

Public Newsletter for the period ended
31 December 2021

Welcome to the Lighthouse Advisors newsletter for December 2021.

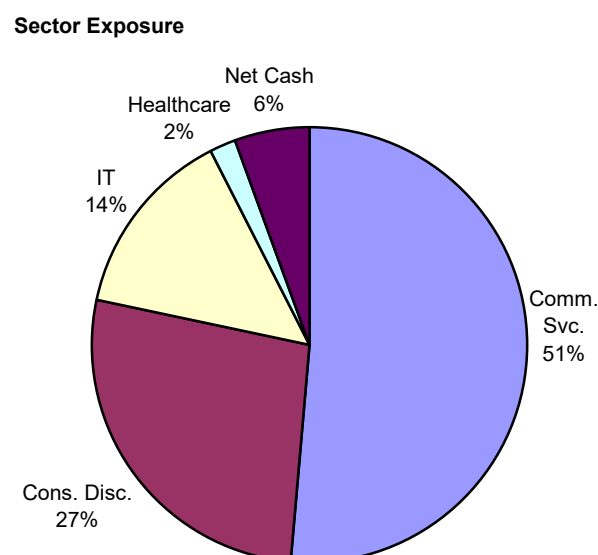
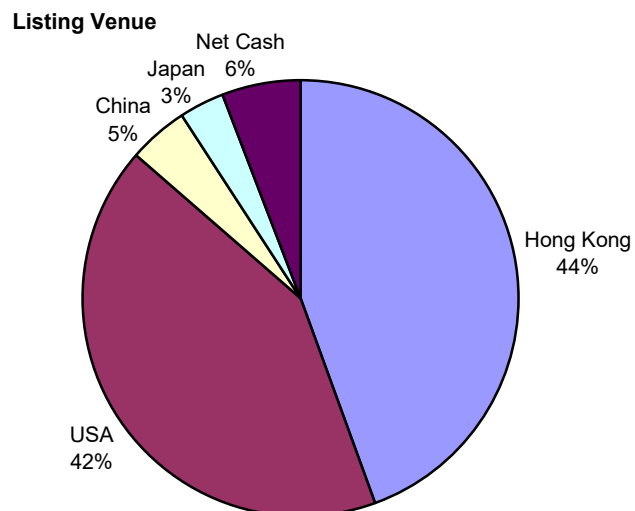
1. Summary
2. Market Commentary
3. Portfolio Review
4. Rights without Votes

1. Summary

The NAV for December 2021 was USD 82.81. (SGD: 111.73). Full-year return was -11.1% (SGD: -9.3%) As the Fund's exposure is now mainly US- and HK-listed technology stocks, the reference indices have been changed to the NASDAQ and the Hang Seng Tech Index.

| Market (Index) | 1Q21 | 2Q21 | 3Q21 | 4Q21 | 2021 |
|----------------|--------------|--------------|---------------|--------------|---------------|
| Hang Seng Tech | -2.9% | -0.4% | -25.2% | -7.1% | -32.7% |
| NASDAQ | +2.8% | +9.5% | -0.4% | +8.3% | +21.4% |
| Fund | +1.9% | +2.0% | -12.2% | -2.7% | -11.1% |

19 securities made up 94% of the Fund's holdings, with the balance in cash and cash equivalents. The following charts show the approximate exposure by place of listing and sector (numbers may not add up or match exactly due to rounding).



NAV values (USD and SGD) are tabled in Annex I.

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2. Market Commentary

Russia sent ground forces into Ukraine in late February, and currently there are reports of fierce fighting. No country has sent troops to Ukraine, but some have sent weapons. The situation remains uncertain. Russia is the largest energy supplier to the European Union, providing 41% of natural gas imports and 27% of crude oil imports in 2019, so there is a clear risk that active involvement by EU countries could result in Russia cutting off the flow of oil and gas in retaliation. Oil prices have climbed accordingly on such fears.

Stock markets have sold off since the conflict began, but have mostly stabilized. The US dollar has strengthened, while the Russian rouble has weakened significantly. Stock market volatility is expected to remain high for the duration of the conflict.

The Fund has no exposure to either Russia or Ukraine. Its global “big tech” holdings such as Alphabet and Microsoft continue to perform extremely well operationally.

