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Prusik Investment Management LLP

An Independent Asian specialist investment manager

NAV Updates

Series	*September '08*	*QoQ*	Since *Inception*
Class A	77.91	-16.60%	-22.09%
Class B	77.91	-16.60%	-22.09%
Class C GBP	40.84	-13.51%	-18.23%

Fund Size $13.5m

Performance

Since Inception -22.09%

The fund declined 16.6% QoQ. Asian equities, in particular in the smaller company sphere, are now exhibiting all the irrational price actions that suggest we are in the hands of some desperate sellers. In this phase of a stock market downturn, some of the soundest of stocks can become victims solely because of the fact that they appear in portfolios where a holder is forced to sell into a market where trading volumes are very low.

We learnt, to our cost, in March how savage this can be when two of our investments in our sister fund, the Prusik Asia Fund, were also held by a Bear Stearns prop book and were promptly sold down aggressively.

At the time of writing, this pattern has emerged in full force across almost every asset class, and regardless of value, quality or industry. Even some of the stocks which have proved very defensive year to date are now under attack.

In preparation for such a scenario, we continued to pare our, already modest exposure and 'saving money' became our paramount goal in the third quarter. In effect, our risk overlay was, and still is, in 'red' mode. During August and September in particular, it became clear that whatever fundamental support a specific company had was becoming irrelevant. Cash levels have remained high through to quarter end and beyond.

At the time of writing, we have yet to start re-investing our cash position as we do not believe that we are quite yet out of the woods. There is, undoubtedly, an argument to be made, in the shorter term, that the relief rally may continue through to year end. However, we would not be surprised to see global markets take a further dive, a rationale for which we will outline later in the report.

Asian markets are unlikely to escape unscathed in such a scenario. However, some attractive valuation entry points and compelling thematic opportunities are starting to blink on our spreadsheets and watch-lists, especially in the smaller companies sphere. Later in this report, we will cover some of these opportunities in more detail. However, we would first like to make a few general observations on the likely change in conditions which, we feel, will significantly impact the longer term outlook for markets. Our views on those potential changes will carry considerable weight as we rebuild our portfolio both in the shorter term but also over the coming year or two.

Currency volatility

At the time of writing, we suspect that the around 43% year to date decline in the Korean Won versus the US Dollar, mainly the upshot of a US Dollar debt funding crisis, will prove to be just one of the first dominoes to fall. Around the world, there are many other emerging countries with similarly unmanageable current account deficits and funding difficulties. Pakistan is the closest to our doorstep.

The Korean example is already causing huge distress in Asia. The Taiwan Dollar has barely moved this year against the US Dollar. Taiwanese corporates locked in direct competition with their Korean peers are therefore struggling to survive. The DRAM sector is particularly affected, with the weaker Taiwanese companies already posting losses in 3Q. We have just learnt that Korean exports have fallen 26% in the first 10 days of November. Imagine, then, how badly impacted exports must be in countries in the region whose currencies have held up.

Elsewhere, in Hong Kong the recent US$2 billion foreign exchange derivative loss at CITIC Pacific, a stock happily not held in either of the Prusik Funds, and similar accidents at some of the Chinese railway companies, also not held in either of the Funds, hint at possible further shocks to come at the company level as the full impact of the current currency volatility is realised. It is not unreasonable therefore to expect some further big losses at both the bank and company level before the current situation is resolved. Such events are bringing the crisis closer to home in Asia.

Future of credit and valuations

The senior debt holders of the fourth largest investment bank in the United States have been, to use the technical term, toasted. We think this could change everything for the future of credit. To put it simply, there will be less credit available and when there is a shortage of anything, we all know what happens to the price.

We think company valuations may well be beginning to reflect a future of lower near-term growth, a prospect which is already widely discussed, if not yet entirely reflected, in analyst forecasts. However, we do not, as yet, see the market making an intelligent, discriminatory response between those companies which have high fund raising requirements in the near future and those which do not. We also believe that many companies and analysts are still too sanguine about the future availability and, importantly, the future cost of credit. This will be especially crucial in the smaller company sphere.

As a result, we do not think that the implications of a future world in which credit is less widely available and more expensive has remotely been factored in by analysts or the wider investment community in terms of what it should do to general valuation expectations. Ultimately, the value of any asset is based on the discounted value of its future cash flows. Higher funding costs assuming that the other inputs, namely equity risk premiums and assumed long-term growth rates, remain the same, should, simplistically, lead to a compression of valuations.

The sensitivity of equity valuations to such a change can be easily illustrated by changing the assumptions within a simple dividend discount model. If we were to assume that the cost of debt rose by 100 bps, our estimated fair value share price would decline by 13%. A 300 bps rise in funding costs would lead to a 30% decline in estimated fair value.

