Letter to Investors

2006 Full Year Review

January 2007

Dear Investors,

Famed financier J. P. Morgan was once approached by a man on Wall Street who asked him for a tip on what the market would do. Morgan's reply? "It will fluctuate." Such was the behaviour of the stock market in the year 2006 – a market of ups and downs. The Singapore market started the year with an "up" - the Straits Times Index rose from 2,369 at the start of the year to a then record high of 2,660 in early May, gaining a remarkable 12% over 4 months. While stock traders were still popping the champagne, the "down" came suddenly, like a thief in the night, sweeping away all the gains made over the year in just one month. From its peak in May, the index fell 14% over the next month. After the sudden and sharp bout of "down" in May and June, the market reversed direction yet again, this time embarking on a sustained "up" movement from July to December, buoying the Straits Times Index to 2,986 by the year's end.

Global markets experienced the same pattern of volatility this year: sharp run-up in the first quarter, dramatic crash in the second quarter, and a continuous rally over the last two quarters of the year.

How does one profit from a volatile market such as this? One way will be to "guess" where stock prices will go in the next week or month, looking at various indicators ranging from economic growth, interest rate hikes, stock price and trading volume movements, global fund flows, etc. The goal of which is to predict the immediate demand and supply of a stock that would drive its price in the near term.

Just how well did the average market participant "guess" this year? A look at trading volumes in the Singapore market showed that average daily trading volumes in 2006 were the highest for the period from March to May, compared to other 3-month periods. This coincided with the sharp market run up before the crash in mid-May. The average market participant has bought most heavily into the market just before it plunged. What happened during the crash was again very interesting – average daily trading volumes from 15 May to 14 June were considerably higher than any other 30-day period during the year. During this period, the Index fell 13% from its then record high to its year low of 2,280 points. The average market participant has chosen to abandon ship and sell stocks at exactly the wrong moment! – because we know from 15 June to 31 December 2006, the Index rebounded swiftly and had a bull run from the low of 2,280 points to 2,986 points. Score: Stock Market – 2, Participant – 0.

We do not believe in "guessing" the market. In fact, market movements are of no concern to us, except that market swings alternately provide us an opportunity to buy good stocks at depressed prices during a crash and an opportunity to sell stocks at high prices during a boom. Our main focus has always been on how the business of the company performs, because in the long run there is only one driver of the stock price: earnings.

The end of 2006 marks the end of the first 5 years of investment management for us. It was a good 5 years. Over this 5-year period, the investment portfolio managed by us grew by 340% - in other words, $100 invested in this portfolio grew to $440 at the end of the 5 years. This translates to a compounded annual return of 34%.

Was the good performance over the past 5 years a fluke? Perhaps we had a long lucky streak? To answer that we need perhaps to examine how it was achieved, and whether this success is *repeatable*. If a fund is evaluted solely by its performance track record, the world's largest funds would have been run by lottery winners.

Over the past 5 years, we have adopted a value investing strategy in managing the portfolio. What is Value Investing, and does it work?

Value Investing is an investment strategy whereby practitioners (or, "Value Investors") buy companies whose shares appear underpriced by some forms of fundamental analysis; these may include shares that are trading at, for example, high dividend yields or low price-to-earning or price-to-book ratios. In addition. these companies usually either operate good businesses evidenced by growing earnings or high returns on capital, or own valuable assets which upon realisation would yield a far greater amount than the companies' market capitalisation.

The essence of Value Investing, as espoused by Benjamin Graham, and reiterated by his more famous student, Warren Buffett, is buying stocks at a substantial discount to their intrinsic value (or business value). This discount is what Graham terms as "margin of safety", which he believed: (a) protects the investor from a substantial loss of capital should he err in his assessment of intrinsic value, and (b) offers a substantial upside when the market recognises the stock for its merits and ascribes a market value to the stock which approximates its intrinsic value. In short, it means buying a stock at 40 cents when one believes its intrinsic value is a dollar after careful analysis.

Does Value Investing work? Countless studies have been done to investigate returns on a Value Investing strategy focused on buying stocks at low price-to-book (or, net assets) and price-to-earnings ratios (such a strategy could be used as a proxy to Value Investing, as buying low price/earning or price/book stocks would suggest generally, over a large number of observations, that stocks are purchased below their intrinsic values). Here are some notable ones:

In 1986, Harry Oppenheimer studied the returns of stocks listed on the NYSE and AMEX trading at 66% or less of their net current assets between 1970 and 1983. The mean return from net current asset stocks during the period was 29.4% per year versus 11.5% per year for the combined indexes.

That same year, Roger Ibbotson studied stocks that were trading at low price/book and price/earnings ratios between 1967 and 1984 and found that stocks with low price multiples had significantly better returns over the period than stocks with high price multiples.

