LUMIERE VALUE FUND

Letter to Investors

2009 Full Year Review

January 2010

Dear Investors,

What a difference a year makes. Just like 2008 will be remembered as one of the worst years ever in the history of financial markets, 2009 will be marked as one of the best. In 2009, the S&P started the year at 903 and closed up 23% to 1,115 by the end of the year. Over the same period, Hong Kong's Hang Seng Index increased 52% from 14,387 to 21,872, while London's FTSE increased 22% from 4,434 to 5,412 and Singapore's Straits Times Index (STI) increased 65% from 1,761 to 2,897.

Against such a backdrop, the Lumiere Value Fund returned 155% in 2009, capping our best year ever. This performance puts us among the top for equity funds worldwide in 2009[1]:

Year	Lumiere Value Fund*	NAV per unit (S$)	Total Fund Assets (S$ million)
4th Quarter 2007	-6%	0.94	4.6
2008	-62%	0.36	2.9
2009	+155%	0.92	10.4

** Returns are net of all fees*

The fund ended 2009 with fund assets reaching a new high of $10.4 million, made up of both capital appreciation of our investments as well as new subscriptions of $2.4 million received during the year. *At the time of publication of this letter in mid January 2010, the Lumiere Value Fund has also surpassed its high watermark*.

The fund's focus on deep value stocks and recovery situations in 2009 has worked out very well. Some of the companies that we invested in early in the year like **Yellow Pages** and **Osim** got rerated very quickly in a matter of months as it became apparent to all that the troubles that faced these companies previously were well on the way to being resolved satisfactorily. Yellow Pages' successful rights issue conclusively removed any lingering refinancing doubts while Osim's remarkable turnaround continued as it reported higher operating margins and profits. Another one of our investments, **Sihuan**, a cardiovascular drug company, got taken private by Morgan Stanley Private Equity at a 40 percent premium to our entry price. This brought us some disappointment as it meant that our upside on this investment would be capped at the privatisation price, which was far short of the 2-bagger that we were originally expecting. We also capitalised on the strong sentiment in oil & gas and property sectors to exit our investments in **Tiong Woon**, **KTL** and **Wing Tai** with a nice profit.

Our relentless search for value took us to Hong Kong in the second half of 2009 where we were able to find a handful of well-run fundamentally strong companies operating in fast-growing industries available at attractive valuations, giving us the potential of getting at least 2-baggers over the next few years. Today, the Fund is in a fully invested position, with approximately 20 percent of our portfolio made up of companies listed in Hong Kong. We will be profiling one of our Hong Kong investments in the company commentary section.

General Comments

All along, the fund's modus operandi has been to take the disciplined approach of buying good growing businesses at deep discounts to intrinsic value. This generally means buying more as prices

[1] Based on Fund Performance and Ranking data obtained from various reputable mutual fund and hedge fund databases.

fall and discounts to intrinsic value widen provided long-term business fundamentals remain intact. This is based on the belief that the stock prices will in the long run converge with the company's business fundamentals. After all, Benjamin Graham, after decades of studying companies and stock markets coupled with his personal experience, came to the conclusion that the stock market behaves like a voting machine in the short-run and a weighing machine in the long-run.

This approach has served us well for many years as we made use of the market sell-downs following the terrorist attacks in 2001, the US ports closure in 2002, SARS in 2003 and the two-year bear market for small and mid-cap stocks in 2004 and 2005 to pick up many good companies trading at bombed out prices, giving our managed accounts a compounded annual return of over 40% between 2002 and mid-2007.

However, the viciousness of the 2008 financial crisis sets it far apart from the previous few bear markets of the past decade. At the depths of the crisis in 2008, the voting machinery was so heavily skewed towards the pessimistic scale that many could no longer discern between reality and perception. In other words, they could not differentiate between the perception of bad news and the bad news itself. Since most investors no longer knew what to believe, they sold down stocks good and bad across the board. If a company was perceived to be a good business franchise with institutional sponsorship, it fell 70 percent from the top. For example, DBS Bank, the largest bank in South East Asia with Singapore government ownership, fell 74 percent from its peak of $25 to a low of $6.45. However, if the company was perceived to be operating in a more risky and cyclical environment such as Oil & Gas, Property or Commodities, it would fall much more. For example, Noble Group, one of the largest integrated commodities supply chain player in the Asia, fell 83 percent from its peak price of $2.83 to a low of $0.47 during the crisis. Small and mid-cap companies that were below the radar of most institutions suffered an even worse fate, with many falling by up to 90 percent from their peak prices. Investing during those turbulent times was regarded by many as walking across a minefield blindfolded, so the best way to ensure not having a leg blown off was to not walk at all!