As for China, the real estate sector is increasingly occupying attention due to a liquidity crisis amid numerous debt defaults by developers. The Fund has no exposure to Chinese real estate.

The next newsletter will be written for the period ending 31 March 2021.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
28 February 2022

3. Portfolio Review

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. Rights Without Votes

Multi-class shares, corporate pyramid structures and circular ownership were all discussed previously in the June 2016 newsletter under the topic heading *Power Is Nothing Without Control*. These involve corporate structures that create or maintain majority voting power and thus control, despite minority ownership stakes. Here we discuss further variations on the theme, where control is created or maintained without actually having voting rights at all.

To promote information transparency and fair market pricing, regulators worldwide set thresholds for voting interest, beyond which participants must disclose their identity or make formal offers to privatize the company. Since stock prices rise when a potential buyer is announced, acquirers seek to hide their activity until the last possible moment.

A popular “cloaking strategy” is to use **cash-settled derivatives**, whereby the potential buyer enters into deals with an investment bank and is paid (or charged) according to movements in the underlying security’s price.

In theory, there is economic interest but no voting interest, so disclosure is not needed. In practice, because the investment bank hedges against movements in prices by buying the underlying securities for its own account, the acquirer can buy the securities and acquire voting power overnight. There is no *written agreement* giving the buyer an option to buy, because the option would need to be disclosed. It is understood that the buyer *must be able to buy the shares if needed* – and is paying the investment bank to hide behind it.

This was precisely the strategy used by **Porsche on Volkswagen** shares. In 2005, Porsche began buying Volkswagen shares. Its stake eventually crossed 30% and it made an offer to buy Volkswagen. The offer failed. As word spread that Porsche wanted to control Volkswagen, other participants bought up the shares, hoping to resell to Porsche at a profit.

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Porsche borrowed €9 bn to buy Volkswagen shares, and used cash-settled options to hide its activity. But the global financial crisis of 2008 drained the banks' appetite for more loans, and when the loans came due, Porsche had to turn to Volkswagen itself for a rescue. The saga ultimately ended in 2009, with *Volkswagen taking over Porsche*, a complete reversal of events¹.

Some sophisticated investors tried to take advantage of Porsche's takeover attempt. It did not end well. Volkswagen had 2 classes of shares: ordinary shares, with voting rights, and preferred shares, without voting rights. The preferred shares historically traded at a discount. Porsche bought the ordinary shares and ignored the preferred shares, widening the price gap.

Some hedge funds bought the cheaper preferred shares and sold short the dearer ordinary shares. They calculated that Porsche would eventually run out of cash to buy Volkswagen shares, and once it stopped, other investors would abandon Volkswagen too, triggering a fall in the price of the ordinary shares, and a return to the historical pricing relationship between the 2 share classes. The hedge funds would then unwind their "pair trade" and book a handsome profit.

But Porsche announced one Sunday that its shares and cash-settled options amounted to a 74.1% stake in Volkswagen. The funds were caught out: 12% of the shares had been sold short, but with the State of Lower Saxony holding a 20.1% stake, less than 6% was available on the market to be bought back.

When markets reopened, the funds scrambled to buy, and Volkswagen's shares briefly touched €999, versus its Friday closing at about €200. Total hedge fund losses from the "short squeeze" were estimated at €20bn². It was a memorable event, to say the least.

¹ *Porsche: The Hedge Fund that Also Made Cars*, **Priceonomics**, 14 October 2014.

² *The Day Volkswagen Briefly Conquered the World*, **Financial Times**, 31 October 2018.

The next situation concerns **regulatory shields**, where local laws prevent outsiders from acquiring an influential stake in particular industries or specific companies. Such laws allow incumbents to protect their interests with artificially low stakes.

Volkswagen makes a reappearance, thanks to the infamous "Volkswagen Law" of 1960³. That law capped voting rights were capped at 20%, and gave both the German government and the State of Lower Saxony the right to each appoint 2 of the 10 representatives on the supervisory board, as long as they held shares (originally 20% each). Also, decisions needing a 75% majority to pass would require 80% instead. After rulings against the Volkswagen Law by the European Court of Justice in 2007, the law was amended, and today only the 80% majority requirement remains.

