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

January 13, 2015

Dear Clients, Partners, and Friends,

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

	Dec 2014	Year
Hong Kong Partners LP	-4.9 %	0.7%
Hang Seng Index	-1.6%	1.3%
Hang Seng Small Cap Index	-3.0%	-7.7%

Partnersô NAV $2.8319 after management fee, but before annual incentive fees of 15% on appreciation.

Our portfolios of small mid cap holdings of Hong Kong listed companies doing business in China saw volatile market conditions as the year ended. There were abrupt stock movements, with many non-index, smaller cap stocks witnessing substantial, almost forced-like selling during last month. The MSCI Hong Kong small cap index, an index created in 1998, declined almost 5% on the selling (and this index declined 14.8% for 2014).

Further thoughts and my review in the following segment.

Sincerely,

Brook McConnell
President
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Hong Kong

ñOne sidelight here: it is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately with people or it doesnõt take at all. Itõs like an inoculation. If it doesnõt grab a person right away, I find that you can talk to him for years and show him records, and it doesnõt make any difference. They just donõt seem able to grasp the concept, simple as it is.ò Appendices, 1. The Superinvestors of Graham-and-Doddsville, By Warren E. Buffett: The Intelligent Investor, Benjamin Graham Fourth Revised Edition, Page 297:

Our focus is a bottom-up, proprietary, screening process based on a Warren-Buffett like approach to owning great businesses operating in China at reasonable prices (with a ñmargin of safetyò). The system determines an intrinsic value and maximum purchase price. We target 20% annual returns.

This systematic approach isnôt a complex, rocket-science scheme to investing; rather, itôs more a common sense approach, similar to what any owner thinks when buying a business. We charge less than normal fees for our services at South Ocean Management in hope our transparency and out-performance over cycles safeguards client loyalty and brings along new referrals to us (I, too, am an owner/investor and the GP in our Delaware L.P.).

Our 2 years returns since inaugurating this enhanced process has seen Hong Kong Partners L.P. gain 12.9% versus +4.2% for the blue chip Hang Seng Index, +3.7% for Hang Seng small cap index.

There were several events last year reviewed briefly in the following section.

I wrote a positive sketch about the onset of the Shanghai/Hong Kong stock connect (It is Different This Time). That positive view was firmly in the minority.

When the linkup of the two bourses was announced, my main arguments that it was an important turning point and significant step forward for China, were not shared widely.

For instance, guarded headlines read:

If history repeats itself, Hang Seng Index could top out in 2014
22 May 2014 -
Through train's exclusive use of yuan a hurdle for Hong Kong investors
5 May 2014 -
Tie-ups between bourses do not always live up to the hype
28 Apr 2014 -

The stock market declined in May last year after the announcement, whereas when the through train was first proposed, in August 2007 (and, subsequently, dropped four months later) the market rallied 50%.

On Hong Kong radio in April, I elaborated my thesis: that the combining of the Hong Kong and China stock markets into the worldôs second largest bourse, would drive underweighted asset allocators into the China region. The radio announcer snapped, ñWell, when is this going to happen, Brook?ò (As if, how can you make such a preposterous claim?).

Well, my reply was when all the wrinkles were ironed out, the through-train would facilitate far larger allocations to this region and that China stocks were undervalued. For example, todayôs total market capitalization of Chinaôs two bourses is US$4.6 trillion compared to PRCôs US$10 trillion GDP (or a 46% ratio). To relate that number, the total capitalization of the US is US$26.7 trillion compared to a ~US$17.4 trillion GDP, or a 153% ratio (historically, the US ratio has been about 80% market cap to GDP).

As the year proceeded, the market breached a six year high in August amidst all the bad economic news of the day, and commentators began suggesting that maybe it was the October adoption of the through-train for the stock marketôs increase. Yet, there was still much skepticism as even the monetary chief of Hong Kong warned ñé money in-flows can turn into outflows.ò

A year ago, Macau's casino revenue was reported at US$40 billion (up 18.6% year on year), compared to the US$5.8 billion generated on the Las Vegas Strip. Deutsche Bank Research was forecasting casino growth of 20 per cent for 2014. There were only broker buy recommendations on Macau gaming shares one year ago.

