SOUTH OCEAN MANAGEMENT, LTD. 南海管理有限公司
HONG KONG

October 11, 2011

Dear Clients, Partners, and Friends,

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

	Sep 2011	Year-to-Date
Hong Kong Partners LP (net)	- 22.1%	- 40.3 %
Hang Seng Index	- 14.3%	- 24.1 %
BNP Peregrine Greater China Index	- 15.8 %	- 24.6%
MSCI HK Small Cap Index	- 13.3 %	-26.8%

Partnersô NAV for Sept 2.1194 after management fee, but before annual incentive fees of 15% on appreciation.

My Dad used to relay a story to me about his years recommending specific stocks to investors while he worked as a broker in New York during the 1960s. He knew his companies well back then. One was American Express, after the salad oil scandal (which, incidentally, made a fortune for investors such as Buffet). Dad recalled pressing his thoughts on one of the biggest mutual fund chiefs in New York, and, then, re-visiting him a short while thereafter to discuss again his thought. Dad walked into the office, seeing this chief hunched over some charts laid out on his table, studying the graphs of AEôs stock price. The chief was trying to decide what to do with AE and my fatherôs recommendation.

My father relayed this story to me to explain how most óinvestorsô have no idea what they own, even the biggest, most famous names in the business.

Today, investors are making buy/sell decisions based on fears, not fundamentals. And, its times like these that fortunes are created. We have been visiting new companies regularly to find values (Joyce has uploaded a number of our insights, in Chinese, to our website).

Sincerely,

Brook McConnell
President
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Hong Kong saw three tempests at the end of the third quarter; one typhoon named Nesat (which closed the city for a full day), then Tropical Storm NALGAE which immediately followed, and on top of all, the biggest cyclone to hit the Hong Kong Stock Exchange since the September 2001 US terrorist attacks in New York City.

Our small/mid cap holdings suffered in this severe correction as two of the biggest fears overhanging the markets (namely, concerns the Western European debt crisis was worsening and that Chinese growth will falter) intensified.

Asian markets have fallen more than the North America or European markets and Hong Kong has been the hardest hit Asian bourse (see chart below). Short selling has exacerbated and contributed to the under-performance in Hong Kong this year (see article below).

We were fully invested by the beginning of September in companies listed in Hong Kong. Unlike in 2008, before the Lehman crash, we were extremely cautious. The Hang Seng Index declined from a high of 31,000 to 11,000 in that period. It was clear to us the market was excessively valued during the latter part of 2007, when valuations on the blue chip index were more 25 times earnings. Today, that P/E ratio is under nine times, and, even with conservative estimates, is selling at historic low levels.

as of September 6, 2011.

We did not envision that investor pessimism would create such negative sentiment and momentum. Europeôs economic debt crisis was a catalyst to Septemberôs market meltdown. From Greeceôs government worker strikes, to the Clockwork Orange riots in England and now, the Occupy Wall Street, discontent has befallen the world, it seems.

The MSCI Asia Apex small cap index ETF was down 25% this year with HK/China standing out as the clear underperformer (down 37% YTD) and the small caps now trading below book values.

As we mentioned in last monthôs letter, fear had overtaken fundamentals. Pessimism towards Chinaôs housing bubble reached disproportionate levels. It is important to note that household debt amounts to less than 20 percent of China's gross domestic product (total mortgage loans amount to 15% of GDP), according to the International Monetary Fund, which is one fifth of the U.S. ratio.

Stephen Green, an economist with Standard Chartered in Hong Kong, recently said, "In the United States, housing was a borrowing vehicle for households. In China, it's a savings vehicle."

Thatôs an enormous distinguishing trait.

Goldman Sach's Jim O'Neill hit it on the head: 'What Is The Matter With Everyone?' *Let's Worry About Everything.* é   Aptly put!

He argued that economic and corporate news was "benign" and the market selloff seemed uncalled for:

ñJudging by the price action, market participants seem to be increasingly convinced of imminent recessions in Europe and the US as well as a prolonged period of ñJapanisation,ò in which positive GDP growth struggles to keep ahead of a weaker underlying growth trend.

ñIf this prospect werenôt grim enough, the notion of a ñhard landingò in China is back on peopleôs minds with a number of participants promoting the idea, and many newspapers honing in on challenges in the property markets and financial sector.