In **Singapore**, the **Banking Act 1970** states that approval from the Minister for Finance is required before a person can cross various levels of ownership in a Singapore-incorporated bank or approved financial holding company⁴. Approval is needed at 5%, 12% and 20%, and also if a transaction would grant the person indirect control. In other words, persons who are considered undesirable for whatever reason can be blocked. This makes it difficult to unseat incumbent controlling shareholders, who can retain control despite holding small stakes.

Next, we come to an inverted situation, where the controlling shareholder's votes are *less* than its economic interest.

SUNeVision is listed in Hong Kong. It operates data centres in Hong Kong. The 2020-2021 annual report shows **Sun Hung Kai Properties (SHKP)** has an interest of 147% of the shares in issue. What is going on?

³ *Law Concerning the Transfer of the Share Rights in Volkswagenwerk Limited Liability Company into Private Hands*, **Federal Republic of Germany**, 21 July 1960.

⁴ *Banking Act 1970, Part 3, Section 15A*, **Republic of Singapore**, 18 July 2001.

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Back in 2010, SHKP held 84.6% of the company. However the Hong Kong Exchange changed its rules to require a minimum free float of 25% by June 2011. The simplest way to comply would have been to place out shares. In this case, a 10% block trade would have done the job.

Instead, the company chose an unusual solution. It executed a 1-for-1 bonus issue, with the choice of receiving either ordinary shares or convertible notes. These notes could be converted into ordinary shares on an equal basis, and received dividends on an as-converted basis, but were unlisted, non-transferable and irredeemable. Naturally, the board of directors recommended that minority shareholders choose the ordinary shares. SHKP took the convertible notes.

Afterwards, minority shareholders held twice the number of voting shares, increasing their voting stake to 26.5%, but with *no change in their share of dividends*. SHKP had reduced its voting block from 84.6% to 73.4%, but its convertible notes ensured it would still receive 84.6% of any dividends. The bonus issue was done solely to comply with the letter, but not the spirit, of the free float requirement.

The convertible notes also have the effect of cementing SHKP's control of SUNeVision: in future, SHKP can significantly reduce its voting block without losing of control, because the convertible notes still grant it a majority on an as-converted basis. In fact, as long as SKHP holds just 14% of the voting shares, a hostile bid for SUNeVision cannot succeed.

Our final case of "rights without votes" is **Far East Horizon**, a leasing company also listed in Hong Kong.

In the 2020 annual report, the CEO Kong Fanxing has a voting interest of 18.6%. Normally this would be regarded as a good alignment of interest. But the 2019 annual report reports the CEO's voting interest at 7.8%. How did he acquire an additional 10.8% voting interest in just one year?

| Voting Rights | 2019 Report | 2020 Report |
|---------------|---------------------------------|------------------------------------|
| CEO | 7.8% | 18.6% |
| Sinochem | 23.2% | 23.1% |
| DCP | 9.2% | 10.4% |
| Cathay | 9.0% (Cathay Life Insurance) | 8.2% (Cathay Financial Holding) |

As can be seen above, during 2020 the other large shareholders did not transfer any meaningful voting rights to the CEO.

Did the CEO exercise a large block of share options? **No**. He did not exercise any options in 2020, and in any case all his options totaled less than 2% of the outstanding shares.

Did the CEO buy the shares? **No**. The company's shares traded above HKD 7 during most of 2019. A 10.8% stake would have cost at least HKD 2.6bn. Even with 50% financing, the cost would top HKD 1.3bn. The CEO's salary in 2020 was RMB 7m. Even if he was paid such a sum every year since starting work in 1991, he could not have bought the shares.

Did other employees pool their resources to buy shares, then give the CEO their voting rights? The Group's 2020 wage bill was RMB 3.7bn, so it was possible, *if* every employee spent an average of 70% of their salary buying shares, clearly a ludicrous idea.

The simplest answer is that there is a "hidden shareholder" which wishes to mask its presence. Disclosure rules target voting rights, but not economic rights, so this shareholder could acquire a large block, but assign its voting rights to a friendly party like the CEO.

