



9 Sept 2015

Dear Clients, Partners, and Friends,

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

	<u>Aug 2015</u>	<u>Year-to-date</u>
Hong Kong Partners LP	-8.9%	4.1%
Hang Seng Index	-12.0%	-8.2%
Hang Seng Small Cap Index	-10.6%	-11.0%
MSCI HK Small Cap Index	-11.9%	-16.8%

Partners' NAV \$2.9492 after management fees, but before annual incentive fees of 15% on appreciation.

August was a wild month for world financial markets after China devalued the Yuan by 2% on August 11. The Shanghai market fell over 12% in August, losing 30% in the past three months. The Shenzhen stock market posted its worst monthly performance with a 15% drop, down 35% in the past three months.

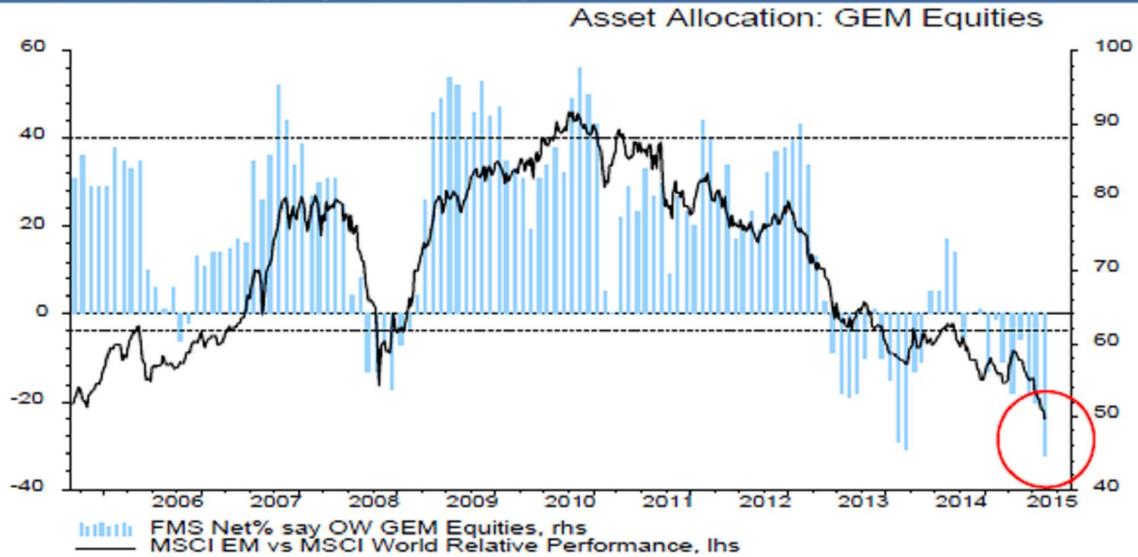
Hong Kong fell 12+% in August, its worst monthly fall since September 2011. The index has declined for four straight months and is off 23% since its high at the end of April.

We own quality small/mid capitalized shares listed in Hong Kong, but no equities that are traded in Shanghai or Shenzhen. There is a near-universal consensus by the media towards China-related equities today, extrapolating the current downtrends in China, roiling global markets and sending investor perceptions to excessive levels of pessimism.

Two interesting charts displayed below from 13D research illustrating the extreme gloom;

First, the long decline in ownership of emerging market equities by fund managers

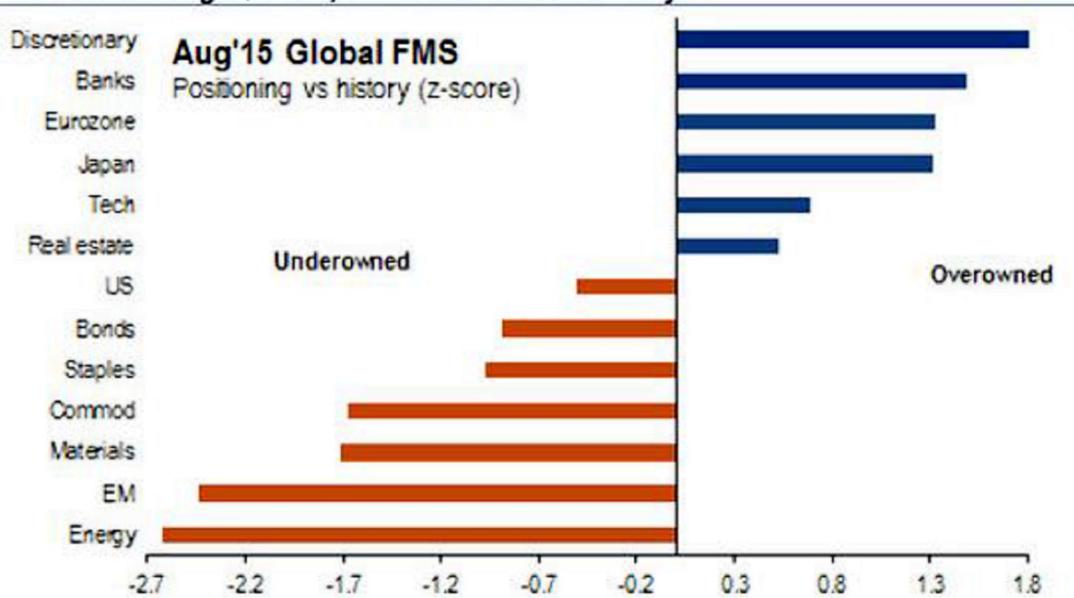
Exhibit 24: Net % AA Say they are OW GEM Equities



Source: BofA Merrill Lynch Global Fund Manager Survey

The second chart is the positioning of under/over-ownership of different investment sectors, with Emerging Markets (EM) at the second most under-owned sector.

