Pangolin Investment Management

# Pangolin Asia Fund First Quarter 2007 Report

At 28th February 2007, the NAV of the Class A shares of the Pangolin Asia Fund was US$140.75, net of all fees and expenses, up 3.17% from US$136.43 in January.

At the end of February the fund was approximately 98% invested. The fund has a November year end which explains why our first quarter ends in February. Our auditors promised us that this would ensure that our audit would not get caught up in everybody else's year end logjam, but unfortunately that doesn't seem to be the case – we are still waiting for it.

As of the end of February, the investments were split approximately as follows:

| | |
|---|---|
| Indonesia | 32% |
| Malaysia | 33% |
| Singapore | 33% |
| Cash | 2% |

## Valuation of the fund's investments

As of today the fund's holdings have a weighted average 2007 PE of 10.6X. The cash level is slightly higher as due to new subscriptions.

Deducting those stocks bought for their asset backing lowers the average PE to 9.3X. The three asset plays trade at discounts of 20%, 50% and 65% to our estimated valuations.

The fund has two warrant positions, the first expiring in November 2009, and together they account for 11% of the portfolio.

Fuller details are available to those interested on request.

## Overview

I had lunch recently with the owner of a manufacturing company over which we discussed the stock market and its prospects. This chap considered his portfolio to be well diversified and was wondering if he should be locking in his gains given the recent market volatility (a word which seems to be used much more commonly when markets fall than when they rise). In my opinion he is hardly diversified at all; 90% of his listed assets are actually in the company he majority owns and manages and no way was he thinking of selling out of this and switching to bonds or cash because of the latest hysteria surrounding the carry trade or whatever. Furthermore, when it comes to his business he takes a long term view; building a new factory or rolling out a new product requires some kind of extended thinking. So why, I asked, does he take a totally different approach to stock market investing?

As a fund we try to align our investing with the decisions made by the managers of the companies we are investing in. If the companies' managements are distracted by the short term performance of their share prices, then they will probably not be taking decisions that will generate profit growth over the long term. We believe that it is the latter that drives share price performance over time and that is the basis of our investing.

Clearly there is a lot of nervousness around at present, and there is a lot to be nervous about. The world is enjoying a liquidity bubble which has, in my opinion, stretched asset valuations in much of the world (China and the US spring to mind) and the deflating of this bubble, when it comes, will not be painless. Is now a good time to be investing in the stock market? That I don't know. All I will say is that at current prices, with at least a three year view, there are still many excellent investment opportunities in the markets we cover. And if there is a sell-off, then despite what they'll tell us on CNBC, investing in emerging markets will not have become riskier, but safer.

Often we find the best investments tend to be in smaller, illiquid companies, generally because no-on else has noticed them. One of our newer positions recently hired an investor relations consultant to raise its profile and sent out invitations to a multitude of brokers and fund managers to attend the year end results presentation. My colleague Vinchel was one of only five who turned up. We think it's a good company but without doubt it is too small for most to bother with. If we are still one of five in a couple of years we'll be worried, but if the story is as good as we think it is there might be a few others in attendance.

**Markets and Politics**

The inflow of funds into the region in recent months continued right up until the end of February, since when the markets have been wobbly. The enthusiasm for the region's markets has driven the prices of many shares to a level that suggests an excess of optimism over realism. Share prices are increasingly being justified by future projects, rather than what is currently in hand. Should the companies fail to secure the said projects or, as is commonly the case, fail to execute their projects as profitably as forecast, their high valuations will quickly look like over-valuations.

In **Malaysia** there has been much political news in the last couple of months. This is in a country in which the media practises self-censorship which ensures that the reporting of bad news is kept to a minimum. Imagine what a free press would have made of the allegations that the head of the Anti-Corruption Agency is himself corrupt, or that a deputy internal security minister has been taking bribes from organised crime bosses in return for lighter sentences.

The Works Minister has recently announced that the concession agreements the government has signed with the private sector are subject to the Official Secrets Act, despite this being an administration that has promised greater transparency and openness since Abdullah Badawi has taken over. This news has landed some opposition leaders in hot water as they have been caught leaking details of the agreements to members of the public demonstrating against recent toll increases. As disinterested observers, our view is that the public should just shut up and pay the higher tolls (and it is purely coincidental that the fund holds shares in one of the concession operators).

The cabinet is apparently going to debate as to whether to allow the details of the agreements to be released. We are confident that the regime is not stupid enough to renege on its present contracts as of course then it would be unable to finance its future schemes, although we'll keep an eye on the situation.

Malaysia's National Economic Policy, which favours the economic interests of the Malays over other races, is looking less viable in the face of globalisation. It is being increasingly criticised, in some cases by the Malays themselves. The policy has a lot to be said for it in that by balancing the wealth of the nation between the majority Malays and the economically dominant Chinese, Malaysia has been spared the racial conflicts and tensions that have affected Indonesia, Fiji and other multi-racial countries.

