



January 12, 2012

Dear Clients, Partners, and Friends,

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

| | <u>Dec 2011</u> | <u>Year-to-Date</u> |
|-----------------------------|-----------------|---------------------|
| Hong Kong Partners LP (net) | 2.2% | - 32.7 % |
| Hang Seng Index | 2.5% | -20.0 % |
| MSCI HK Small Cap Index | -2.1 % | -28.6% |

Partners' NAV for Dec 2.3535 after management fee, but before annual incentive fees of 15% on appreciation.

ACCORDING TO THE CLASSIC TOME I CHING, DRAGONS SHOULD STAY OUT OF THE WATER.

BUT 2012 IS THE YEAR OF THE WATER DRAGON, WHICH MEANS THE DRAGON IS HIDING IN DEEP WATER AND THAT WILL CREATE PROBLEMS WORLDWIDE.

DRAGONS SHOULD BE FLYING IN THE AIR TO COMMAND AND STRIKE ACCORD.

A DRAGON IN THE WATER IS TRAPPED OR IN HIBERNATION - AND IT IS HELPLESS.

As we end this Year of the Rabbit and enter the Year of the Dragon, we want to thank and wish all our Clients, Partners and Friends, a very Happy New Year.

Sincerely,

Brook McConnell
President

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

Last year was one tough one for equities. Global stock market capitalization dropped 12.1 percent to \$45.7 trillion in 2011, according to Bloomberg data, and that included a flat year in the largest capitalized market, the USA.

Asian equity markets were hit particularly hard with Japan's Nikkei index losing 17.3 percent, Hong Kong's Hang Seng index 20 percent and the Shanghai Composite 22 percent.

A reported 123 hedge funds in Asia shut down during the year (through November). This count is second only to the massive liquidations that occurred post Lehman Brothers in 2008. Many funds are wrapping it up today as the promise of a hedged portfolio that would make money in markets that both went up and down, withered like grapes left on the grapevine. By October, the Hang Seng Composite Index, comprised of the top 386 market-capitalized stocks, had 91 names that posted price declines of more than 50% for the year. Selling of China shares was relentless through the third quarter.

This performance was discouraging. By the fourth quarter, the blue chip Hang Seng Index had fallen all the way to levels first reached in 1997; 14 years ago!



(Over that period, though, our Delaware LP, Hong Kong Partners LP, August 1997 through August 2011, gained **120.3%**, net).

As uncertainty grew in the second half, many investors either went to the sidelines or speculated in warrants or CCBBs (Callable bull/bear contracts reached a single-day record of HK\$15.7 billion in transactions on October 11. A CBBC is a derivative product that allows an investor to make a leveraged bet on the direction of an underlying asset, either a stock or an index). When investors start buying structured products, fewer invest in shares.

Hong Kong's IPO market sank in the second half last year. Smaller company new issues fared extremely poor. Even the two largest IPOs, Glencore International and Hutchison Port Holdings, went down 25%, more than the overall blue chip index.

By the end of August, small caps had declined 15.1 % (after rising 2% in the first four months of the year), many selling down to low single digit price earnings valuations (the small cap index, for the three months ending August, declined 17.1%).

In September alone, the MSCI Hong Kong small cap index fell another 13.3%, to top off the summer declines. Subsequent performance remained lackluster through the end of the year, on very light volumes.

Glad 2011 is behind us!

THE TWIN CONCERNS OF THE Euro-zone crisis and China's slowdown weighs heavily on investor's minds as we enter 2012. These two impediments will not be easily rectified, at least in the short run.

The market has priced in a very hard landing for China's economy. Daily press reports have resembled this:

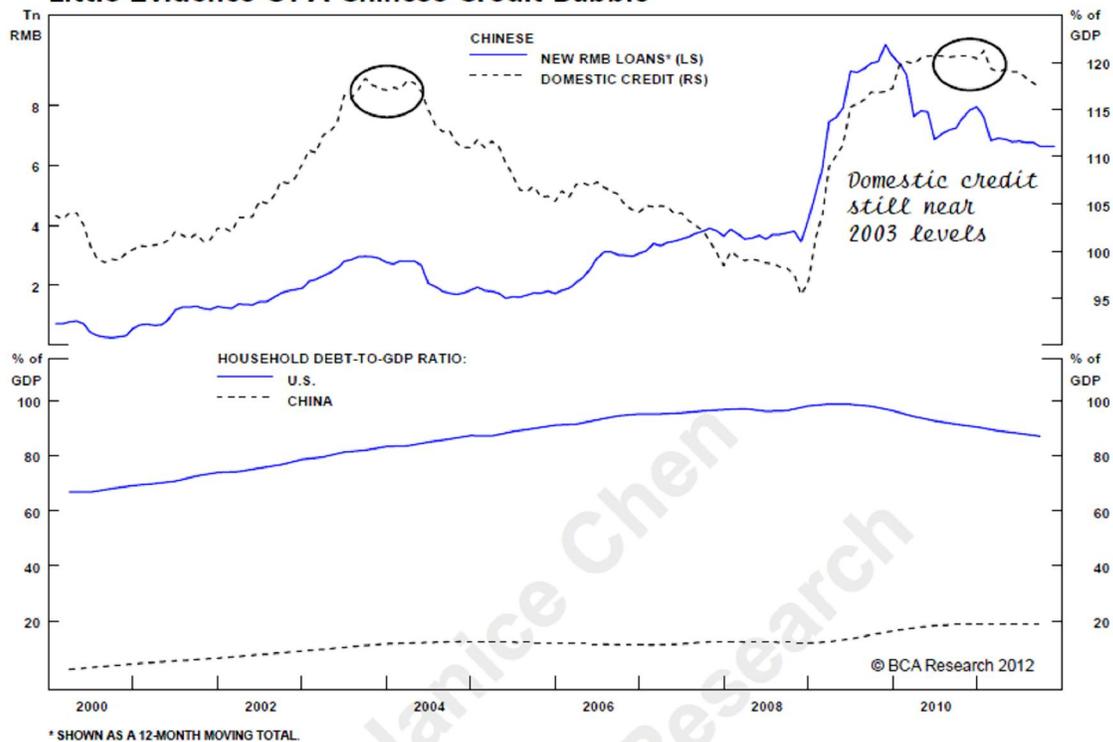
The government spent 15% of GDP largely on public works projects in inland regions, financed with loans from the state-owned banks. Investment as a share of GDP soared to 48.5% in 2010, and the M2 measure of money supply ballooned to 140% that of the U.S.

Now comes the hangover...

Granted, China has its problems, but has played its cards well. Beijing recognized the property bubble and deliberately popped it. Importantly, China is a relatively unleveraged economy. Bank credit to property developers is less than 10% of overall bank credit, so relatively little exposure of China's banking system to the real estate sector. Also, the bank loan-to-deposit ratio is just 70%, so banks have plenty of back-up liquidity to deal with any potential sour loans.

Note the difference between household debt in China versus the USA in the bottom section of the following chart. It hovers at levels way below what even developed economies rank;

CHART 26
Little Evidence Of A Chinese Credit Bubble



China can absorb a lot of loan default distress because it is unleveraged.

The HSBC China services purchasing managers index (PMI, a barometer for domestic economic conditions), which stood at 52.5 in December, was unchanged from November. That signals a steady, if sluggish, expansion in the sector. Notably, it was the 74th straight month that the index had read above 50. The steady state of the HSBC index reinforces the observation that China's economic slowdown will be modest and brief.

Lastly, the People's Bank of China (PBOC) cut the Bank Reserve Rate Ratio (RRR) by 50bp on December 4 for the first time in over 2 years. This signals a shift by Chinese authorities. With inflation coming under control and the government moving to back-stop growth, a swift re-rating of greater China valuations could easily evolve.

Local commentator Stephen Vines noted the cheap valuations in Hong Kong, Dec 12, 2011;

...Here in Hong Kong, we are down to a historic PER of eight times, with an average yield on shares of 3.8 per cent.

A year ago, the market was trading at an average PER of about 14, yielding a more modest 2.5 per cent. When the market reached its peak in 2007, the PER was about 26 times and the yield was a miserable 1 per cent.

So, there is no doubt that shares are rather cheap now...the corporate sector is in far better shape than the economies within which most companies are operating.

In Hong Kong, companies are not only unburdened by debt but are sitting on an average HK\$3,000 in net cash per share. Overall earnings for Hang Seng Index constituent companies are expected to rise 11.2 per cent this year and 13.5 per cent next year...

South Ocean invests primarily in small/mid caps listed in Hong Kong. We concentrate in areas of the Hong Kong equity market where there are often mispriced stocks (and Hong Kong's stock market, especially in the small cap sectors, is particularly inefficient).

Because large caps, such as China Mobile and HSBC, have more than 40 research analysts covering these names, we find little opportunity to add any value to a portfolio, by analyzing the analysts.