While the CEO could technically vote the assigned shares against the hidden shareholder, this would be extremely risky. It can be reasonably assumed that he will vote in line with its desires. As to the identity of this shareholder, perhaps it is a politically sensitive issue. Further speculation is left to the reader.

❧ End ❧

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Annex II

NAV in USD (Official)

| | 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% |
| 2018 | 113.04 | 109.56 | 109.03 | 105.39 | 109.62 | 104.37 | 101.26 | 93.71 | 94.25 | 85.19 | 86.83 | 86.66 | -20.8% |
| 2019 | 91.98 | 92.36 | 90.04 | 90.21 | 82.80 | 84.21 | 82.57 | 78.45 | 76.52 | 77.82 | 78.75 | 82.80 | -4.5% |
| 2020 | 78.58 | 75.37 | 67.15 | 71.23 | 70.50 | 77.22 | 82.23 | 88.36 | 84.97 | 86.77 | 90.34 | 93.20 | 12.6% |
| 2021 | 99.54 | 99.36 | 94.98 | 99.37 | 96.76 | 96.86 | 86.54 | 87.88 | 85.09 | 90.51 | 85.32 | 82.81 | -11.1% |

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.

The following data is for the convenience of SGD-based investors and is for reference only.

NAV in SGD (for reference only)

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | YTD |
|-------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------------|
| 2008 | | | | | | | | | | 50.68 | 50.69 | 51.20 | 2.4% |
| 2009 | 52.22 | 51.91 | 50.74 | 54.21 | 66.70 | 66.59 | 72.06 | 71.60 | 74.19 | 75.67 | 78.50 | 84.15 | 64.4% |
| 2010 | 83.11 | 85.83 | 91.17 | 93.55 | 89.79 | 91.72 | 96.10 | 97.84 | 106.70 | 108.12 | 112.34 | 115.86 | 37.7% |
| 2011 | 111.57 | 109.76 | 111.06 | 113.64 | 112.11 | 112.14 | 109.75 | 100.70 | 89.85 | 97.91 | 93.64 | 94.48 | -18.5% |
| 2012 | 97.39 | 103.46 | 103.79 | 103.05 | 98.44 | 97.76 | 96.12 | 97.20 | 98.89 | 96.95 | 100.95 | 103.74 | 9.8% |
| 2013 | 113.19 | 120.44 | 124.03 | 123.50 | 125.34 | 120.54 | 125.55 | 127.49 | 126.57 | 126.83 | 128.86 | 127.81 | 23.2% |
| 2014 | 124.51 | 128.55 | 125.58 | 127.84 | 132.26 | 132.85 | 135.95 | 135.58 | 132.14 | 133.61 | 132.91 | 132.34 | 3.5% |
| 2015 | 132.68 | 133.74 | 134.11 | 137.66 | 139.74 | 136.08 | 131.71 | 121.30 | 119.78 | 124.68 | 121.53 | 122.26 | -7.6% |
| 2016 | 116.13 | 117.82 | 119.59 | 123.86 | 126.08 | 123.36 | 126.71 | 129.30 | 129.32 | 129.95 | 131.79 | 130.54 | 6.8% |
| 2017 | 131.35 | 135.81 | 141.22 | 141.04 | 146.29 | 147.44 | 148.75 | 147.28 | 149.30 | 153.38 | 146.00 | 146.32 | 12.1% |
| 2018 | 148.13 | 145.04 | 142.95 | 139.64 | 146.74 | 142.24 | 137.76 | 128.59 | 128.83 | 117.98 | 119.13 | 118.06 | -19.3% |
| 2019 | 123.77 | 124.86 | 123.01 | 122.81 | 113.88 | 113.93 | 113.02 | 108.85 | 105.83 | 105.92 | 107.71 | 111.33 | -5.7% |
| 2020 | 107.23 | 105.02 | 95.47 | 100.41 | 99.64 | 107.68 | 112.93 | 120.15 | 116.02 | 118.55 | 121.20 | 123.14 | 10.5% |
| 2021 | 132.30 | 132.32 | 127.74 | 132.16 | 127.85 | 130.26 | 117.21 | 118.19 | 115.50 | 122.11 | 116.41 | 111.73 | -9.3% |