Manager Quarterly Commentary
2016 Q2

Portfolio Review

Our last outlook turned out to be too optimistic. We were trapped by the valuation, and, even though there was a good rebound in February and March, the Quam China Focus SP (QCF) saw a loss of 9.83%. Our Event Book actually did quite well; except for the two pharmaceutical names, most events delivered positive or outperforming figures. We captured several new names, including re-building Dah Sing Financial (440.HK), Crocodile (122.HK), and Biostime (1112.HK) for potential business disposal, back door listing (BDL), and M&A, respectively. The newly built Tysan (687.HK) had potential for asset disposal and BDL. However, the contribution of these did not offset the overall loss in Q1.

The pharma names accounted for half of the total loss in Q1, as the whole industry suffered from a huge price cut. The outlook is unclear. The overall loss was at about in line with mutual fund peers, but we are the absolute return manager. A number of names have the convicted upcoming return, together with a limited downside in event names. We are confident that we will recover the loss and show a positive return at the end of the year.

Table 1. Event Driven Names

	Event	Upside	Downside
Crocodile (122.HK)	BDL	79%	-31%
Quam Ltd. (952.HK)	BDL	42%	-41%
Dah Sing Financial (440.HK)	Business Disposal	14%	-10%

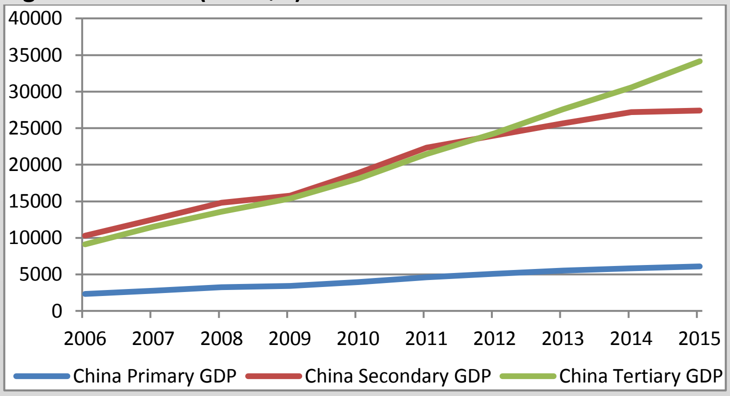
Data as of 31st Mar, 16

The fixed income portfolio did fantastically well. Convertible bonds, straight bonds, and high dividend stocks all generated positive returns in Q1.

Phases of Economic Development

China has enjoyed good economic growth since the 80s. Its strong export performance was due to low production costs. China became the world's factory. While China may still supply huge quantities of cheap products, low-end manufacturing enterprises are struggling now. As the chart below shows, the growth of secondary GDP is slowing down, despite the huge contribution from investment. However, what is encouraging is the tertiary GDP, which even out-performs secondary GDP.

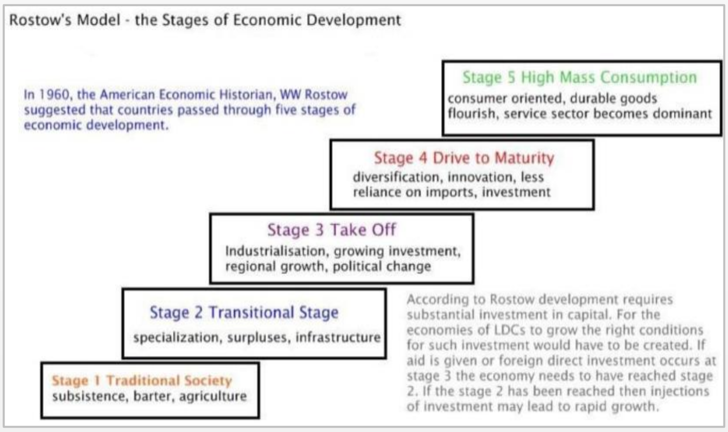
Fig. 1. China GDP (RMB $B)



Source: Bloomberg

Unfortunately, most Chinese industries or companies are related to secondary GDP. Secondary GDP (investment) can only provide survival for related companies, not growth. The real worry concerns manufacturing GDP. The dumping/over-capacity in mining, heavy industries, and low-end products make the situation very negative. From figure 2, China should have moved out of Stage 2, but it has not yet qualified as Stage 3.

