Lighthouse Advisors Private Limited
Reg. No. 201212773E
Suite 1103, #11-00 The Octagon
105 Cecil Street, Singapore 069534
www.lighthouse-advisors.com

Public Newsletter for the period ended 31 December 2017

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for December 2017.

This newsletter follows the same format as previous issues. The special topic for this issue is **National Service**.

2. Market Commentary

2017 was a very good year in general for equity investors as all major stock markets climbed.

Market Index	4Q17	2017
S&P 500	+6.1%	+19.4%
UK FTSE 100	+4.3%	+7.6%
Nikkei 225	+11.8%	+19.1%
Shanghai Composite	-1.2%	+6.6%
Hang Seng Index	+8.6%	+36.0%

US president Donald Trump finally got something done, in the form of a tax reform bill. Its main effect was to permanently reduce taxes for corporations and the ultra-rich, while raising taxes in the long term for the middle class. It has been estimated that about half the total tax benefits will go to the top 1% of income earners, while 1 in 5 middle class families will see their taxes go up. Essentially, Trump's tax plan takes from the masses and gives to the rich. Of course, Trump never claimed to be Robin Hood, only that he was different from the average politician – which he certainly is.

The tax cuts might spur corporations to increase their business activity, but many large US corporations already pay far less than the headline rate by using tax planning strategies, so the official rate is unlikely to be meaningful to them. Apple, for one, has famously shielded hundreds of billions of dollars in profits from US taxes by using companies in Ireland and Jersey to book its profits[1].

Brexit negotiations continue, with the UK and the EU agreeing in principle to a Norway-style transition, where the UK accepts all EU rules and remains a full EU member in all but name, until December 2020[2]. Clearly this is just a delay tactic, with the EU hoping the UK will hold another referendum and this time vote to "Bremain", while UK Prime Minister Theresa May still believes she can get a favorable trade deal. Triggering Article 50 gave the UK two years to negotiate the exit, set for 29 March 2019, but now they have an extra 21 months to do so, to December 2020.

European economic activity remains subdued, as the region continues to depend on German exports of machinery and cars, though Airbus' beleaguered A380 jumbo has just been thrown a lifeline by key customer Emirates[3].

China had a good year with healthy economic growth, despite a crackdown on highly leveraged conglomerates such as Anbang, Dalian Wanda, Fosun and HNA. These companies are being forced to sell their overseas assets as the government has ordered the banks to not support any deals that are not of strategic interest. The risks of being "too big to fail" are clearly on the minds of Chinese

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[1] *After a Tax Crackdown, Apple Found a New Shelter for Its Profits*, **The New York Times**, 6 Nov 2017.

[2] *Post-Brexit transition deal will resemble Norway single market membership – MEPs*, **Daily Mail**, 22 Jan 2018

[3] *Emirates hands Airbus A380 superjumbo a lifeline with $16 billion order*, **Reuters**, 18 Jan 2018.

officials, and they are reining in these mega-acquirers[4]. Of course, outward investments in infrastructure and acquisitions of critical technologies are still being financed[5].

Closer to home, privatizations are continuing in Singapore, pointing to undervaluation among the Lion City's small- and mid-sized companies. In Hong Kong, many companies trade below fair value as investors ignore them in favour of large-cap stocks surfing a wave of hot money flowing in, from both abroad and mainland China itself.

The wild ride of cryptocurrencies yields a cautionary tale about chasing returns: Bitcoin jumped over 1,400% during 2017, but then fell about 50% from its highs in January. Stocks that have been pushed up too high, too soon, may suffer similar declines. Indeed, the Chinese government issued a warning that "certain shares" were rising too fast.

Today's large tech companies such as Alibaba and Tencent are not loss-making dotcom duds headed for implosion; on the contrary they are profitable and growing rapidly. But the same could have been said of the "Nifty 50" stocks in the US during the 60s and early 70s. Companies such as Anheuser-Busch, Black & Decker, Bristol-Myers, Coca-Cola, Dow Chemical, General Electric, IBM, Johnson & Johnson, 3M, McDonald's, Merck, Disney, Walmart and so on. As household names making useful products and providing valuable services, they were widely regarded as "one decision", "buy and hold", "blue chip" investments. But once the bear market hit, their high valuations caused them to underperform the broader market.

There is a price beyond which a good company becomes a bad investment. Your manager simply prefers to err on the conservative side when setting a price limit.

[4] *China's Dealmaking Tycoons Scrutinized by Banking Regulator*, **Bloomberg News**, 22 June 2017

[5] *Paths diverge for Chinese firms chasing overseas assets*, **South China Morning Post**, 16 Sep 2017

The strong momentum from 2017 carried over to January, but volatility in February has erased the early gains. However, in China, economic growth seems robust as many companies are issuing positive profit alerts. Your manager expects the companies held by the Fund to do well this year. The Fund is essentially fully invested and welcomes additional subscriptions. The next newsletter will cover the quarter ended 31 March 2017.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
7 February 2018

3. Portfolio Review

As at 31 December 2017, the Net Asset Value (NAV) of the Fund was USD 109.41. Net of all fees, the return for the 4th quarter was +0.1%, while the full-year return was +21.3%.

For reference, during the 3 months and 12 months ended 31 December 2017, the changes in the Fund's key markets were:

Market	Index	4Q17	2017
Singapore	STI	+5.7%	+18.1%
Hong Kong	HSI	+8.6%	+36.0%
Shanghai	SSE	-1.2%	+6.6%
Fund	**n/a**	**+0.1%**	**+21.3%**

22 securities made up 92% of the Fund's holdings, with the balance in cash. NAV values are tabled in Annex I.