Much of the criticism surrounds the policy's implementation, with government contracts allegedly being awarded to its supporters rather than to those best equipped to do the work. A recent speech by the Prime Minister highlighted a Works Ministry report stating that 85% of projects awarded to Malay contractors had "flowed" (been sold) to those of other races. This awarding by patronage has resulted in a class of politically active Malays who attach themselves to the coat tails of their seniors in the hope of economic rewards. This stifles political criticism – it would be economic suicide – and also entrepreneurial spirit; one is more likely to be awarded a contract to build a road if seen as being politically sound, than if one is experienced road builder who prefers to vote for the opposition.

In Malaysia the ruling classes have a habit of confusing the stock market with the overall economy, and assume that if they are feeling well off then everyone else must be doing all right too. A recent phone-in on a State owned TV channel featured two economists who opened the show by talking about how well everything was doing before taking questions. The first three callers were all critical of the government's economic performance, with the common theme being a lack of trickle-down to the ordinary people, who are of course still being squeezed by the inflationary effects of last year's oil price rise.

The news in **Indonesia** seems to be permanently awful. During the two days I was there last week there was an earthquake and a plane crash, and the previous week's mudslides in Flores which killed 34 and made many more homeless hardly made the headlines, largely due to the lack of white victims. This follows on from the floods that paralysed Jakarta in January as well as other recent transport disasters.

The companies I spoke to report little pick up in consumer demand in the first two months of 2007, which is disappointing as the hope was that we are over the worst. We remain optimistic that the consumer will return and that valuations are not excessive and there is hope is that the government's proposed infrastructure spending will give the economy the boost it needs.

With much of the population feeling the pinch it is hardly surprising that the opinion polls are showing a surge in the popularity of the PDI-P, the party led by the former president Megawati. The economy did well under her, although as the nation was still effectively being managed by the IMF, how much credit she is due is questionable – although not to her, presumably. Foreign investors considered her defeat to President Susilo a good thing, so presumably will be wary of her return. The elections are not until 2009 but Susilo has a mountain to climb if he is going to retain power.

**Singapore**, as far as I can make out, continues to make far fewer mistakes than its neighbours, and continues to outpace them accordingly. It feels like a boom town and the companies I saw this week were a lot more optimistic than their Indonesian neighbours. If one had to look for a flaw, then with hindsight Temasek's investment into Thailand's Shin Corporation doesn't look quite so clever.

We continue to remain un-invested in **Thailand**. The risk of the military government retaining power, becoming increasingly nationalistic and repressive, and implementing more and more dumb policies does not appear to be priced into the market as far as we can see. The problem the military has had all along is that, if allowed the people would vote overwhelmingly for Thaksin, has not been resolved, and the generals are losing support even from those who were their most enthusiastic backers when they seized power.

The Ford Motor Co. is considering scrapping a proposed U$1bn investment into Thailand as a result of the recent implementation of capital controls. These controls were initially designed to try and stop short-term money driving up the Baht's value. Due to the collapse of the stock-market following the announcement of these measures, the government removed them for stock market investors. At a stroke they have saddled the economy with penalties for long-term investors like Ford but not for speculative hedge funds, for example. In a democracy someone might have pointed out that this is the wrong way round, but presumably the military just follow orders.

The Islamic separatist insurgency in the southern states continues to get bloodier and more horrific by the day; yesterday 9 bus passengers were shot dead. Any hope that the Muslim led military government might be able to negotiate a peace has dissipated as the body count has risen, and the risk of this conflict expanding is real. I would probably be slightly less worried if the coup leaders had chosen a slightly better name for their regime, but their choice of "Council for National Security" sounds so similarly innocuous to the name chosen by neighbouring Myanmar's "State Law and Order Restoration Committee" as to give me the shivers.

I hope I'm wrong on Thailand but as there is no shortage of investment opportunities elsewhere, we'll continue just to keep a watchful eye on the place.

*More details concerning the fund's investments are always available to shareholders in the fund on request.*

*Further information can be found at www.pangolinfund.com.*

James Hay.
16th March 2007.

