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

May 14, 2014

Dear Clients, Partners, and Friends,

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

	April 2014	Year-to-Date
Hong Kong Partners LP (net)	-4.6%	1.5%
Hang Seng Index	-0.1%	-5.0%
Hang Seng Small Cap Index	-4.4%	-8.8%

Partnersô NAV $2.8922 after management fees, but before annual incentive fees of 15% on appreciation.

Our small/mid cap, Hong Kong-listed holdings, benefiting from growth in China, have outperformed over the one year period ending April 30:

HK Partners LP +12.3% versus -2.7%% Hang Seng Index.

Large cap shares in Hong Kong rallied early last month (briefly) on news of the Hong Kong/Shanghai stock exchange link-up (see my further thoughts below). There was a knee-jerk reaction in larger capitalized, dual-listed China shares, sectors where we have little exposure in our portfolios.

Small/mid cap stocks didnôt participate and, generally, lagged. In fact, Hong Kong-listed small/mid cap shares have witnessed volatility recently as sentiment changed abruptly, with no warning (the only ósparkô I could pin point to the sudden decline was, perhaps, in relation to the steep falls in Nasdaq technology and biotechnology shares in the US).

On the bright side, our holdings began this correction in good shape. We own solid companies in areas that are essential and needed by China.

Beijing Enterprise Water Group, code 0371, is the leading water treatment, sewage and desalination plant operator in China. The capital municipality investment arm, Beijing Enterprise, acquired a 50% stake in the former private company, retaining management. The company partners with China Development Bank to acquire and upgrade regional government and local water treatment plants in many Provinces throughout the mainland (40% of the worldôs population lives in China and India which has only 10% of the worldôs drinking water).

We have positions in electric/hydro utilities, selling at 5x earnings with 6-7% dividend yields. We own the largest BMW dealership on the mainland (Baoxin Auto, code 1293: BMW is perhaps Chinaôs most coveted brand). Several other holdings include a patented (in USA/Macau), Live Multi Game operator (Paradise Entertainment, code 1180)), an Alibaba-like (for small businesses) internet company (HC International, code 8292), the leading motor-bicycle battery manufacturer (Chaowei Power, code 2380), the largest high-intensity, power transmission cable manufacturer (Jiangnan Group, code 1366) and several 4G mobile telecommunications-oriented companies (China Fiber Optic, code 3777, Ka Shui International, code 822 and Tongda Group, code 698).

These strong growth companies have all reported encouraging financial results this year, yet have suffered share price pressure with the overall small cap correction. The Hang Seng Small Cap index today sells at 8.7 times trailing earnings. Our weighted average P/E on this yearös estimates is 7.8x.

Sincerely,

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It is Different This Time

Asset allocations to the region will rise and Hong Kong share prices are set to re-rate.

April 14, 2014

By Brook McConnell

A recent proposal by the Chinese government to allow cross border trading between the Shanghai Stock exchange and Hong Kong stock exchange, linking the two exchanges, came as a surprise to the market last week.

There was a knee jerk reaction as wide price gaps between dual listed securities of the two markets narrowed.

A similar plan was introduced in 2007 when Hong Kong investors were exhilarated with the prospect of a tie up with China.

The Hang Seng Index vaulted, hitting all-time highs, from an August 2007 low of 19,400 to over 30,000 by October, as speculation gripped giddy investors of a 'through train' being implemented. China A-share prices rose to 60 times earnings, and Hong Kong's Hang Seng Index price earnings multiple was 24 times. Trading volume in Hong Kong reached HK$200 billion a day or US$26 billion (as compared to last month's average volumes of HK$68 billion or US$8.8 billion).

Today, China shares trade at single digit P/Es and the Hang Seng at 10.3 times.

The 2007 ill-conceived 'through-train' plan was abandoned within four months. Share prices in Hong Kong and the Mainland collapsed and remain almost 40% below those peak levels nearly 7 years ago.