To protect the interest of clients, detailed discussion is confined to the client-only version of this newsletter. Client newsletters are embargoed for one year, after which they are made available online.

4. National Service

National service, in the context of the stock market, refers to companies engaging in activities that are not truly commercial in nature, but that serve other strategic interests of the government. Obviously, companies

involved in national service have less resources available for their core business. If the national service activities consume enough management time, the company can ultimately turn out to be a poor investment despite appearing attractive at first glance.

For example, wireless telecommunications businesses normally generate attractive cash flows, while power utilities grow steadily. But when these businesses are required to do national service, their underlying earning power and cash flows are dissipated.

There are 3 wireless communication operators in China: **China Mobile**, **China Unicom**, and **China Telecom**. All are state-owned, and all are forced to make investments in comprehensive network coverage, regardless of profitability. China Mobile, for one, was tasked to deploy China's proprietary TS-SCDMA 3G technology in 2009. The total cost, including network build-out, compatible device development and marketing, was estimated at US$32bn, yet by 2014 the TS-SCDMA network was obsolete as users had already migrated to 4G services.

Despite the elevated capital expenditures and suppressed cash flows from such forced investments, the telcos cannot recover the full cost of these projects, as the government has pressured them to reduce consumer charges. For example, domestic roaming fees have been abolished, and unused minutes and data now roll over to future months.

Meanwhile, excess cash on the balance sheet is not being returned to shareholders, so there is effectively no difference between China Mobile, which had net cash of RMB 400bn as of 30 June 2017, and China Unicom, which had *net debt* of RMB 138bn on the same date. Cash that will never be paid out might as well not exist. Those who think the cash gives China Mobile an advantage in making acquisitions need to ask themselves if they *really* think China Unicom will be unable to finance a purchase that the Chinese government believes will be important. Unsurprisingly the telcos have not generated impressive returns in recent years, whether via cash dividends or capital appreciation. Some pundits joke that **China Mobile** should be renamed **China *Im*mobile** because of the stock price's inaction.

A comparison of the Chinese telecos with those in Taiwan, Hong Kong, Japan, and Singapore makes clear that under normal conditions, when there are only 3 operators, cartel behaviour dominates and all the players are highly profitable. But China is decidedly *not* normal and investors who think the Chinese telcos will soon operate solely on commercial terms are fooling themselves.

As for power generation companies in China, they have a long runway of growth, given that China is transitioning to a middle-income country and per-capita energy use is likely to increase substantially. However, government mandates to keep electricity affordable for the masses take priority over cost-recovery concerns. During 2008 to 2012, when coal prices were elevated, **Huaneng Power**, **Huadian Power**, and **Datang International Power** all reported record-low profits or even losses, as they could not pass their high fuel costs on to consumers. Their profits recovered when coal prices subsequently fell, but coal prices rose again in 2017. Indeed, Huadian has just issued a profit warning, stating it expects 2017 profits to be 83% to 93% lower than 2016, due to high thermal coal costs.

A private equity buyout is unlikely as power generation and transmission-related assets are seen as critical infrastructure in China. The minority investor's return must therefore come from dividends (paid from profits) and capital appreciation (driven by earnings). But since earnings can be depressed at will to keep power affordable, long-term capital appreciation is uncertain, and the dividend is no sure thing. The power generation companies' shares are thus little more than long-lived put options on coal.

Unsurprisingly, the shares of state-owned enterprises whose core businesses have been "hijacked" for national service trade at a

discount to their privately-owned for-profit peers. Doing national service means they cannot deliver shareholder value: while they may aim to be profitable, their true goal is to serve their political masters. Investors who expect a "reversion to the mean" may be in for a long wait. Perhaps they might do better to bet on the companies that are receiving such government largesse, rather than on the hapless ones doling it out.

☙ End ❧

Annex I

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2008										34.16	33.49	35.62	**+4.3%**
2009	34.57	33.52	33.37	36.69	46.20	46.00	50.06	49.68	52.66	54.17	56.68	59.94	**+68.3%**
2010	59.05	61.09	65.17	68.27	64.14	65.69	70.65	72.24	81.06	83.56	85.10	90.30	**+50.6%**
2011	87.21	86.29	88.13	92.81	90.85	91.35	91.17	83.69	69.04	78.23	73.00	72.88	**-19.3%**
2012	77.40	82.90	82.52	83.32	76.36	77.25	77.27	77.91	80.57	79.44	82.70	84.92	**+16.5%**
2013	91.43	97.36	99.96	100.24	99.14	95.09	98.50	100.00	100.86	102.24	102.63	102.93	**+21.2%**
2014	99.15	101.78	99.80	101.84	105.45	106.57	109.05	108.58	103.60	103.91	101.87	99.94	**-2.9%**
2015	97.97	98.16	97.74	103.80	103.69	100.99	96.17	85.91	84.17	88.91	86.20	86.35	**-13.6%**
2016	81.56	83.81	88.82	92.18	91.50	91.52	94.48	94.86	94.87	93.34	91.92	90.20	**+4.5%**
2017	93.18	97.08	101.10	101.39	105.74	107.11	109.67	108.57	109.35	112.57	108.28	109.41	**+21.3%**

Note: The Net Asset Value of the Fund has been linked to the rebased NAV of the Reference Account, which had the same investment style. Until the launch of the Fund, the Reference Account served as the model portfolio for all the separately-managed client accounts. Its trading records were distributed to clients as proof that the Manager's interests were fully aligned with those of the clients. The Reference Account was started at the end of 2008 and became inactive following the launch of the fund on 1 September 2013.