Over a cycle, though, small caps outperform in Hong Kong.

While larger companies generally offer better liquidity, we look for smaller, undiscovered names that are likely to grow into the radar screen of institutional buyers/analysts, given several years expansion. As Warren Buffett's partner Charlie Munger was quoted, *"How do you get into these great companies? One method is what I'd call the method of finding them small get 'em when they're little. For example, buy Wal-Mart when Sam Walton first goes public and so forth. And a lot of people try to do just that. And it's a very beguiling idea. If I were a young man, I might actually go into it."*

We look to find bargains in the less followed, smaller capitalized sectors of Hong Kong's stock market. But, we don't invest in the China A share domestic markets.* *Why don't we invest in China A shares? Simple: insider trading, market manipulation and massive stock scams.***

My partner (Percy Au-Young) and I visited close to 100 companies last year together. When we find good ideas, run by able managers, we generally like to add to these positions on market declines. In fact, concentration is where we have achieved above average returns. Or as Charlie Munger (again) puts it, *"loading up,"*

I think a select few - a small percentage of the investment managers - can deliver value added. But I don't think brilliance alone is enough to do it. I think that you have to have a little of this discipline of calling your shots and loading up - if you want to maximize your chances of becoming one who provides above average real returns for clients over the long pull.

Our portfolios were relatively quiet in December except for one event: Li & Fung Company (the unlisted arm of the Fung family) made an offer to acquire retailer Hang Ten (448 HK ó). The offer price at HK\$2.7 per share was a 59% premium against the last closing price of HK\$1.7, or about 11x historical PE (FY3/11). We will be accepting the cash offer for our 8%, long time holding in the retailer.

This was our third takeover for the year. While we are not speculating on takeover events, it's an indication that real companies see our holdings as cheap as well. Low interest rates and cheap stock prices are conducive for takeovers today. These upticks in our returns from surprise bids for our holdings is gratifying, though we lose having a terrific operating company as a part of our portfolio, and need to find its replacement.

Since last summer, we have chronicled the saga of short sellers uncovering fraudulent China shares listed in North America. This pall affected private China-related listings in Hong Kong as well. Two of our holdings, vegetable producer, Chaoda Modern Agriculture and China's largest orange grove firm, Asian Citrus, were both accused by anonymous short sellers of fraud. As an update, though Chaoda has been suspended from trading since late September, we remain encouraged about a (hopefully) soon to be announced resolution to the suspension and a financial report issued to shareholders thereafter. Please refer to our earlier letters for more on this subject.

This down cycle will end, and things will improve, but we don't know when.

The key to making money in stocks is not to get scared out of them.

Peter Lynch

Lynch said, you must stay invested in the market at all times, even through economic down cycles. That's because you will never time getting back into the market before a swing up in stock prices. In just a few hours of trading, a lot of the appreciation and gain can be missed if you're not onboard and invested.

Companies we visit have recently told us they have experienced reduced orders from the US and Euro zone, starting in the third quarter. Today, nobody can say they see any light at the end of the tunnel. But, with the sharp falls last year in stock prices, especially in the latter half of the year, insiders became the heaviest buyers of shares. The buying was broad-based, across most of the Hong Kong market. Coinciding with this buying was an overall increase in short sales by hedge funds.

At the beginning of summer, our portfolios sold at 4.8x expected earnings for 2011, 19.4% ROE, 1.1x average book value. We thought those valuations were "very cheap."

Today, our portfolio sells at weighted average 2.9 times our estimates of next year's earnings, which is a 20.0% earnings yield, a 0.7x book value ratio, an average return on equity of 19.3%, a 5.2% weighted average dividend yield from holdings of companies with cash-rich balance sheets.

Our "very cheap" valuation metrics early in the year, however, became even "cheaper." We didn't expect that to happen. On CNBC TV, I elaborated a bit:



[Look at Small Caps in 2012](#)

Fri. Jan. 6 2012 | 9:30 AM[04:46]

Brook McConnell, President, South Ocean Management, says small caps have outperformed over time, and investors should find the right price t...

January this year will be shortened by the early lunar arrival of Chinese New Year's. The Year of the Dragon begins January 23rd, and though we don't expect any fireworks in the

markets here this month, we remain committed to our long held core holdings of cash-rich companies aimed at China for growth.

Brook McConnell

Hong Kong

***Special Report: "Rats" and "black mouths" gnaw at China stocks**



On Thursday September 29, 2011, 9:35 am EDT

By Jason Subler

SHANGHAI (Reuters) - Even before China's great stock market bull run of 2006-2007, Wang Jianzhong had become known as China's "god of stocks" for his prescient picks.