Even some of the more level-headed institutions who tried to discern for quality had their hand forced by their own investors' call for cash, thus had to sell into the falling market regardless of business fundamentals to meet the massive redemptions. It was a terrible time indeed and one which many of us hope will not happen again in our investment lifetimes. However, a closer study of stock market cycles will reveal that these extreme market panics are by no means a once in a generation type of event.

The Asian Financial Crisis of 1998 saw Asian stock markets plunge by over 60%. Similarly, the market panic in 1987 also brought global markets down over 50% at its worst point. Before that, we had the long bear market of 1974 and 1975, which was so deep that it coaxed value maven Warren Buffett out of retirement. While it is not our intention to predict when the next financial crisis will occur, just the knowledge that it will no doubt happen (could be 15 years, 10 years or 5 years down the road) is sufficient to make us want to prepare for it.

The defining characteristic of these major market panics is the *short and sharp* drop in stock prices across the board during the worst part of the crisis, when uncertainty is at its peak. These declines are usually in excess of 50 percent and happen very quickly, typically in 6 months or less. Since the intrinsic values of a large basket of highly regarded blue chip companies (which typically make up the stock market index) do not deteriorate by so much within so short a period of time, one can only conclude that such market crashes are due to forced liquidation and widespread investor panic. Both of these factors have very little correlation to the business fundamentals of the companies being

sold off, thus fundamental analysis usually provides only limited downside protection during these extreme episodes.

The following tables illustrate the magnitude and length of declines for the STI and Hang Seng Index during the worst periods of major market panics over the past two decades:

Year	% Decline of STI at Worst Period	Period	Length of Decline
1987	-54%	Oct 87 – Jan 88	4 months
1998	-52%	Mar 98 – Aug 98	6 months
2008	-51%	May 08 – Oct 08	6 months

Year	% Decline of Hang Seng at Worst Period	Period	Length of Decline
1987	-52%	Oct 87 – Dec 87	3 months
1998	-47%	Aug 97 – Jan 98	6 months
2008	-52%	May 08 – Oct 08	6 months

While the act of buying more stocks as discounts to intrinsic value widen lies at the heart of the value investor's core philosophy, it is our experience that the relentless purchase of stocks as prices plunge and value springs forth, will usually result in investible cash running out well before stock prices bottom, especially during severe market panics such as the 1998 Asian Financial Crisis and 2008 Global Financial Crisis. Moreover, switching between stocks to get greater value in a market freefall is frequently a costly exercise due to heavy attrition cost, as liquidity usually shrinks and bid-ask spreads widen significantly going into a crisis.

Going forward, we will be complementing our value averaging approach with "time diversification" when investing during these severe market sell-downs. By time diversification, we are referring to the staggering of our purchases as the bear market elapses, such that only a pre-determined portion gets invested in our best ideas during each time period, regardless of the pace of the decline. Without the benefit of hindsight, one will not be able to determine with absolute certainty at any point in the crisis whether the worst period is ahead or behind us. Furthermore, most major crises drag on far deeper and longer than expected and is only earmarked as a major episode well into the crisis. Thus, time diversification will allow us to spread out our purchases over the entire period of the downturn, giving us a low enough average cost and minimising the attrition cost involved in switching between stocks at market bottoms. Even if stocks do not fall that low for us to fully utilise our investible cash, the small upside that we have given up will be more than compensated for by the more palatable levels of portfolio downside volatility.

"When is it a good time to get back into the market?"

