades, chiefly because of market-oriented reforms that have created a vibrant private sector, which now accounts for about two-thirds of China's GDP. But the state-owned sector remains too big and inefficient. Great challenges lie ahead. China's saving rate will drop significantly as its population ages, and investment will slow. The country will need to continue to reform and privatize its state-owned firms—and shift from investment to private consumption—or it will not be able to sustain its growth.

Are you concerned about China's debt?

I see no systemic risk either in China's banking system or in its economy. Pundits tend to be alarmed by a default here and there. But defaults and bankruptcies are common in a market economy. Only a sudden surge of such events would herald an economic crisis. In 2020, a year of severe difficulties all over the world, there was no significant increase in Chinese corporate defaults. In fact, China is the only G20 country to have posted positive growth. Its monetary policy is reasonably tight, with the yield on government bonds about 3.5 times that on U.S. Treasuries. Its currency appreciated 6% against the dollar last year. All these testify to the strength of the Chinese economy.

What is it that Americans don't understand about China?

They don't know how capitalist China is. China's rapid economic growth is the result of its embrace of a market economy and private enterprise. China is among the most open markets in the world: It is the largest trading nation and also the largest recipient of foreign direct investment, surpassing the United States in 2020. The major focus of government expenditure is domestic infrastructure. China now has better highways, rail systems, bridges, and airports than the United States does. For example, over the past 15 years it has built the longest high-speed rail system in the world. At 22,000 miles, it is twice as long as the rest of the world's combined. China's high-speed rail could cover the distance between Boston and Chicago in about four hours, whereas Amtrak's fastest service takes 22 hours. One reason China can spend so much on infrastructure is that its defense budget, after years of increases, is still only about a quarter that of the United States.

And what is it that the Chinese don't understand about the United States?

They don't know how socialist it is, with its Social Security system and its policies to tax the rich by collecting capital gains taxes. China is still in the process of building a social safety net that is largely undefined and underfunded, and it has no tax on personal capital gains. In 2020 China had more billionaires than the U.S. did, and it outpaces the U.S. three to one in minting them. Consequently, inequality is greater in China than in the United States, measured by the Gini coefficient.

A version of this article appeared in the May–June 2021 issue of *Harvard Business Review*.
Read more on **Globalization** or related topics **Global strategy**, **Economics** and **East & Southeast Asia**

- **Adi Ignatius** is the editor in chief of Harvard Business Review.

*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.
The S&P 500 Index is a market capitalization- weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard and Poor's chooses the member companies for the 500 based on market size, liquidity, and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies.

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.