Fig. 2. Rostow's Model: The Stages of Economic Development



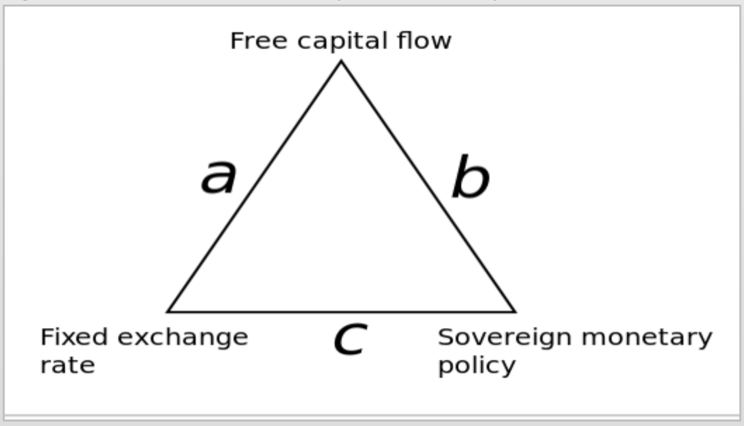
Source: Lewis Historical Society

The Government has not demonstrated an ability to tackle the issue. A suitable approach to resolve the over-capacity would be to shut down or privatize enterprises. We do not see any possibility of China's going in this direction for structural reasons. China does not allow ghost movies, but there are a lot of zombies in various industries! The economy is suffering from a lack of innovation.

Economic Trilemma

When RMB was appreciating, the Government was so happy to allow it to run and fell into the capital trap. Now, the Government hesitates about depreciation. Why?

Fig. 3. Robert Mundell: The Impossible Trinity



Source: Wikipedia

A weak economy will trigger currency depreciation pressure. The impossible trinity clearly states that a country cannot enjoy three sides of the triangle simultaneously. If the government keeps controlling the exchange rate, it will cause capital outflows. Declining foreign reserves will trigger concerns about the broken fixed exchange rate, which will have a reflexive effect of more capital outflows. China tried to control the three sides of the triangle in 2H15, but this only triggered bigger risks, as per the Impossible Trinity. In 1Q16, China used its entire means to limit capital outflows. However, this has only made the economy weaker, due to the overpriced exchange rate and higher risks in the financial system.

Bubble, Bubble

Figure 4 shows the Shanghai property price chart. The latest price is RMB 39,896/sqm, while the average income is RMB 49, 867 p.a. and it takes 24 years for a three-person family to pay for a 90-sqm flat. So far in 2016, housing prices have surged by 14%.

Fig. 4. Shanghai Second-hand Housing Price Chart

Source: www.fangjia.com

Will History Repeat itself?

No government like China should move to buying stock to "support" the market—but it did. Investors are excited in expectation of a rally from the state pension's RMB 800B potential stock purchase.

The latest move is the debt-conversion-into-equity policy. The Bank of China, other banks, and suppliers of Huarong Energy (1101.HK/2956.HK) "agreed" to convert their debt to equity at $1.20. The conversion has not been completed, but it has already recorded a 36% loss as at 6 Apr 16. Some one trillion USD worth of debt is to be converted following this policy, which lenders will suffer from similar situation like Huarong Energy.