Today, the investment climate towards casino stocks has crapped out. Gaming revenues for 2014 actually fell 2.6%, and casino stocks were off 35-50% in 2014. We sold our gaming holdings last year as they had reached our targeted prices (Galaxy Entertainment, code 0027hk, hit our $82 target price and we sold, a long-term profit of $44/share. Today, the shares sell for $39/share).

Frustratingly, our large holding in smartphone/PC casing manufacturer, Tongda Holdings (code 0698hk) rose to HK$1.41 per share (our initial cost ~$0.36/share), just below our target price of $1.46. It placed new shares at a discount and the stock has tumbled to $0.90. It didnôt get quite cheap enough to add to the position, but we find the business outlook for the foreseeable future quite promising and continue to hold the position.

Overall, our discipline of seeking to own great businesses, using an intrinsic valuation process, has been rewarding, even in a global context. (Last year was difficult for most markets outside the US, in US$ terms).

Americas

Name	YTD %	YTD USD %
S&P 500	11.39%	11.39%
DJI	7.52%	7.52%
NASDAQ 100	17.94%	17.94%
S&P/TSX	7.42%	-1.81%
BOVESPA	-2.91%	-13.70%
MXSE IPC	0.98%	-10.75%

Europe

Name	YTD %	YTD USD %
STXE 600	4.35%	-8.16%
FTSE 100	-2.71%	-8.49%
DAX	2.65%	-9.65%
CAC 40	-0.54%	-12.46%
FTSE MIB	0.23%	-11.78%
SMI	9.51%	-1.65%
AEX	5.64%	-7.02%
IBEX	3.66%	-8.77%
OMXS 30	9.87%	-9.28%

Asia

Name	YTD %	YTD USD %
NIKKEI 225	7.12%	-5.75%

S&P/ASX 200	1.10%	-7.35%
HANG SENG	1.28%	1.28%

Reuters

During the 4th Quarter in Hong Kong, market volatility was heightened as the Hang Seng Index experienced abrupt, sharp moves and numerous gap openings

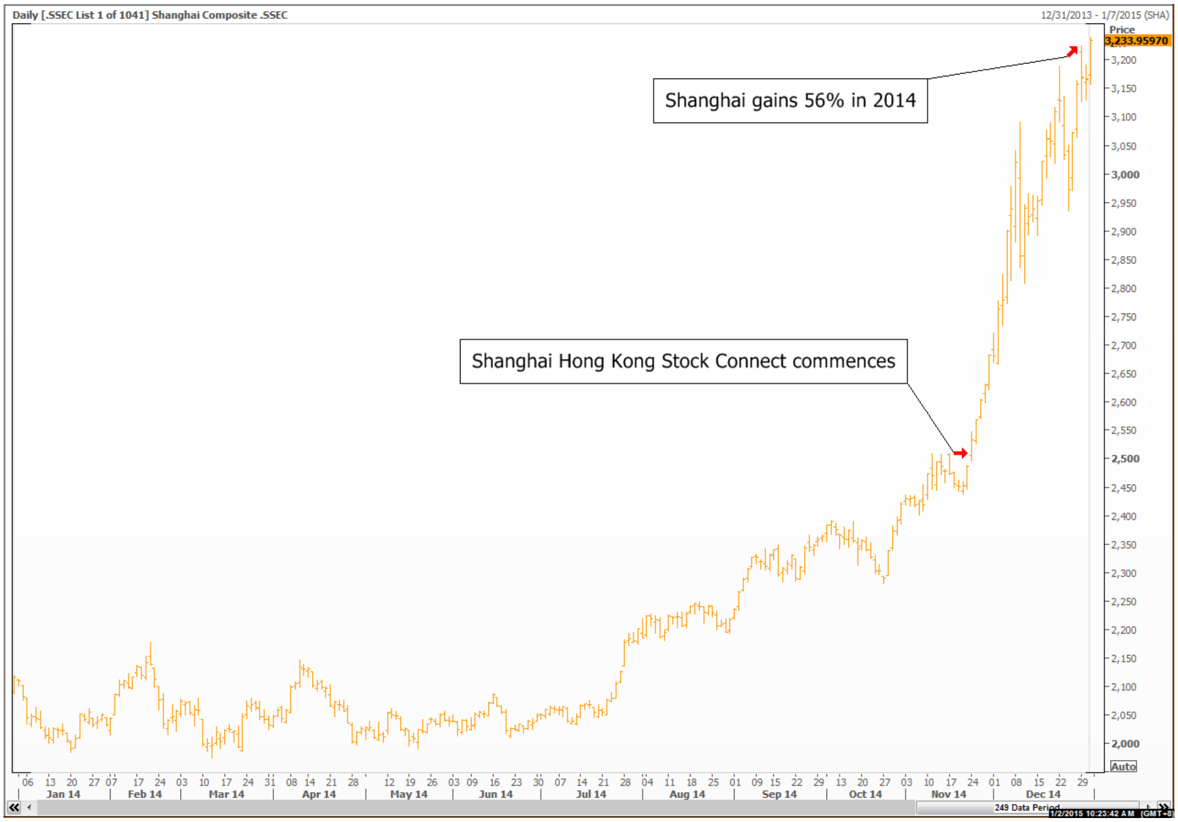
Daily rumors of the Peoples Bank of China lowering interest rates or providing fiscal stimulus accentuated price moves in the predominately finance/property large cap sectors. This shifting sentiment also occurs because China investors tend to not focus on picking the right stocks as to trying to figure out what the government is doing (a speculative endeavor, in our opinion, yet a widespread occurrence).