Such was his influence at the market's peak that reports by his company, Beijing Shoufang Investment Consulting, republished in dozens of influential newspapers and websites, were themselves often cited as a reason for a particular share price rising.

By late 2006, it was generally expected that whichever companies Wang recommended in his columns would be among the biggest gainers the next trading day in the Shanghai and Shenzhen markets.

Wang knew it as well, and put that knowledge to use.

Between January 2007 and May 2008, Wang bought shares in 38 companies, wrote reports on them, and then unloaded the stocks after his recommendations helped lift their share prices.

It was a lucrative ramping scheme. In 55 separate transactions during that time, Wang earned 125 million yuan (\$19.5 million), according to regulators.

The financial sleight of hand has now given him the dubious distinction of being China's first convicted stock market manipulator. He was sentenced in August to seven years in prison and fined 125 million yuan, on top of having illicit earnings of the same amount confiscated.

While his case went hardly noticed in the Western media, Wang is now known as China's most famous "black mouth" -- a Chinese expression for a commentator who manipulates the market by talking up companies in which they have taken stakes.

Wang's case is just one high-profile example of widespread wrongdoing in China's capital markets, according to eight industry insiders interviewed by Reuters. The shady practices not only hurt millions of retail investors but create challenges for the foreign money managers and investment banks that invest their clients' cash in mainland Chinese equities.

Employees of Chinese brokerages, fund managers, and company executives are among those engaged in illicit activities, ranging from falsifying numbers on listing prospectuses to insider trading, the industry sources said.

These disclosures about how the markets are being manipulated follow a Reuters investigation into accounting fraud at Chinese companies listed in North American exchanges.

The accounting scandals exposed a subculture of bookkeeping shenanigans in Chinese finance, underscoring the dark side to the explosive growth of China's nascent financial markets and the risks to investors entering them.

FALSE IPO DATA

One of the most common of the illegal stock trading practices is including false figures for revenue and other data on IPO prospectuses, said one senior manager with a brokerage firm based in eastern China.

"It's just a bunch of bosses meeting up and filling in the forms. 'What kind of price do you want? We'll get you that price,'" said the source, who asked not to be identified for fear of repercussions.

"Often it's because someone's kid is doing a certain business, so if I help him with an IPO now, he might help me with something else down the road."

Another practice involves collusion between company executives and major institutional investors. They get together ahead of a planned secondary share offering, and agree to ensure the company's share price performs well enough to attract demand for the offering.

The investors then dump the shares after the offering when the share price has reached a high enough level. Along the way, commentators help talk up the stock among retail investors amid well-timed releases of positive news on the company, said another industry source, again on condition of anonymity.

"We'll set it up for them. Everyone will get together in a room and work out a schedule," the source said. "We'll know when the stock will reach a certain point, and set a target for when those involved will aim to get out."

The source declined to give names of particular companies affected by such practices for fear of incriminating his firm. But it is not uncommon to see share prices of some listed companies, especially smaller firms listed in the southern boomtown of Shenzhen, experience massive run-ups followed by precipitous falls after a secondary offering.

To be sure, that type of scheme is facilitated by the herd mentality of China's retail investors, who account for some two-thirds of stock market turnover and are known to trade on very short-term horizons based less on fundamentals than on daily rumors about policy support for certain sectors or deals by individual companies.

The sheer amount of effort the China Securities Regulatory Commission (CSRC) has devoted to combating the problem of insider trading is one indication of the extent of the problem.

The CSRC has in the past year published more than half a dozen statements about insider trading on its website, in addition to holding symposiums on the issue, after China's cabinet ordered a crackdown late last year.

The CSRC declined repeated requests for comment. But the regulator said in a statement on its website (<http://www.csrc.gov.cn>)

this month that it had taken on 83 new cases of market malpractice in the first half of this year, including 45 cases of insider trading.

"In the second half, with changes happening in market conditions and uncertainty in the external environment, illegal activities will take on new forms," CSRC warned in the statement. The regulator said "it will continue to prioritize the crackdown on insider trading ... 'rat trading' and illegal information disclosure."

RATS' NESTS

The misuse of private trading accounts by mutual fund managers is a practice, which like that of "black mouths," is common enough to have been given a colorful nickname in Chinese: "rat trading."