In 1992, acclaimed professor Eugene Fama and Kenneth French studied nearly 30 years worth of monthly stock returns between 1963 and 1992. They showed that low price/book stocks outperformed high price/book stocks by, on average, 4.9% per year.

The next year, Josef Lakonishok, Robert Vishny, and Andrei Schleifer examined the investment returns of all NYSE- and AMEX-listed companies relative to their price/book, price/earnings, price/cash flow ratios between 1968 and 1990. The trio found that value strategies not only offered higher returns, but in addition, they concluded that value stocks were *less risky* too: Value stocks generally outperformed growth stocks during the market's worst months.

More recently, Jeremy Siegel, the Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania and author of the best-selling classic, "Stocks for the Long-Run" conducted a study of investment returns of all the companies in the S&P 500 from 1957 to 2003. He too found that stocks in the lowest price/earnings quintile significantly outperformed both the S&P 500 and stocks within the highest price/earnings quintile. This outperformance also came with lower risk.

Many, many more academic studies have shown similar results pointing to superior investment returns from buying stocks trading at low price/book and price/earnings ratios. Value Investing has been proven by academic research to be a superior investment strategy.

Does Value Investing work in the real world? In his 1984 speech titled "The Superinvestors of Graham-and-Doddsville", Warren Buffett mentioned he had in the 1950s and '60s come to know very well a group of people whom he believed then were superior investors. Many of them were either his colleagues at the Graham-Newman investment partnership he worked for, or classmates in the investment course conducted by Benjamin Graham at the University of Columbia. All the people in the group had one thing in common – they were practitioners of Value Investing, and believed in buying businesses worth a dollar for 40 cents.

In 1984, Buffett went on to investigate the investment records of this same group of investors he identified earlier on. One of them, Bill Ruane, had even been recommended by Buffett to his investors when he closed his investment partnership in 1969. Below are the results he compiled:

Name	Fund managed	Period	Compound Annual Return	S&P500* Compound Annual Return
Walter Schloss	WJS Partnership	1956-84	21.3%	8.4%
Tom Knapp	Tweedy, Browne Partners	1968-83	20.0%	7.0%
Warren Buffett	Buffett Partnership	1957-69	29.5%	7.4%**
Bill Ruane	Sequoia Fund	1970-84	18.2%	10.0%
Charles Munger		1962-75	19.8%	5.0%**
Rick Guerin	Pacific Partners, Ltd	1965-83	32.9%	7.8%
Stan Perlmeter	Perlmeter Investments	1965-83	23.0%	7.0%**

** Includes dividends paid for both S&P 500 Composite Index and Dow Jones Industiral Average*
*** Dow Jones Industrial Average*
Source: "The Superinvestors of Graham-and-Doddsville" by Warren E. Buffett

What is important here is that this group of very successful investors were *pre-selected* by Buffett in '50 and '60s, based upon their framework for investment decision-making then. It was not as if Buffett searched among thousands of investment records and selected only the successful ones with the benefit of hindsight.

Another important point is the investment results of the group were achieved over different periods of time and hence varying market conditions; over different spans of time (longest being 28 years and shortest being 13 years); buying different stocks; using different portfolio allocation strategies (some hold concentrated portfolios consisting of only a handful of stocks while others hold dozens of stocks in their portfolio). However the one common denominator of these investors is, they are, mentally, always *buying the business, not the stock, and paying a market price substantially lower than the intrinsic value of the business*.

In 1934, Benjamin Graham formalised the teaching of Value Investing through a book written by him and David Dodd titled "Security Analysis". 72 years on, one who reads his Graham-and-Dodd continues to prosper using the same methods. Going forward, it is our belief that the Value Investing approach will continue to enrich those who practise it.

Once again, we have come to the part of the letter where we discuss some of our recent investments, and, more importantly, the thinking that goes behind making those investment decisions.

Recently, Singapore's Building and Construction Authority (BCA) announced that they expect construction activity to continue picking up after an estimated $16 billion in construction contracts were awarded in 2006. This is 42 percent higher than in 2005. Going forward, mega projects that will underpin the growth momentum include the two Integrated Resorts, the Business Financial Centre, the new malls along Orchard Road, oil-tanking investments on Jurong Island, plus a slew of other commercial and residential developments all across the island. Thus, it is not too hard to imagine the next three years as being very positive for companies that will actually participate in this massive infrastructure build-up.

However, construction companies are known to be notoriously cyclical, with performance usually swinging wildly from being marginally profitable to being deeply in the red. In between these wild swings, the balance sheets of these companies are often battered beyond recognition. Examples of companies that have succumbed during the last downturn include Econ and Chew Eu Hock, both of which were established construction players in their heydays. So with no earnings or assets, is it then possible for a value investor to derive an intrinsic value for such companies, let alone invest in them?