The prevalent thinking in the run up to the Hong Kong Shanghai stock connect in November was that mainland investors would embrace their best mainland companies that were listed in HK, such a China Mobile, Tencent and Lenovo.

Instead, Shanghai stocks rose.

Chinaôs surprise interest rate cut, coinciding with the commencement of the Hong Kong Shanghai stock connect program, ignited the long moribund mainland markets in December.

The Shanghai market actually began to turn in July and the rise accelerated in the last part of the 4th Quarter. This is a chart of the Shanghai Composite last year:



Many smaller Hong Kong stocks, it turns out, were likely used as a source of funds to enter the rising Shanghai stock market. Verily, there were plenty of mainland investors already invested in Hong Kong before the stock connect. When sleepy stocks in the north suddenly awoke, those mainland investors, which were invested in Hong Kong smaller cap stocks, sold heavily (and indiscriminately) to redeploy into the booming Shanghai market.

Mainland investors tend to be momentum-driven, preferring to buy on rising markets, and are prone to ñexuberant buying and panic selling.ò Trading volumes in China swelled and buying became so great that China brokers were reportedly maxed out on margin debt capacity by the end of December (there were reports of mainland individuals selling their properties and factories to get in on the action).

The selling in Hong Kong of small caps beget further selling, and the non-index sector of the Hong Kong stock market suffered. Five times more stocks hit new 52 week lows than 52 week highs during December (a fact largely unnoticed when the main ñindexò rallies).

Hong Kong has historically been a volatile market. An inherent factor to this is the stock exchangeõs rules requiring only semi-annual financial reporting versus quarterly reporting. Consequently, investors are in the dark for up to 9 months on any updates on their investments.

