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

May 11, 2015

Dear Clients, Partners, and Friends,

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

	Apr. 2015	Year-to-date
Hong Kong Partners LP	17.4%	30.0%
Hang Seng Index	13.0%	19.2%
Hang Seng Small Cap Index	27.9%	33.2%
MSCI HK Small Cap Index	12.7%	13.6%

Partnersô NAV $3.6809 after management fees, but before annual incentive fees of 15% on appreciation.

Hong Kong stocks exploded in April. Trading volumes quadrupled. As stated in our March client letter, China has continued broadening its reform programs, allowing domestic mutual funds to invest in Hong Kong for the first time.

Our portfolios of quality, small/mid cap, Hong Kong-listed holdings, with businesses geared towards China, rallied strongly.

Few had expected this sudden turnaround.

As we have been highlighting since 2002, and more specifically, last year, in our April 2014 letter, (1) ñIt is Different This Timeé ***Asset allocations to the region will rise and Hong Kong share prices are set to re-rate,"*** Hong Kong is a very under-owned stock market. As we hypothesized a year ago, substantial capital inflows would be destined for Hong Kong;

> … 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.

There had been little support to this viewpoint. Now, more and more banks and research firms are embracing this theme.

One astute analyst (Louis Gave) stated last week Hong Kong/China was ñThe Worldôs Most Crowded Trade.ò ñé outside of a few Chinese retail investors, everyone is ñshort/massively underweight China:ò

> *Today, China accounts for 15% of global GDP ...yet, how many large pension funds, insurance companies, global equity investors, or endowments have 10% of their assets in China today? Or even 5%? We would venture not more than a handful; and this for an obvious reason: China remains an inconsequential part of most people's benchmark. But will this still be the case in a few years' time?*

Goldman Sachs reported recently, ñé active fund managers (are) still underexposed to the market, the rally isn't overé

> *"But despite the rally making China shares more expensive, pressure for active funds to add more mainland exposure is likely to build… Funds of various mandates are underweight the market… (this) has directly led to underperformance ..., and thus have marked benchmark stress and a need to raise exposure to China… If emerging market funds alone increase allocations in the largest underweight sectors in China to marketweight, inflows could be worth $26 billion."*
>
> *"The opportunity set for active managers has been almost completely limited to the HK/China space, which may intensify the pressure for them to close underweight positions."*

Goldman believes including mainland A-shares in the MSCI index would see significant, long-lasting capital flows into the mainland markets.

Credit Suisse expects further gains as the mainland liberalizes its capital account: "More legitimate capital outflow is likely to be the trend in China." (Our own contention is that outbound Chinese capital flows will be a recurring, key headline in the years to come.)