The rats are fund managers who buy securities in their own personal trading account ahead of large purchases of the same security by their fund house, hoping to profit from a rise in the share price from their firm's larger transactions.

The CSRC has been especially cracking down on this practice because it is holding back the development of the mutual fund industry. In one illustrative case, the regulator meted out punishment to Huang Lin, former money manager at Franklin Templeton Sealand Fund Management Co in Shanghai.

Using an account in an associate's name, Huang, 32, bought or sold stocks from May 2007 to July 2008 ahead of transactions in the same stocks by the mutual fund he managed, the CSRC said.

Ironically, the 15 illegal transactions, which involved eight stocks, including Ningbo Huaxiang Electronics (Shenzhen:[002048.SZ](#) - [News](#)) and Huafa Industrial (Shanghai:[600325.SS](#) - [News](#)), resulted in a loss for Huang of 54,000 yuan, according to the watchdog, which said it collected evidence from trading and chatroom records.

The regulator barred him from working in the fund industry and fined him 300,000 yuan.

In the mutual fund industry, perhaps more than anywhere else, investor distrust is holding it back. The fund industry's assets under management have fallen steadily, to the point their equity holdings now account for only 19 percent of China's total trade able share capitalization, down from a third in 2007, according to Huatai United Securities.

"I suspect 'rat trading' has been quite rampant in the industry and only a fraction of such malpractices have been caught," said Zhang Haochuan, head of research at fund consultancy Z-Ben Advisors. "This has certainly hurt the industry's growth."

The reluctance of small retail investors to entrust their cash with professional money managers has, in turn, helped perpetuate a speculative investment culture that almost guarantees a volatile market, with amateurs engaged in herd-like day trading.

With distrustful investors avoiding mutual funds, the market is starved of stable long-term stock investments, the type that has helped support more mature markets.

That is at least one reason why China's stocks have not performed in line with record corporate profits and booming economic growth, which has averaged in the double digits for most of the last decade, analysts say.

The Shanghai Composite Index ([^SSEC](#) - [News](#)) fell 14 percent in 2010, when it was one of the world's worst performers despite the more than 10 percent growth in the economy. It is down another 14 percent so far this year.

CAUGHT IN OWN TRAP

Sometimes the rats get caught in their own trap.

In one example, real estate executive Qing Shaoqiu bought more than a million shares in the company he chaired, Shanghai Xingye Resources Holdings (Shanghai:[600603.SS](#) - [News](#)), just hours ahead of a share suspension, betting a merger his company was planning to announce would lead to a jump in share price.

It ended up being scrapped due to adverse market conditions, leading to sharp falls in Xingye's share price. When trading resumed, Qing was stuck with a 2 million yuan loss.

Not only that, last November the CSRC fined Qing, now 40, 200,000 yuan for insider trading, barred him for life from China's capital markets and banned from serving as an executive on any listed company for five years.

Such practices pose huge headaches for the 116 foreign institutions allowed to trade on China's equity and bond markets through the Qualified Foreign Institutional Investor (QFII) program.

Smaller companies can be especially challenging, many of them listed on the small- and medium-sized enterprise board and Nasdaq-style "innovation board" in Shenzhen, bordering Hong Kong. Their share prices are easier to influence by virtue of their smaller size, analysts say.

The CSRC has strict reporting requirements for the more than 2,200 companies listed in Shanghai and Shenzhen, but many analysts question the quality of the data, especially that of the smaller companies.

"You have some pretty creative accounting techniques that Chinese companies often use," said Kent Kedl, managing director of Greater China and North Asia with consultancy Control Risks.

"Some will have one set of books internally, one set of books for the tax authorities, and another one to potentially show investors. It's a pretty common thing."

That makes it essential for foreign investors to have an on-the-ground presence to oversee investment targets, said Ching Shao, chief executive and co-founder of the SMC China Fund in Shanghai.

"You really need to do your own due diligence," she said. "Not only talking to the companies, but going to talk to their competitors, their enemies, their suppliers -- the people who conduct business with them," she said. "That's really the very reliable source."

TOUGHER PENALTIES

Companies have gone to unusual lengths to corner any "rat traders."

"When you come in at 8:30 in the morning, you hand over your mobile phone. Then from the time you walk into your office to the time you sit down at your workstation, you're on camera," one fund industry source said.

"Once you log in, you're getting screen shots of your desktop every three or seven seconds. But what's the reality? Everybody's got three mobile phones because their line is recorded, so they use their mobile phones. And it happens a lot."