O'Neill put this matter in perspective; ñ...But back in the surreal world of markets, my inbox was full of really gloomy stuff about hard landings, property collapses, major NPLs and so on. As I said earlier, ñwhat is the matter with everyone?ò

Mark Mobius, Executive Chairman at Templeton Emerging Markets says the downtrend is temporary and Asian stocks will bounce back. "There will be a reversalé this is just a correction in an ongoing bull market.ò

The fear in the markets had become so intense that investment guru Warren Buffett, decided late in September he needed to support his own stock (something he has stated in the past he did not believe was a good idea). Even Hutchison Whampoaôs CEO, Canning Fok, in a rare display, has been out talking to the biggest shareholders, saying the stock is at deep discount to NAV and that the EU business remains resilient. Regrettably, we cannot improve our results by buying in shares of our company/fund like Warren Buffet is doing.

Being here in Hong Kong, on the ground, visiting our holdings and getting first hand updates on their business prospects (our companies, for the most part, remain exceedingly upbeat), itôs extremely hard to be nearly as pessimistic as are investors today. The stock market meltdown this summer took many small cap shares near the lows of 2009, with many of our holdings selling at only 2 to 3 times this yearôs earnings estimates.

Our plan is to ride out this correction with our holdings of well managed, fast growing companies listed in Hong Kong. Over a cycle, small caps tend to out-perform (at least, they have, every time in the previous 14 corrections we have gone through since we started managing portfolios here in 1993).

We will (as always) continue to monitor and analyze all developments of our holdings, as they occur, and make any necessary adjustments in the portfolios. We have cash today of 11% of total portfolio value, which are the proceeds from Akzo Nobel completed take-over of our holding in Schramm Holding (thank you, Peter Brenner, for our 179% gain this summer).

Stephen Roach of Morgan Stanley/Yale made some valid points about China in the following article. Additionally, we have uploaded to our website articles we wrote this year for a local weekly financial magazine, for our Chinese readers.

Brook McConnell
Hong Kong Website: www.south-ocean.com

China's Landing – Soft not Hard

Stephen S. Roach

2011-09-30

NEW HAVEN ï Chinaôs economy is slowing. This is no surprise for an export-led economy dependent on faltering global demand. But Chinaôs looming slowdown is likely to be both manageable and welcome. Fears of a hard landing are overblown.

To be sure, the economic data have softened. Purchasing managersô indices are now threatening the ñ50ò threshold, which has long been associated with the break-even point between expansion and contraction. Similar downtrends are evident in a broad array of leading indicators, ranging from consumer expectations, money supply, and the stock market, to steel production, industrial product sales, and newly started construction.

But this is not 2008. Back then, global commerce was collapsing, presaging a 10.7% drop in the volume of world trade in 2009 ï the sharpest annual contraction since the 1930s. In response, Chinaôs export performance swung from 26% annual growth in July 2008 to a 27% contraction by February 2009. Sequential GDP growth slowed to a low single-digit pace ï a virtual standstill by Chinese standards. And more than 20 million migrant workers reportedly lost their jobs in export-led Guangdong province. By late 2008, China was in the throes of the functional equivalent of a full-blown recession.

Thanks to a massive fiscal stimulus, China veered away from the abyss in early 2009. But it paid a price for this bank-funded investment boom. Local governmentsô indebtedness soared, and fixed investment surged toward an unprecedented 50% of GDP. Fears surfaced of another banking crisis, the imminent collapse of a monstrous property bubble, and runaway inflation. Add a wrenching European crisis to the equation, and a replay of 2008 no longer seemed far-fetched.

While there is a kernel of truth to each of these China-specific concerns, they do not by themselves imply a hard landing. Nonperforming loans will undoubtedly increase in response to the banking sectorôs exposure to some $1.7 trillion of local-government debt, much of which was incurred during the stimulus of 2008-2009. But the feared deterioration in loan quality is exaggerated.

The reason: With rural-urban migration projected to exceed 310 million people over the next 20 years, there is reason to believe that much of the apparent overhang of housing supply will be steadily absorbed. Like Shanghai Pudong in the late 1990ôs, todayôs Chinese ñghost citiesò are likely to be teaming urban centers in the not-so-distant future. Meanwhile, deposit-rich Chinese banks have ample liquidity to absorb potential losses; the system-wide loan-to-deposit ratio is only about 65% ï well below earlier pre-crisis levels that were typically closer to 120%, according to a recent analysis by the Xerion team of Perella Weinberg Partners.