After stock markets have run up so strongly over the past few months, it is understandable that many investors, having missed the market bottom in March 2009, are fearful of investing in funds or stocks just as the next down-cycle starts. Thus, one of the most common questions we have been getting recently is "When is it a good time to get back into the market?" Our studies of over two decades of stock market data show that the median bull market for small and mid-cap companies is 13 months, which makes January 2010 the 10th month of this bull cycle. However, simply looking at

the median will obscure the fact that these bull market durations range from as short as 7 months to as long as 26 months. In other words, the lengthiest bull market is almost four times longer than the shortest! Thus, the aspiring market timer faces a potentially huge margin of error. If this does not yet convince you of the difficulty in timing your investments in the market, we suggest reading our more comprehensive take on this in our *June 2005 Investor Letter*.

Instead of attempting to time the markets with your investments, time diversification may prove to be a more systematic and rational approach for most investors. Embarking on such a program to space out one's investments in funds or stocks over pre-determined time periods not only cultivates the emotional fortitude needed to buy into value when others are fleeing, but also spreads out the average investment cost over time. After all, in an investment lifetime that usually spans decades, the lowest average cost wins.

Company Commentary

What you're about to read should not be misconstrued as investment advice. Instead, our intention for devoting the entire section on company commentary is so that readers can understand the thought process underlying our investment philosophy.

Chow Sang Sang

Chow Sang Sang is a premier jewellery retailer and manufacturer in Hong Kong and Greater China. The company has a long operating history of 75 years stretching back to its founding in 1934, and was listed on the Hong Kong Stock Exchange in 1973. Currently, the company is the largest listed jewellery retailer in China, as well as in Hong Kong, in terms of jewellery sales. Headquartered in Hong Kong, the company has 120 jewellery stores in China, 47 in Hong Kong, 21 in Taiwan, and 2 in Macau. The company sells jewellery mainly through stores with the "Chow Sang Sang" brand name, as well as smaller amounts through stores under the "Emphasis Jewellery" brand name. The company also has a securities business which contributes to a small part of its earnings.

Over the last 10 years, sales have grown 141% from HK$4.1 billion in 1998 to HK$9.9 billion in 2008. Profits have grown even more, expanding fourfold from HK$106 million in 1998 to HK$471 million in 2008. The company's profits, since bottoming in 2001 due to the global recession stemming from the internet bust, has had 6 years of continuous growth from 2001-2007. Even with the onset of the global financial crisis in 2008, the company's net profit fell less than 10% in the year ended 31 December 2008. In the first half of 2009, even though profits were down 20% from 1H2008, it was still higher than in 1H2007, which was the year the company achieved its best ever results. This attests to the company's resilience through difficult times.

A large part of the company's fast growth over the last 7 years was due to the consumption boom in China arising from strong economic growth. This consumption boom has benefitted Chow Sang Sang in 2 ways – firstly, the company's Hong Kong sales have been boosted through increased purchases by mainland Chinese tourists visiting Hong Kong. Its strong and well established brand name, good product quality and creative designs have led mainland shoppers to prefer the company's products over mainland Chinese jewellery retailers. In addition, tourists get more competitive prices in Hong Kong which has a zero VAT (Value-added tax) rate, compared to China, where purchasers of jewellery have to pay a 5% consumption tax, on top of a VAT of 17%.

Secondly, the company's sales from its retail stores in China has been a big beneficiary of the consumption boom. Chow Sang Sang was founded in 1934 in Guangdong, China, and subsequently relocated to Hong Kong in 1948. Since then, its growth from the 1950s till 1990s has been powered

by the strong growth in the Hong Kong economy. In 2002, the company embarked on a plan to rapidly expand its then small presence in China to capture a larger market share. It grew its retail network in China from 16 shops in 2002 to 120 shops in 2008. As a result of this expansion, the company's China sales grew 15-fold from HK$100 million in 2002 to HK$1.5 billion in 2008, a CAGR of 57%! Share of the company's profits derived from China have also grown from scratch in 2002 to 35% in 2008. While growth in the last few decades came from riding on the strong economic growth in Hong Kong, growth in next few decades will come from China, where the company is among the top few players.

Other than rising consumption fuelled by rapid economic growth, jewellery demand in China is also expected to rise due to the fact that the per capita consumption of gold is still very low. In 2008, china's consumption of gold per capita is 0.30 grams, compared to 0.88 grams in the US, 0.62 grams in India, and 0.45 grams worldwide. Over the past 5 years, gold consumption in China has grown from 225 tons in 2003 to 396 tons in 2008, achieving a CAGR of 12% - outstripping China's economic growth over the same period. Going forward, China's consumption in gold is likely to continue growing at a fast pace.