The problem is part of a much larger China syndrome. Whether it's food safety or rampant counterfeiting, those who want to cheat or cut corners will usually find a way around any restrictions, because enforcement resources are so woefully inadequate.

Industry participants have called for stiffer penalties for offences, and some point to the increasing trend of criminal penalties, including jail terms such as Wang's, as a sign of progress.

In many ways, the problems with China's markets are growing pains. The stock markets were established just over 20 years ago, and some of the problems of manipulation and insider trading that have cropped up also plagued more developed markets, especially when they were at a similar stage of development.

FAIR PLACE TO GAMBLE

Many retail investors shrug off the inherent disadvantage they face, with so many insiders privy to so much information that they are not. That includes the chronic leaking of important economic data, prompting the statistics agency to crack down on the practice this year.

"This market isn't healthy, it isn't fair, but what can I do?" said Ms. Xu, a 56-year-old retired worker, monitoring the prices of shares she had bought at a brokerage in the eastern city of Hefei, in Anhui province.

"I'm retired, and don't have much else to do. At least this way I can come here every day, have something to do, and the chance of making a little money," she said, surrounded by other retail investors, many of whom passed the time by knitting sweaters and playing cards.

While some individual investors might be resigned toward the market manipulations, the Chinese government itself has much higher expectations, announcing plans to turn Shanghai into a global financial center by 2020.

"Things have actually been improving quite a lot, especially for larger enterprises," said Geng Xiao, an economist who formerly worked for the Hong Kong Securities and Futures Commission and is now director of research for the Fung Global Institute in Hong Kong.

But, he added, regulators need to do more to stamp out insider trading and other market malpractices. They need to provide better oversight, particularly of smaller companies, if they hope to make China's capital markets serve their ultimate function of channeling investment to the most deserving ends.

They will never be able to erase the rambling-gambling nature of China's markets, he said.

"I'm not against it being a casino, because it is in a way," he said. "But it has to be a fair, efficient casino. And then you can use that to diversify risk and allow people to help the real sector."

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Dec 12, 2011 The mainland's top securities regulator has revealed its largest market-manipulation case ever, a massive pump-and-dump stock scheme resulting in illegal profits of 426 million yuan (HK\$520 million).

The China Securities Regulatory Commission (CSRC) said last week that a company in Guangdong enlisted 30 securities analysts to plant phoney recommendations for hundreds of stocks on television, artificially inflating their value, according to the China Securities Journal.

The company, identified as Guangdong Zhong Hengxin, sold at a profit after prices rose.

The suspect trading involved 148 stock accounts at 44 brokerage outlets and represented a combined transaction value of more than 57 billion yuan. The company invested 2 billion yuan to finance its trades and influenced the value of 552 stocks.

The CSRC referred the case to law enforcement in March 2010 and it remains under investigation.

The crackdown followed a series of high-profile actions carried out under the CSRC's new chairman, Guo Shuqing, the former head of China Construction Bank and an advocate of more relaxed capital controls, according to bankers.

"Based on the latest developments, the CSRC is definitely tightening monitoring efforts, which the market has long awaited," said Liu Shengjun, deputy director of the China Europe International Business School's Case Centre in Shanghai.

Analysts say two critical flaws exist in the country's stock market: insider trading and a system where the CSRC has too much clout in approving initial public offerings.

Mainland companies that want to list but do not meet the requirements often bribe their way through the regulatory bureaucracy, or call on private equity companies or someone with political connections to influence approvals.

"Reforming the IPO approval system is something beyond Guo's personal capabilities and needs muscle from higher above," Liu said. "For now, cracking down on insider trading and irregularities is what Guo can do to promote transparency, fairness and justice."

While Guo's predecessor, Shang Fulin, had a reputation for being pragmatic and was lauded for his reform in making non-tradeable, state-owned shares in listed companies tradeable, he has also been blamed by investors for the weak and scandal-ridden stock market.

Guo, after taking over the hot seat, has so far rejected several IPOs, inspected rogue traders and announced that he would crack down on securities crimes.

"The CSRC has zero tolerance for insider trading and crimes in the securities and futures markets," Guo said in Shenzhen earlier this month.

This year the CSRC has investigated 82 securities market cases, with insider trading accounting for nearly half. It has imposed fines totalling 335 million yuan and banned eight investors from the market, according to the commission.

Qian Qimin, deputy head of market research at Shenyin & Wanguo Securities, said the CSRC would also need to improve efficiency and enforcement.

"There's no lack of regulation and laws," Qian said. "The problem lies within the level of enforcement."

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