Nor is the Chinese property market about to implode. Yes, a building boom and speculative excesses have occurred. But a year and a half ago, the government moved aggressively to dampen multiple property purchases ï raising down payments to 50% for second homes and to 100% for third homes. While that halted much speculative activity, house prices have remained at elevated levels ï underscoring lingering affordability issues for Chinaôs emerging middle class.

Notwithstanding that problem, major imbalances in Chinese property markets should prove to be the exception over the next two decades. While there could be supply-demand mismatches in any given year, with an average of roughly 15 million citizens a year slated to move from the countryside to newly urbanized areas, demand should rise to meet supply. Meanwhile, there are encouraging signs that property inflation is now cooling: For 46 of 70 major Chinese cities, property prices either declined or stayed flat in August 2011 compared with 31 cities that reported similar conditions in July.

Inflation is always a serious risk in China ï especially with headline increases in the countryôs Consumer Price Index surging through the 6% threshold this summer. The government has responded forcefully on four fronts.

First, food inflation, which accounts for about half the recent run-up in overall prices, has been addressed by administrative measures aimed at cutting fertilizer costs and removing bottlenecks to increased supplies of pork, cooking oil, and vegetables. Second, in an effort to curtail excess bank lending, reserve ratios were increased nine times in the past 11 months. Third, the rate of currency appreciation has edged up. Finally ï and perhaps most importantly ï the Peopleôs Bank of China has raised its benchmark policy rate five times since October 2010. At 6.5%, the one-year lending rate is now 0.3% above Augustôs headline inflation rate.

If food inflation recedes further, and the headline inflation rate starts to converge on the 3% core (non-food) rate, the result will be the equivalent of "passive monetary tightening" in real (inflation-adjusted) terms ï precisely what the inflation-prone Chinese economy needs.

All of this underscores a potential silver lining. An increasingly unbalanced Chinese economy cannot afford persistent 10% GDP growth. Provided that there is no recurrence of the severe external demand shock of 2008 ï a likely outcome unless Europe implodes ï there is good reason to hope for a soft landing to around 8% GDP growth. A downshift to this more sustainable pace would provide welcome relief for an economy long plagued by excess resource consumption, labor-market bottlenecks, excess liquidity, a large buildup of foreign-exchange reserves, and mounting inflationary pressures.

For China, there is a deeper meaning to recent global developments. A second major warning shot in three years has been fired at this export-led economy. First, the United States, and now Europe ï China's two largest export markets are in serious trouble and can no longer be counted on as reliable, sustainable sources of external demand. As a result, there are now major questions about the sustenance of China's long powerful export-led growth model.

Accordingly, China has no choice but to move quickly to implement the pro-consumption initiatives of its recently enacted 12th Five-Year Plan. Strategic transition is what modern China is all about. Thatôs what happened 30 years ago, when economic reform began. And it needs to happen again today. For China, a soft landing will provide a window of opportunity to press ahead with the formidable task of increasingly urgent economic rebalancing.

***Stephen S. Roach, a member of the faculty at Yale University, is Non-Executive Chairman of Morgan Stanley Asia and the author of* The Next Asia.**

Hong Kong ranking in September:

		Month of		
	Last	Sep	Asia MSCI indexes	Sep
HANG SENG INDEX	17,592	-12.3	HONG KONG	-14.2
SZSE 100 INDEX/d	3,670	-10.7	THAILAND	-12.9
S&P/TSX 60 IDX/d	671	-9.1	PHLPPNS	-10.7
MICEX INDEX	1,394	-8.9	INDO	-9.1
OSE BENCH IND_GI	350	-7.7	CHINA	-8.5
CAC 40 INDEX/d	3,000	-7.0	KOREA	-7.6
OMXH25 INDEX	1,875	-6.7	TAIWAN	-7.6
S&P/ASX 200	4,009	-6.7	MALAYSIA	-6.6
MXSE IPC GRAL /d	33,686	-5.7	SINGPORE	-6.4
BVSP BOVESPA IND	-	-5.5	AUSTRAL	-6.4
TOP40 -TRADEAB/d	26,314	-4.6	NEW ZLND	-1.4
DFM GENERAL ID/d	1,432	-4.1	VIETNAM	-1.0
DJ INDU AVERAGE	11,154	-5.2	TR INDIA	-0.8
ESTX 50 PR/d	2,187	-3.9	PAKISTAN	4.1
FTSE MIB	14,978	-3.3		
AEX-Index/d	281	-3.1		
NIKKEI 225 INDEX	8,700	-2.8		
STXE 50 PR/d	2,158	-2.7		
OMXS30 INDEX	918	-2.5		
XETRA DAX PF/d	5,537	-2.5		
NASDAQ 100	-	-1.9		
OMXC 20	353	-1.6		
IBEX 35 INDEX	8,575	-1.4		
SENSEX	16,472	0.1		
SMI PR/d	5,546	1.4		
ISE 100	59,563	9.3		