Fig. 5. Price Chart of Huarong Energy

Source: Bloomberg

Source: The Economist

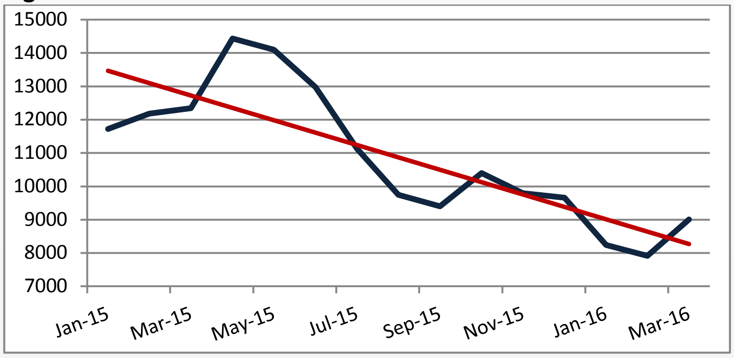
Recently, Moody's has given a negative credit outlook to China and, sadly, Hong Kong. Of course, both governments defend themselves, but please take a look of their explanations.

China experienced and suffered from the Great Leap Forward and Cultural Revolution. This reminds us that history repeats itself, but never in the same way.

Portfolio Strategy

Based on this macro view, we are very cautious in managing the portfolio. Starting in the middle of Q1, QCF has reduced its equity exposure; QCF current exposure is about 87% in equity and 24% in fixed income. Beta may be driven higher in Q2, but we doubt whether this will be the last breath. We prefer to consider timing, to look for short selling opportunities.

Fig. 6. HSCEI Index



Source: Bloomberg

The portfolio has a number of names that deliver promising and attractive dividends from a stable income. Such names may have surged as a result of potential acquisition or asset disposal.

Table 2. Names with Potential Acquisition or Asset Disposal

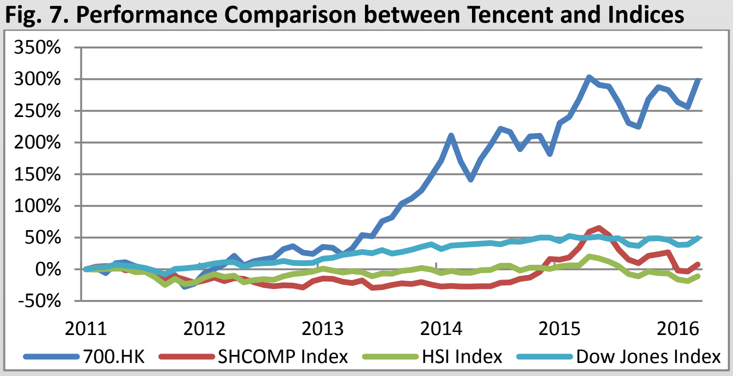
Company	P/B Ratio	Net Cash/Price	Yield or YTM
Dan Form (271.HK)	0.38x	59.32%	9.67%
Safety Godown (237.HK)	0.48x	62.29%	4.49%
Cross Harbour (32.HK)	0.74x	92.04%	3.58%
YT Realty (75.HK)	0.87x	20.53%	100.00%
Yugang Int'l (613.HK)	0.43x	83.18%	2.76%
Biostime CB			8.12%
HC Int'l CB			21.23%

Data as of 31st Mar, 16

As mentioned, there are some names whose event is about to crystalize (in Q2). Based on our analysis, the likelihood of success is high. Even if the events fail, it is only a matter of time before these names show positive results.

Tencent (700.HK) is the core position in the growth book. It accounts for about 10% of both the QCF and the Quam Greater China (QGC) UCITS Fund. With a high entry barrier, unlimited business expansion, good execution, and management integrity, any price correction will represent a buying opportunity.

Fig. 7. Performance Comparison between Tencent and Indices



Source: Bloomberg

Middle class spending is the main theme in the Growth Book. We have JD.com (JD:US) and Ctrip.com (Ctrp:US), which are running the online shopping and online travel agency services, respectively. Business growth here is promising.

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