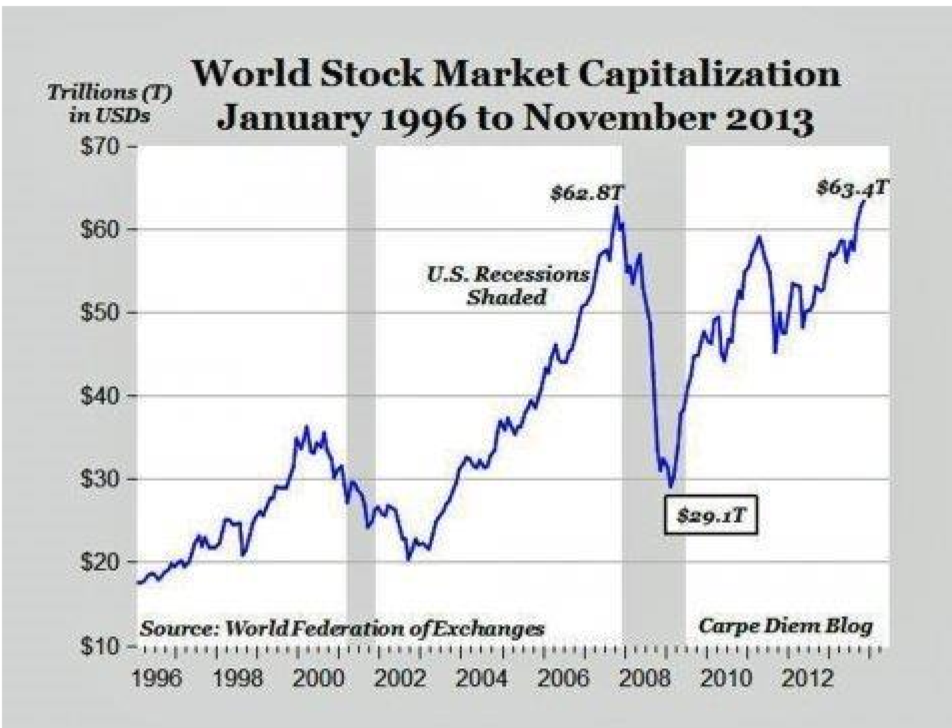
Thereafter, foreign ownership policies of domestic China shares, such as the QDII and QDFI schemes, were convoluted and ad hoc. Like the first B-shares (China exchange traded stocks only available to foreign investors) in the 90s, these former campaigns were just testing grounds.

Under the proposed "through train" scheme, there will be caps that investors will be able to trade in the beginning (transactions up to 550 billion yuan, or HK$691 billion, worth of Hong Kong and Shanghai stocks, net). Yet, lifting shareholder ownership restrictions is an important step to dismantling China's closed capital account.

This new reform is a significant opening and liberalization of the Yuan convertibility.

Which brings up our "Big Bang Theory," which goes like this:

The total world stock market capitalization today is ~$60 trillion.



Hong Kong's stock market capitalization amounts to $3.1 trillion and is ranked 5th largest.

China's stock market has grown from zero, twenty years ago, to one of the largest stock markets in the world. The Shanghai and Shenzhen total stock market capitalizations together amount to US$4 trillion. China and Hong Kong combined amount to US$7.1 trillion. That compares to the world's second largest market, Japan, at US$4.1 trillion.

Yet global pension assets, which amount to US$30 trillion, have only a fraction invested in the Greater China region. For instance, the relative weighting of global investment allocation to Japan was 12.5% in 2012 (down from 15% in 2002). For Hong Kong, it's was just 0.4%. And there isn't any allocation to China, yet.

To index and properly allocate weightings uniformly by stock market capitalizations, global asset allocators need to dramatically increase investments in the region. Moving these gigantic sums takes a lot of time, too, like turning a 747 around in a parking lot. It will be years in the making (Bridgewater Associates founder Ray Dalio says 85% of US pensions will go bankrupt in the next

30 years, with $3 trillion in assets against $10 trillion in liabilities. He noted required pension returns are 9% and pension funds are lucky to get 4%).

The new 'through-train' reform is a significant step forward. There are many regulatory issues and differences, of course, between the two markets that need to be ironed-out. Nevertheless, this should facilitate far larger allocations to the region in the future. When pension asset allocators are forced to increase weightings due to a 'combined' China/Hong Kong stock market, they will be unable to ignore investing in these stock markets anymore.

Presently, ICBC, China Construction Bank and Agriculture Bank of China shares are all quite cheap; they are also the world's three largest public companies (with Bank of China and Petrochina ranked #9 and #10).

With China's economic growth posed to overtake the size of the US economy, the cosmic shift in the global pension allocation universe is only just beginning.

Brook McConnell is President of Hong Kong-based South Ocean Management, Ltd., a SFC/SEC licensed investment manager.