Short end of the stock

Predatory hedge funds have been whacking your China equities. Should they be stopped

Jasper Moiseiwitsch
Updated on *Oct 10, 2011*

Ping An, a Hong Kong-listed mainland insurer, has had a rough time of late. The stock has dropped 20 per cent over the past 2-1/2 weeks, including a 13 per cent drop on October 3. That's partly due to rumours that HSBC, its main shareholder, is looking to sell down its stake in Ping An - rumours the insurer has denied.

But there is another factor explaining Ping An's declines: the stock has been a target of short selling, with shares sold short in the insurer amounting to 20.2 per cent of the stock's total turnover on September 28.

For some, the recent massive sell-off in Ping An and other China equities is a strong sign that the mainland economy is heading for a hard landing. Others see something more sinister: hedge funds predatorily shorting the local market, sometimes with the assistance of negative (and false) rumours.

"The news cannot explain why the stock [Ping An] was down 13 per cent in one day," says Raymond Chan, chief investment officer, RCM Asia Pacific. "People short the name and spread the rumours and create panic ... and retail [investors] follow it. I have no proof but I can easily see the pattern."

Todd Martin, Asia equity strategist for Societe Generale, strongly agrees: "The hedge fund cabal is breast-thumpingly bearish about China equities. I see evidence of China slowing down, but I also see a community that is massively short of China that goes beyond the call of fundamentals.

"This is a bunch of hedge funds that are desperate - they have not had a great year - they are desperate for a big win. This [China equities] is their version of the big short," adds Martin, referring to hedge funds' ability to profit massively by short selling mortgage debt during the 2008-09 credit crisis.

Short selling is the practice of selling stocks that you do not own (typically they are borrowed) on the expectation the shares will decline. After the stock has dropped by a reasonable amount, the short-seller buys back the securities at a discount, returns the borrowed shares, and counts his profit.

The practice is often controversial. Last Tuesday, brokers met officials from Hong Kong's Financial Services and the Treasury Bureau to lobby for limits on short selling, up to and including a temporary ban on the practice. Brokers dislike short selling because it drives down share prices, killing demand and trading volumes. Investors hate it because it destroys the value of their equity portfolio.

"Hong Kong's economy is not too bad," says Brian Fung Wei-lung, chairman of the Hong Kong Securities Association, who was present at the meeting. "So yes, the market might have needed to drop a bit, but when compared to other parts of the world, Hong Kong's drop has been too much. We think short selling is one reason contributing to this."

Short selling volumes in Hong Kong hit 14.1 per cent of total trading levels on September 30, according to Bloomberg data, versus a 6.9 per cent average seen for Hong Kong stocks in the period January 1 to August 31.

Macau gaming stocks Wynn Macau, SJM, Galaxy Entertainment and Sands China recently dived after being heavily sold short - on September 30, short selling equated to 37 per cent of Wynn Macau's share trading turnover. Galaxy Entertainment's short selling volumes on September 30 was 2-1/2 times the two-week average prior to that date.

Mainland property and banking stocks are increasingly favoured shorts for hedge funds, along with anything else that is big and liquid. Societe Generale's Martin describes the mainland/Hong Kong market as the "world's most crowded short". He says this is because hedge funds have been restricted from short selling in much of Europe, and are therefore taking the strategy to Asia, and because China is at the height of a monetary tightening cycle, making it an easy target.