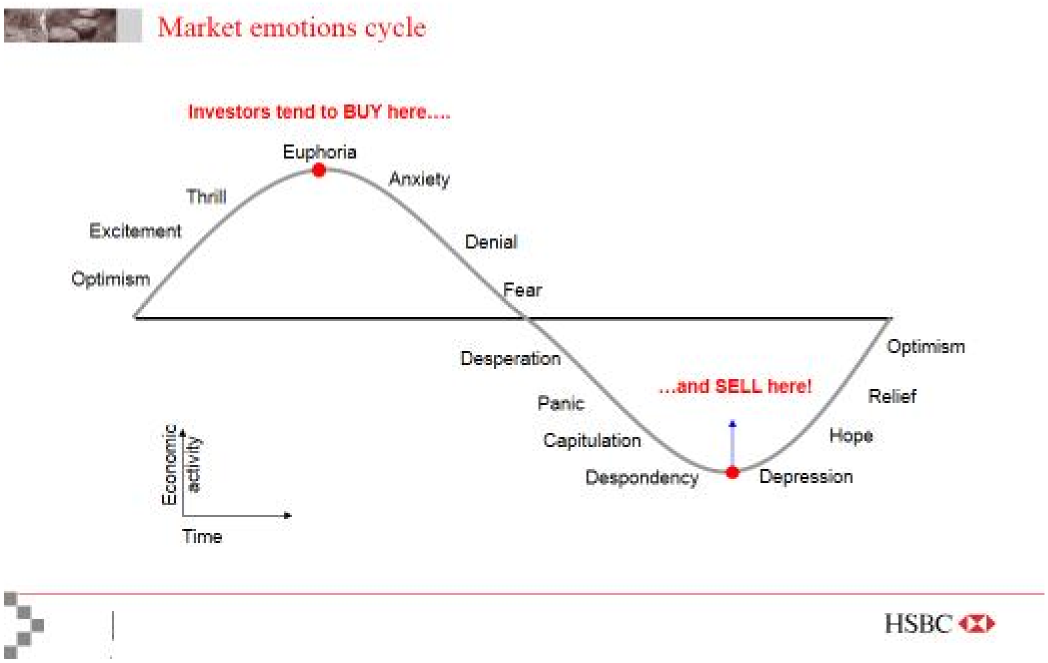
As the year ended, we began receiving numerous inquiries for our opinion whether to buy the Shanghai market after the remarkable, sudden rally. We believe

China's stock market is still undervalued and over the longer term, China stocks will rise spectacularly.

Long term investors are beginning to become interested. Noted value investor Wilbur Ross commented recently on CNBC; *"I think a very interesting market is becoming the Chinese stocks. They had been kind of bashed by the fears of recession in China but now with this linkage between Shanghai and Hong Kong and the tax benefits and all that, I think that market deserves another look*," Ross saidé *China has been the best-managed economy for decades*, he added*. "They avoided the big Asia crisis in the late 90s, [they've] never had to devalue their currency, they've been doing just fine. I don't think it's surprising that there should be some bumps as they try to transition from an investment and export-led economy to a consumer–based economy. I think they're managing [that transition] pretty well."*

Viewed from the following perspective, Shanghai appears to be only in the beginning stages of a long-term, bull market:

Sir John Templeton once commented, "Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."



As stated in our February 2014 [letter](), investor sentiment in the Hong Kong and China markets was somewhere between the Despondency and Depression stages of the cycle. Coupled with the pro-democracy, umbrella movement, I believe Iõve never seen as much skepticism amongst local investors in Hong Kong as there is of late.

Further interest rate cuts, relaxation of how much money banks must put aside as reserves, reforms at State enterprises and falling commodity prices (China is a huge importer of oil) are ultimately positives for China shares. Still, we donõt own Shanghai listed companies in our portfolios due to lack of quality in terms of corporate governance and accounting standards on the mainland. The recent reforms instituted by China pointedly address these concerns. Meanwhile, we have many superior investment opportunities here in Hong Kong to capitalize on for the foreseeable future.

Like a rogue wave at sea, we were taken-aback somewhat by the unexpected surge of selling in December. We immediately began re-visiting management of each of our top holdings during the month. CFOõs of our largest core holdings sat down with us and analyzed, in depth, their current businesses. They were just as perplexed as we were to their stock price movements. We found each companyõs business was moving forward as planned, with ôno holes in their hullsö

At present, our weighted average price-earnings ratio on next yearõs expected earnings is just 6.4 times on an expected average increase in EPS of 30.0%.

We added to several existing holdings during the decline. When the selling of small/mid cap stocks is finally exhausted, no bell will be ringing to announce the end. Similar to a sea-worthy ship hit by a huge wave, strong fundamental stocks ï cash-rich companies with promising businesses, selling at undervalued prices - will right themselves once the scallywag, emotional wave passes.

I would be surprised, though, to see these deeply discounted, depressed valuations last long.

Brook McConnell
Hong Kong