Pangolin Investment Management

Pangolin Asia Fund Third Quarter 2005 Report

The Net Asset Value of the A shares was U$94.90 at the end of the period. Please note that the fund has a November year end, thus the third quarter ended on August the 31st.

At the quarter's end the fund was approximately 95% invested. Investing cash has not been difficult recently as share prices of target companies have been weak. Sadly these same prices have not immediately recovered following our purchase, hence the lacklustre NAV performance.

The major Asian economic event since the last report was the loosening of Chinese currency controls followed immediately by Malaysia's un-pegging of the ringgit. Many investors, especially hedge funds, had been assuming a sharp increase in the value of the Malaysian currency and had placed their bets accordingly, mainly via equity purchases. The Malaysian government loves a weak currency and given that they manage the float, the actual appreciation has been less than 1%. This has been disappointing and some of these funds have been withdrawn, resulting in a weak stock market, especially in second liners.

One Malaysian holding in particular, Silver Bird, has been hit especially hard, as investors' appetites for smaller companies have waned.

The assumption that the Malaysian ringgit would appreciate once floated may well prove a false one. It is quite possible that a weak ringgit policy will continue. Malaysia has never been keen to raise interest rates, even in the pre-crisis days of M3 growth of over 20%. Instead, measures were taken to slow lending to particular sectors which tended to be both largely ineffective in the sectors concerned and to have the effect of driving the bubble elsewhere. Politics and business are far from separate in this part of the world and most businessmen prefer low interest rates and a weak currency; it will be interesting to see how Malaysia responds to inflationary pressures and it will show whether the new administration of Abdullah Badawi is really prepared to tackle economic issues head on.

I am rather pessimistic but would love to be proved wrong.

Indonesia, another major part of the portfolio, has been hit by a weakening Rupiah as investors worry about the size of the country's overall debt burden. Currently approximately 30% of government expenditure is spent on fuel subsidies with petrol retailing at U$0.25 per litre. This price is likely to rise by 50% next month but clearly still has a long way to go. The president has stated that all subsidies will be removed in time but obviously the pace must be gradual in order to avoid social disorder.

Indonesia's greatest problem is in attracting foreign investment, not helped by the imprisonment of a couple of Malaysian KPMG auditors recently. Auditors are never likely to be popular in much of Indonesia, especially when they have been flown in from another country (presumably because International Nickel Corporation did not trust the local numbers). The unfortunates were arrested for not having work permits, despite being on a business assignment for which none was required. They were refused bail and jailed with hard core criminals. Malaysia is one of Indonesia's largest investors but there are still many who will not go near the place and they certainly will not now. Unfortunately the imprisonment of foreign businessmen for little reason other than bribe extraction is quite common, which of course results in there being fewer foreign businessmen to arrest and extort. Surely there has to be a better way of earning hard currency?

Indonesian companies, like others everywhere, are having to adjust to lower margins as costs are driven higher by oil.

Bird flu has been much in the headlines with confirmed outbreaks in Indonesia. If the WHO is correct then this is going to be a serious disease that will affect the world. Unlike SARS which was effectively controlled by screening airline passengers, this flu can be spread internationally by migrating birds. Let's hope that the risk is being overstated; the impact on regional tourism would be huge if the doom mongers are correct, not to mention the human cost.

There has been little of interest happening in Singapore (surprise, surprise) while the uprising in Southern Thailand is worsening. The people in the restless southern provinces are Malay and Moslem and some of them are demanding a separate Islamic state or even to join Malaysia. The response of the Thai government has not improved the situation and low level ethnic cleansing by the rebels is underway. It is feared that the conflict will attract foreign jihadis and it looks almost certain that there will be attacks in other areas of Thailand. Meanwhile Thai-Malaysian relations are being strained with all sorts of accusations flying between ministers. The situation is unlikely to be resolved quickly.

Amidst all this gloom and doom, Asian businessmen continue to exhibit rather strange behaviour. Instead of cowering under their beds, they get up as normal and, after eating delicious cholesterol packed breakfasts, go to their offices, factories and shops and do their utmost to get rich. Not only that, they to do so for less pay than many of their Western rivals and seem happy to spend longer at their workplaces. Nothing* seems to deter them; they appear immune to changes in the oil price, inflation, exchange rates, politics, good news or bad news. These oddballs should be locked up for their own good. However, until some bright politician does that, Asia should remain a favourable place to invest.

Shareholders in the fund are reminded that the minimum additional subscription is U$5,000 and that periodic additions will smooth out any shorter term market movements.

Investors are encouraged to suggest ideas, comment or interrogate as they see fit.

James Hay

26th September 2005

*Almost nothing. Expect a four week regional productivity drop during next summer's world cup finals.