"Hong Kong is one of the world's worst performing markets globally. Why? It's the ability to short-sell. It exacerbates problems," says a Hong Kong-based hedge fund manager.

Short selling has been getting attention mostly because of share markets' recent dramatic declines, but also because of hedge funds' tendency to play shock jock - to drop bombshell reports on firms after applying massive short positions on their stock.

The hedge fund Muddy Waters targeted Sino-Forest with a damning report in June, leading to the suspension of trading of the stock on the Toronto exchange. The fund also disclosed that it had shorted Sino-Forest ahead of that report, and thus profited richly from its actions.

Anonymous Analytics, which says it is dedicated to promoting "access to information, free speech and transparency", on September 26 issued a highly critical report on Chaoda Modern Agriculture.

According to the *Financial Times*, Anonymous Analytics also shorted locally-listed Chaoda ahead of the report.

On the same day the report appeared, the financial secretary's office asked the Market Misconduct Tribunal to investigate allegations that Chaoda's two top executives engaged in insider trading. Chairman Kwok Ho and finance director Andy Chan Chi-po "do not accept" the charges, the mainland vegetable producer said.

While hedge funds have provided some excellent independent research on mainland companies, a recent note by ratings agency Fitch was critical of their methods. "A typical initial market reaction to a damning report will be a significant fall in share prices, allowing an opportunity for the short-sellers to make their money," says Fitch.

It added: "The increased market volatility and uncertainty introduced by `whistle-blowing' short-sellers of Chinese companies is likely to outweigh any positives for investors."

This point can be more clearly seen in cases where stocks are targeted by rumours and short selling, where the rumours prove to be false.

For example, in the period June 20 to 24, Hong Kong-listed China Yurun Food Group saw short selling rise to an average 43 per cent of stock trading volumes, as the company fought merely the rumour that it was the subject of a Muddy Waters report. No such report materialised, but its share price still dropped 20 per cent on June 27.

It is very difficult to prove anyone is spreading false rumours - the practice is prohibited by the Securities and Futures Commission - but circumstantial evidence is rife.

For example, while the Macau casino stocks were plummeting last week following big short positions against the counters, an old rumour resurfaced that Beijing would once again start restricting the number of mainland visitors coming to Macau.

Analysts covering the stock had heard the rumours but were doubtful that they were true.

So there is no doubt that hedge funds and short selling are currently making a big impact on China equities. Remember, the main reason stock markets are down right now is because of fears that a spreading euro-zone crisis and a recession in Europe and the US will hit the Chinese economy.

But consider this. Such a recession would hit South Korea harder than China, as the former country is more dependent than its neighbour on exports to the West. Its biggest stocks are manufacturers that export heavily to the US and Europe, whereas China has a relatively stronger domestic market that can prop up its economy should the rest of the world falter.

But South Korean equities have dropped less than Hong Kong-listed mainland equities in the recent sell-offs. The Hang Seng Index (HSI) is down 13.7 per cent since the start of September. The Kospi Index, South Korea's benchmark, is down 6.4 per cent over the same period.

The difference? South Korean regulators don't allow short selling. In other words, if Hong Kong likewise banned short selling, it's possible the HSI would also only be down 6.4 per cent over that time frame.

"The Korean economy is very dependent on the US and Europe. They also do not allow short selling. You can see the difference that makes in the relative performance of Hong Kong and Korean markets," says Jim McCafferty, Asia research product manager at RBS Global Banking & Markets.

The current debate on short selling is in many ways reminiscent of the difficult choices Hong Kong regulators had to make during the 2008-09 global financial crisis and the 1997-98 Asian financial crisis.

During the global financial crisis, the Securities and Futures Commission stood out among major regulators for not issuing an outright ban on short selling, as was seen in Britain and the US, which prohibited the short sale of financial stocks for a time. The commission is proud that it held off from such an intervention and let the market run its course, and might be expected to likewise resist pressure now to ban the practice.

But perhaps the more meaningful comparison is with the Hong Kong government's massive intervention in the local stock market in August 1998. The action was intended to combat funds that were short selling shares during the Asian financial crisis, contributing to a 50 per cent decline in the HSI. The intervention was led by then financial secretary (and current Chief Executive) Donald Tsang Yam-kuen, suggesting authorities are not opposed to taking the fight to short sellers, if absolutely necessary.

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