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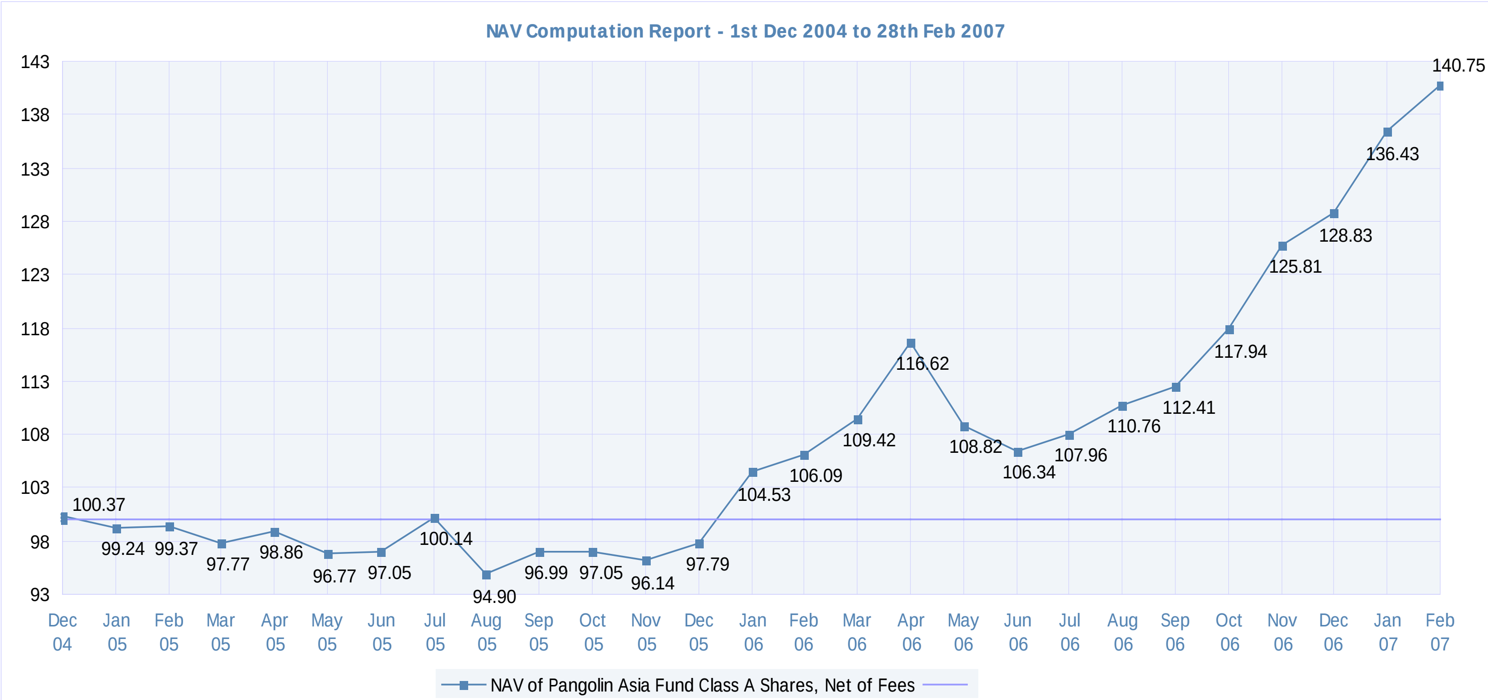


## NAV of Pangolin Asia Fund Class A Shares, Net of Fees

| MONTH | NAV | % chg |
|---|---|---|
| 1 Dec 2004 | 100.00 | |
| 31 Dec 2004 | 100.37 | 0.37% |
| Jan 2005 | 99.24 | -1.13% |
| Feb 2005 | 99.37 | 0.13% |
| Mar 2005 | 97.77 | -1.61% |
| Apr 2005 | 98.86 | 1.11% |
| May 2005 | 96.77 | -2.11% |
| Jun 2005 | 97.05 | 0.29% |
| Jul 2005 | 100.14 | 3.18% |
| Aug 2005 | 94.90 | -5.23% |
| Sep 2005 | 96.99 | 2.20% |
| Oct 2005 | 97.05 | 0.06% |
| Nov 2005 | 96.14 | -0.94% |
| Dec 2005 | 97.79 | 1.72% |
| Jan 2006 | 104.53 | 6.89% |
| Feb 2006 | 106.09 | 1.49% |
| Mar 2006 | 109.42 | 3.14% |
| Apr 2006 | 116.62 | 6.58% |
| May 2006 | 108.82 | -6.69% |
| Jun 2006 | 106.34 | -2.28% |
| Jul 2006 | 107.96 | 1.52% |
| Aug 2006 | 110.76 | 2.59% |
| Sep 2006 | 112.41 | 1.49% |
| Oct 2006 | 117.94 | 4.92% |
| Nov 2006 | 125.81 | 6.67% |
| Dec 2006 | 128.83 | 2.40% |
| Jan 2007 | 136.43 | 5.90% |
| Feb 2007 | 140.75 | 3.17% |

| | |
|---|---|
| 2005 return | -2.57% |
| 2006 return | 31.74% |
| 2007 return | 9.25% |
| Average monthly return | 1.33% |
| Average return (annualized) | 15.93% |
| Best monthly return | 6.89% |
| Worst monthly return | -6.69% |
| Return since inception | 40.75% |
| Maximum drawdown | -8.81% |
| % of positive months | 74.07% |
| Standard deviation | 3.35% |
| Standard deviation (annualized) | 11.61% |
| Semi deviation | 2.41% |
| Semi deviation (annualized) | 8.35% |
| Sharpe ratio | 1.03 |