Well, we think that you can't. But fortunately for us, there are a number of companies trading on the SGX that are obvious beneficiaries of the impending construction boom and also have strong earnings track records and sound balance sheets that allow us to capitalise on the upturn in construction activity. We now take you through some of the investment merits of these companies.

Note: *Long-time readers of our letters will no doubt notice that the profile of the following featured companies may depart slightly from our usual fare of growth companies with pristine balance sheets and impeccable growth records. However, readers should bear in mind that the following three companies we will be mentioning are tried and tested survivors of one of the longest construction slumps faced in recent times. You will also be pleased to know that the potential investment returns to be reaped from investing in such cyclicals are no less superlative.*

Tai Sin – Tai Sin was established since 1980 and is today a leading electric wires and cable manufacturer with turnover of $183 million in the most recent financial year. Other than its cable and wiring business, which make up over half of turnover, it also manufactures and distributes electrical equipment, switchboards, lighting and sanitary ware, all of which are essential supplies for the construction industry. A quarter of its sales are derived from exports to Malaysia, Brunei and New Zealand.

As competitors struggled to survive during the construction downturn, Tai Sin was busy growing its core cable and wiring business and also acquiring a number of complementary construction supplies businesses. As a result, turnover over the past 5 years has grown at an amazing compounded rate of 35% per annum. Profit before tax has grown at an even more astounding rate of 62% per annum over the same period, leading to marked improvements in net profit margins and returns on equity.

Despite having strong business fundamentals and excellent prospects, we were able to take a position in Tai Sin at 5 times forward earnings back in December 2005. Since then, its share price has almost doubled on the back of a 110 percent increase in profits for the latest financial year ended June 2006. Notwithstanding this sharp price increase, Tai Sin is still unbelievably cheap at only 6 times historic earnings. Apparently, the Managing Director of Tai Sin, Mr Bobby Lim, also shares our sentiment that Tai Sin's best days are yet to come - he has recently spent $300,000 of his personal funds purchasing almost 1.4 million shares in the open market.

Lantrovision – Lantrovision provides systems integration services for structured cabling systems, which are used in Information Communication infrastructure such as Local Area Networks (LANs) and Wide Area Networks (WANs). With the demand for greater connectivity, one can just imagine the number of offices and commercial buildings that will need such networks.

Lantrovision's turnover has grown steadily over the past 5 years but profitability was affected in FY2005 when one of its customers ran into financial difficulties. As a result, Lantrovision had to make a one-time $10.3 million provision for doubtful debt. Investors, fearing further write-offs to its receivables, fled the stock in droves. This led the stock to plummet more than 50 percent to a level that was well below its net asset value.

In this case, the trade receivables write-off did not in any way signify deterioration in Lantrovision's business fundamentals, though there was certainly room for improvement in its credit management policies. In fact, its core structured cabling business remains promising and looks set to perform even better in the coming year. Furthermore, its strong balance sheet and ample cash balances certainly helped in cushioning the impact of this write-off.

As a result of this sharp sell-off by investors, we were able to purchase Lantrovision at approximately 50% of its net working capital, or just over 3 times its FY2006 earnings. Generally, businesses that trade at such low valuations or huge discounts to net working capital are those that are under severe financial distress or face significant contingent liabilities. Lantrovision certainly does not fall into any of these troubled categories. The last we checked, Lantrovision shares have increased over 50 percent from our entry levels, but remains undervalued at 6 times forward earnings.

Kian Ann – Kian Ann was established since 1965 and is today one of the region's largest independent distributors of heavy equipment parts and diesel engine spares with turnover of $113 million in the latest financial year. They distribute more than 1.3 million item lines covering over 200 brands from 170 suppliers, to a global customer base (more than 60 countries) of dealers and end-users in infrastructure development, construction, forestry, agriculture, mining and marine industries. Their spares are generally used in bulldozers, wheel loaders, trucks, tractors, excavators, power generation sets and marine engines. With the strong ongoing infrastructure development in most parts of Asia Pacific, the high demand for heavy industrial and earth moving equipment will likewise boost demand for machine parts.

Even without the benefit of a construction boom, Kian Ann's profit before tax has grown at a compounded annual rate of 21% for the past 5 years. Similarly, Returns on Equity and Operating Margins have steadily improved over the years, due to better sourcing and more effective cost management.

Lately, it has been actively expanding its presence in the region through synergistic joint ventures to distribute diesel engine parts and to repair and maintain diesel engines used in automobiles and heavy machinery. With these ventures on the verge of maturing and with the construction boom coming along, we believe that Kian Ann's fortunes are about to improve significantly. Like Tai Sin and Lantrovision, we managed to take a position in Kian Ann on the cheap, at only 7 times forward earnings and at a 50 percent discount to its net tangible assets.

With that, we come to the end of this year's investment round-up. If you have any questions or clarifications relating to your investments, be sure to let us know.

Yours truly,

Wong Yu Liang

Victor Khoo

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