Apart from being a beneficiary of the booming jewellery industry in China, Chow Sang Sang possesses a strong competitive advantage within the industry in China, due to a well-established brand name built over several decades. Brand name and expertise takes a long time to build in the jewellery industry – most of the leading global names in this sector like Tiffany and Bvlgari have more than 100 years of history. Chow Sang Sang has, over 75 years of operations, managed to build itself to be a top jewellery retailer in Hong Kong. In China, the company has an even bigger advantage when competing against the mainland jewellery players. This is because in 1949, the Chinese government outlawed private ownership of gold, and also took control of the entire industry from exploration to distribution. The mainland jewellery industry basically disappeared with the ban, and was restarted from scratch only in 1982 when the ban was lifted. Hence, superior branding and expertise built over the decades will help the company capture market share from its mainland competitors. In addition, Chow Sang Sang is also one of the 79 sightholders chosen by the Diamond Trading Company of De Beers (the largest supplier of rough diamonds in the world, with 40% market share) – De Beers sells its rough diamonds exclusively to sightholders, which gives Chow Sang Sang a cost and quality advantage in sourcing of rough diamonds.

Besides having the business acumen in growing Chow Sang Sang over the years, the company's management team have also shown themselves to be shareholder friendly – over the period 2001-2008, the company has on average paid out *more than half* its earnings in dividends. Average payout ratio over the 7-year period was a whopping *59%*! This also speaks volumes for the company's high earnings quality, and its strong free cashflow generation capability. As the company's share price fell with the onset of the financial crisis in 2008, one of the company's founders Chow Kwen Ling bought 300,000 shares of the company – a display of his belief in the company's undervaluation and its long term growth potential.

We concluded that Chow Sang Sang is the "right" business, in the "right" industry, run by the "right" management, and was also trading at the "right" price – hence we acquired the shares in the company during the second half of 2009, paying a price of around 7 times earnings, and getting a dividend yield of around 5%. The stock has since appreciated considerably.

CSE Global

CSE Global Limited is one of the largest independent systems integrators in the world, with an international presence spanning Americas, Asia Pacific, Europe, Africa and the Middle East. The company provides industrial control automation systems, system integration and telecommunications solutions to the oil & gas, and infrastructure sectors; and IT consulting services such as installing the Electronic Road Pricing (ERP) system in Singapore and patient record system to the healthcare industry in UK. CSE started operations in 1985 as the engineering projects division within the electronics arm of Singapore Technologies. The company was eventually spun-off in a management buyout in 1997 and was listed on the Singapore Exchange in 1999.

Since its listing in 1999, CSE global has achieved an amazing track record of growth, where it achieved growth in sales *every single year* for 10 years in a row. Over the last 10 years, sales grew almost tenfold from S$47 million in 1998 to S$442 million in 2008. Similarly, profits grew remarkably, increasing eightfold from S$6 million in 1998 to S$48 million in 2008. As a testament to the quality of its business and management team, the company has managed to achieve a high return on equity and stable profit margins despite growing at a blistering pace over the last 10 years. Over the 10-year period from 1998-2008, return on equity averaged 33%, and gross profit margin averaged 34%, with fluctuations occurring within a very small range of between 33-37%. The company has also generated strong free cash flows which has allowed it to pay out a large portion of earnings in dividends – dividend payout ratio has averaged 40% over the period 2002-2008.

Through a successful acquisition and expansion strategy over the last decade, CSE has built up an integrated service offering capability as well as a global customer base. The company has been able to cross-sell products and services globally, which has been a contributor to past performance and will help propel future growth. Other than having a strong product offering, the company's growth has been helped by its established business in the booming oil and gas sector, which accounts for about 65% of its revenue currently.