Exhibit 1: The Longs & Shorts, relative to Global FMS history*



Source: BofA Merrill Lynch Global Fund Manager Survey

Market extremes tend to end with such levels of pessimism, doubt and despondency.

It appears a bit of a stretch, in our opinion, that a 2% devaluation in the Chinese currency can be blamed for the world market rout and mayhem in August. The Yuan has depreciated 3% over the past year but the Euro, Japanese yen, Canadian dollar and peso are down 15-20%. The USA does twice as much trade with those countries as China. The

blame may just be the excuse for investors selling after years of continued stock market gains without any (>10%) corrections (at least, in the S&P 500).

We've held a 20% cash position all through the market decline, which seemed an appropriate level of risk control (normally, we hold less than 10%). In a market environment that was clearly overvalued (in late 2007), the Hang Seng Index reached an historic high P/E ratio of 26-27x. We resorted to higher cash levels, less equity market exposure during that period. In the fourth quarter of 07, we held 50% cash along with two put warrants, in a very defensive posture (in hindsight, only an 80+% cash holding would have completely side-stepped the ensuing market decline in 2008).

At the peak in April this year, the Hang Seng Index sold only between 13-14 times. Today, the index sells at single digit levels. It would have, in our judgement, been highly risky to carry 80% cash levels this summer in such a cheap market environment.

Today, 80% of our portfolios are invested in holdings that are leaders in their respective fields, have strong management teams and generate strong, consistent earnings growth. Many of these great franchises have had meaningful corrections and are beginning to trade again at very sensible valuations.

The challenges and misconceptions about China, all too evident in the media today, were clearly defined in a recent Stephen Roach article entitled: China is juggling too many complex transformations

<http://www.marketwatch.com/story/china-is-juggling-too-many-complex-transformations-2015-08-25>

In brief:

"There are many moving parts in China's daunting transition to what its leaders call a moderately well-off society. Tectonic shifts are occurring simultaneously on several fronts — the economy, financial markets, geopolitical strategy, and social policy. The ultimate test may well lie in managing the exceedingly complex interplay among these developments. Is China's leadership up to the task, or has it bitten off too much at once?...Most Western commentators continue to oversimplify this debate, framing it in terms of the proverbial China hard-landing scenarios that have been off the mark for 20 years...In the wake of this summer's stock-market plunge and surprising devaluation of the renminbi, the same thing is happening again. I suspect, however, that fears of an outright recession in China are vastly overblown."

With all the concerns about China's Yuan devaluation, Matthews Asia had some clear insights on the subject which are copied below. The Yuan devaluation looks like a smart move to us.

Sincerely,

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What happened this week with China's currency?

Since 2005, China's currency, the renminbi, has had a de facto soft peg to the U.S. dollar (USD). While its central bank, the People's Bank of China, never explicitly stated how it determines the official daily exchange rate, also known as "fixing," it was clear that it was largely based on the USD. The intra-day band around which the RMB was allowed to float against this fixing had widened from +/- 0.5% to +/- 2% in March of this year. On August 11, the central bank announced that the fixing, going forward, would be based on the close on the prior day. With one stroke of the pen, the driver of the renminbi fundamentally changed. Its compass changed from that of the U.S. dollar to a more market-driven equilibrium rate.

How does Matthews Asia interpret this change in currency regime?

We view this RMB change, from a soft USD peg to a managed float, as first and foremost a big step forward in the government's stated objective to liberalize its capital account. This is a logical next step in line with China's reform agenda, its desire to be included as part of the International Monetary Fund's basket currencies of Special Drawing Rights (SDR), and its more gradual growth path and easy monetary stance.

Why now?

We think that the timing is a reflection of several factors, including the potential lifting of interest rates by the U.S. Federal Reserve, its candidacy to be part of IMF's SDR, and a slowing economy—all of which converged to make this change take place earlier, rather than later.

First, monetary policy between the United States and China has clearly diverged since the end of 2013 as it became increasingly clear that the U.S. recovery was on track, while China's growth was slowing. As interest rates in the U.S. drifted higher and China lowered rates, the once attractive 4% pickup in yield collapsed to less than 2%. The economics of the long RMB—short USD carry trade* was no longer attractive. The same economics that squeezed the juice out of the carry trade had real effects on corporates and consumers as well. Given the choice, Chinese corporates increasingly held USD-denominated assets over RMB-denominated assets. In order to manage the USD, in the first half of 2015, China's central bank engineered the highest sale of its reserves in the last two decades. Any rate hike by the Fed would only exacerbate the selling pressure on the RMB, and would result in further use of currency reserves.

At the same time, China has been vocal about its wish to become part of IMF's SDR basket. The controversy surrounding the RMB's inclusion has always centered around the "freely usable currency" criterion. Instituting a managed float now would arguably provide three months of data to support China's argument that it is serious about adopting a more freely usable currency. Furthermore, a little noticed but important part of liberalization has been the further opening of the interbank market to foreign institutions.

Last but not least, adapting a more market-driven exchange rate—and the resulting short-term depreciation of the RMB—should help China's slowing economy. It provides a boost to Chinese exports, exerts an inflationary affect onshore and helps accelerate the economy.

Is China purposefully depreciating its currency?

The fact that the RMB depreciated, not appreciated is a reflection of the fact that the currency had appreciated beyond its equilibrium exchange rate. According to the Bank for International Settlements, in 1H15, the RMB's nominal effective exchange rate appreciated by 3.62% and the real effective rate appreciated by 2.95% (and by more than 50% over the past decade). Moreover, the RMB appreciated by almost 8% against the euro and more than 2% against the yen during the first six months...*Matthews Asia Perspective: China Currency Teresa Kong, CFA, Portfolio Manager*