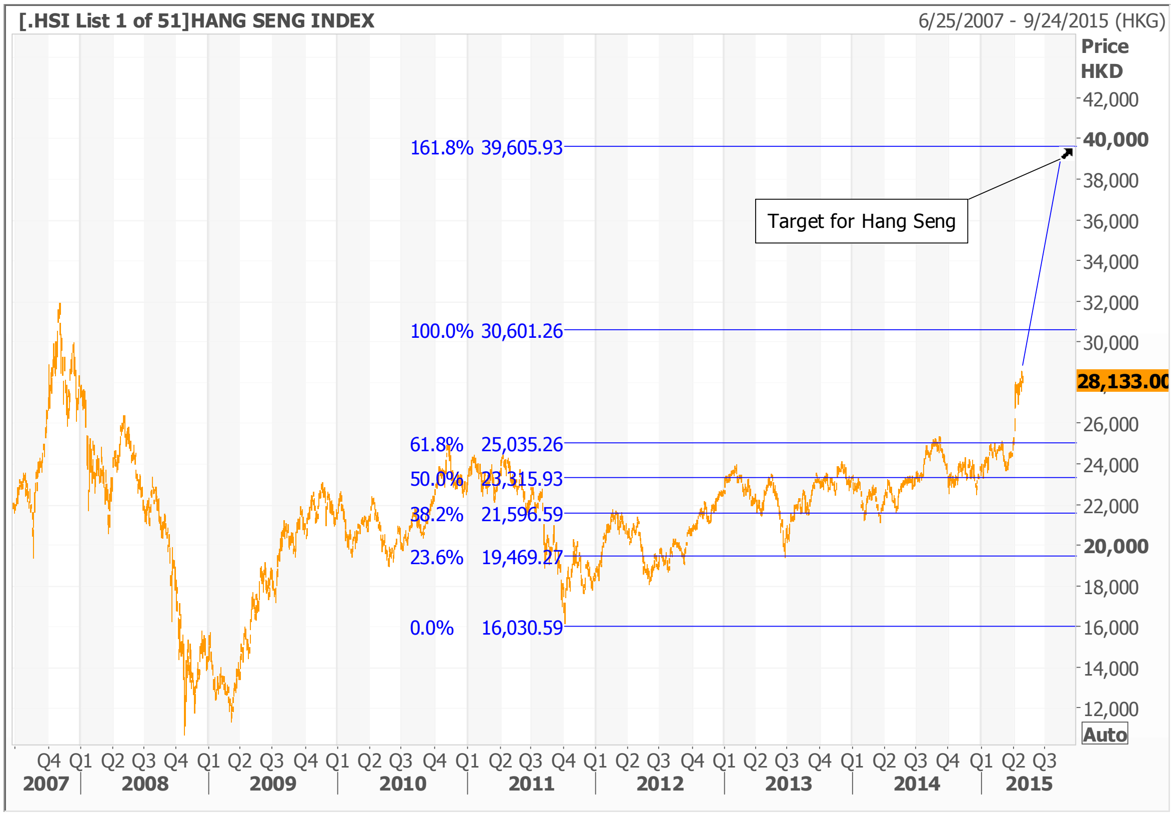
The astounding rise in Chinese citizensô commitments in the mainland A-share market reveals an underweight position in stocks and excess savings. China is ósufferingô from a surplus of savings, with household deposits today standing at US$7.9 trillion (a óhigh qualityô problem). Nomura Bank (Whatôs behind Chinaôs stellar market rally?), believes the real driver of Chinese equities is the direction of savings flows away from property and back into equities. One estimate counts mainland retail investor share holdings in China worth RMB 13 trillion (US$ 2.1 trillion) versus wealth-management products at RMB15 trillion (US$2.4 trillion) and urban housing at RMB 150 trillion (US$24.1 trillion).

In our December 2013 letter (2), we postulated the potential of a much higher Hang Seng Index. *With pessimism this intense and pervasive, we contemplate what might the flip side look like (should pessimism be replaced by optimism)? How about the Hang Seng Index, (currently trading at ~23,000), rising to 38,000 in two years?*

We presented this chart:

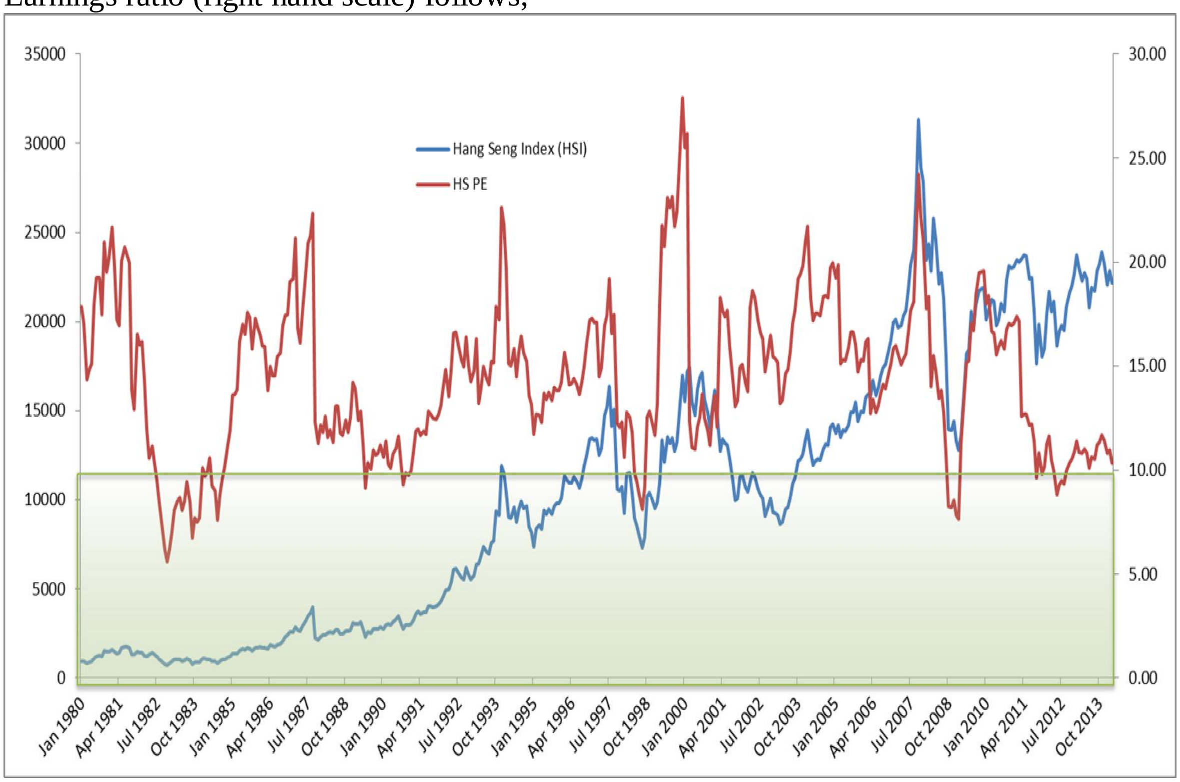
(Fibonacci, the [mathematician](#) from the 13th century, constructed some basic numeric sequences. The above [projection](#) is generated from those sequences).

We reaffirm that outlook with the matching Hang Seng Index chart updated below:



Laughable?

A chart of the Hang Seng Index going back to 1980 overlapped with the monthly Price-Earnings ratio (right hand scale) follows;



As history reveals, the main index has traded between a depressed P/E of 10 times and a high multiple of >20 times earnings. Consider this simple equation: with 2015 consensus earnings projections for the Hang Seng Index at 2,311, a 20x price-earnings multiple (which is below historic highs) would equate to a ~46,000 level for the Hang Seng.

The Hang Seng sells at just 11.5x trailing earnings today!

Additionally, Chinaôs FX reserves and its money supply are many times greater than Hong Kong. Stock prices in Hong Kong could see multiples far higher than in previous economic cycles purely on the facility to arbitrage differences between the two systems. Itôs not unlikely our 39,600 target could be markedly overshot; in 2007, mainland A-shares reached 60+ multiples!

The action last month is reminiscent of when I was a broker in Washington DC in August 1982. The US markets made a bottom, after years of underperformance and deleterious sentiment. Depressed share prices bolted upwards:

The Dow Jones Average surged amidst much doubt (stagflation, ôDeath of Equitiesö), and began a 20 year bull market. Like 1982, negative sentiment towards Chinaôs economy has been a dominant and prevalent refrain for years. At the end of the ô82 bear market, reformist leaders had taken the helm (Reagan/Thatcher), as in Asia today (Xi/Abe).

The Shanghai Index has risen 86% since November last year. We believe the Hong Kong market has just started (it has only just traded above its multi-year highs: see chart above). Corrections and advances will be sharp, all part of a normal bull market.

More thoughts in this video-taped interview with my long time journalist/editor friend Chris Oliver at his start-up financial media firm in Cyberport. The segment can be viewed here (3 Ctrl- click the link to access this video).

Sincerely,

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Links:
1. http://south-ocean.com/Client%20letter%202014/Client%20Letter%20Apr%202014.pdf

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