However, this exposure to the oil and gas sector proved to be a double-edged sword with the onset of the financial crisis in late 2008. As the oil price dropped from US$130 to US$40 between late 2008 to early 2009, investors feared investment in new projects in the oil and gas sector would fall off a cliff and hence affect the portion of CSE's revenues derived from this sector. Furthermore, CSE had S$117 million in short term debt on its balance sheet, and with the credit crisis in late 2008, worries arose that they would not be able to secure refinancing to roll over the debt. These concerns caused investors to sell down the stock. After hitting a high of $1.73 in 2007, CSE's stock price crashed 85% to a low of $0.265 in March 2009. We have been following CSE for years on the side, knowing that it is a good company with a strong business franchise. Unfortunately, it has never fallen into the range of valuations we were willing to pay. With the large drop in CSE's stock price, it finally came into our investment radar.

While future orders from the oil and gas sector may decline due to the falling oil price, about 50% of CSE's revenue is recurring in nature. This "recurrent" stream of revenue pertains to equipment and plant upgrades at petrochemical plants and oil rigs which need to be undertaken every few years, as well as routine maintenance work. These plants and rigs represent a huge investment outlay, so once they have been built, they will continue to operate as long as the marginal cost of extraction of oil is lower than its selling price and the refining operations yield marginal profits. A meeting with the company's CEO also confirmed that CSE was still seeing stable recurring revenues from the brownfield (existing plants) projects with the recurrent business yielding better margins than new projects. Apart from the recurrent earnings, 35% of CSE's revenue comes from the infrastructure and healthcare sectors – these sectors are more resilient in economic downturns and hence will further

buffer profits from the fall in business from the oil and gas sector. And also on the bright side, while the oil price has fallen, rebar steel prices have also plunged 50% from its high of US$1,000 per ton in mid-2008 to US$500 per ton, leading to significantly lower construction costs of building new petrochemical/oil and gas facilities, which would further mitigate the decline in new project investments.

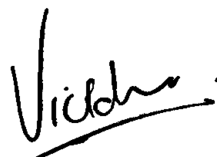
Despite having S$117 million in bank borrowings, the company has $42 million in cash on its balance sheet, effectively reducing its net borrowings to only S$75 million. The company made a combined EBIT (earnings before interest and tax) of S$132 million over the 2-year period from 2007 to 2008, which means the company could possibly pay back its short term loan in 2 years or so. Due to the company's business model which requires low capital expenditure, it has been generating strong free cash flows for the last 6 years. Coupled with its strong financial track record, and strong recurring earnings profile, it seemed that CSE will have a very high chance of refinancing its short term debt. Our discussions with the CEO also confirmed as much. The company's confidence in securing refinancing is further demonstrated by the declaration of a generous dividend of S$0.04 per share, or a *41% payout ratio,* in February 2009, during the worst period of the credit crisis.

While these aspects of CSE's business are hardly unknown to the market, it seemed investors have either overlooked them, or have simply chosen to ignore the resilience in the company's business and its strong debt servicing capability. At its March low of $0.265, CSE was trading at a price-earnings ratio of 2.7x, and at a dividend yield of *15%*! Prior to the crisis, CSE has always traded at premium valuations, due to the quality of its business and stellar track record - over the period 2003-2008, CSE traded at an average price-earnings ratio of 15x, with the stock hitting a high of 18x in 2004 and 20x earnings in 2007. Even during the recession in 2003 brought on by the SARS epidemic, the lowest valuation the company has traded at was a price-earnings ratio of 9x. Hence when compared against its past trading history, a price-earnings multiple of 2.7x looks simply ridiculous. Even assuming a worst-case scenario where CSE's sales from new oil and gas projects drops to zero, the company would still achieve half of its 2008 profits just based on recurring profits. Even in such a case, CSE will still be trading at an undemanding 5.4x earnings during its lows in March 2009.

We were unable to resist the temptation of investing in such a high quality business at such low valuations, and purchased the stock in April 2009 at a price of less than 4x earnings. A month after we bought the stock, the company paid us a dividend of $0.04 per share, representing a yield of more than 10% on our purchase price. Subsequently, the company proved itself to be more resilient than expected. Despite the onset of the severe economic and financial crisis in 2008/9, sales for the first 9 months of 2009 suffered only a small of drop of 11%, and profits fell only by 20%, which turned out much better than our "worst-case scenario". CSE today trades at substantially higher prices as the market once again acknowledges its strong business franchise.

As always, please feel free to let us know if you have any clarifications regarding your investment in the Lumiere Value Fund.

Yours truly,



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