Inevitably, the market's response to such a change would likely be more complex and subtle. Higher funding costs would likely have ramifications for the market's view on what should be the 'correct' equity risk premium and terminal growth rate to be discounted by the market. Those of us who experienced the Asian Crisis, all of the team here at Prusik, can still remember vividly the violent fluctuations in debt costs and equity risk premiums which Asian asset markets tried to discount over that period and the resulting impact it had on asset and equity valuations.

As a result of this, we are thinking very hard about what is 'good value'. Measuring companies as 'cheap' in comparison with the valuation range seen over the last five years is an easy game, and currently brings up quite a few apparent 'bargains'. However, we are cautious as to the wisdom of accepting such a view beyond the very short term. We are therefore also working in a parallel world where we are also trying to look at value in a new context, and one in which we can only hazard a guess as to the cost of capital, but where the numbers are much higher than has recently been the case.

This is one of the many advantages of having so much cash and being able to rebuild the portfolio almost from scratch. At the moment, it may seem that we are being far too demanding in our valuation criteria. However, we feel that, first, if we cannot be rigorous on our valuation entry points at times such as this, then at what point can we be? Second, we hope that we can sidestep some of the risk of re entering companies at a falsely attractive level. Perhaps, most importantly, we are looking for the moment when our favourite companies look attractive on our new 'austerity' valuations. This is, in some cases, not so far away as you might imagine. Our Prusik Smaller Companies Fund at end September traded, we estimate, on a forward weighted PE multiple of just 7.1x earnings and now trades on only 5.8x forward earnings.

'Local'

We have written in the past, in the context of expensive or scarce oil, about the concept of 'local' and how this will increasingly become the way we live, consume and manufacture. We think that this theme will become first, a huge challenge and then a major driving force and awesome investment opportunity within Asia. In short, Asia's phenomenal growth story over the last two decades needs to shift to another gear.

In the past, Asia's growth has, broadly, come down to a combination of three factors. These are first, hugely favourable demographic trends, second, over exploitation of the region's natural resources and, third, subsidies of food, fertilizer, energy and credit. We do not think there is much we can add on these points that you have not already read in the Economist et al. For example, demographic trends in China may look among the most positive in the world today but, in fifteen years time, will look vastly different and far less healthy. The water table in parts of India is now 500 metres below ground level, the result of over-exploitation. The textile industry in India is shutting down capacity due to a lack of electricity, the result of years of underinvestment generated by subsidised energy prices... and so on.

It is perhaps inevitable that the exhaustion of this happy combination of circumstances comes at a time when global demand for Asia's cheap products is also if not exhausted, then flagging. At first glance, such trends have significant consequences elsewhere impacting, for example, global growth trends, commodity consumption, investment flows into the US, global liquidity and corporate profitability.

However, the great challenge, of course, is to Asian growth rates and to the development of domestic Asian economies. Such development includes what many hope will be the next big cycle, rising domestic consumption on the back of a consumer credit boom.

China

Many are still looking to China to remain a strong source of growth for the region, indeed for the world. However, we think they will be disappointed. Perhaps an instructive clue to the more likely outcome came a few weeks ago when RMB forward rates fell below spot for the first time. Ed has just spent a week visiting companies in China. His negative discoveries are echoed by one of our advisors who travels extensively in China studying copper demand. The economic situation in China looks worse than has been the case at any point during the last fifteen years.

No matter what you may have been told, manufacturing, in its fullest sense, remains the key driver of China's economic growth. China has therefore reached a watershed in her growth trajectory as falling exports are generating weakening feedback loops to margins and investment. We are hearing some really quite huge numbers in terms of inventories that have built up in recent months. For example, air conditioner inventory now stands at some 25% of annual production. This is particularly instructive as this reflects not just weak overseas demand but also weak demand at home as well. We think, as an aside, that it is also important to note how dependent China's exports are on healthy property markets elsewhere in the world.

This time around, however, the PRC

Authorities and traditionally state linked banking system will not, we think, be injecting more capital to develop more industrial capacity regardless of returns. PRC Government policies have very clearly changed towards a focus on preserving resources, improving returns and adding value. This time around, we can see that the PRC government are allowing capacity to close and want more efficient and higher margins businesses to evolve. Banks' lending policies will be implicit to this process. Last time China faced a slowdown, the banks were state owned and directed. Not so this time. Now listed, they are likely to make a stiffer response to any pressure by the PBOC to increase credit quotas. Indeed, anecdotally, we believe they are as cautious as any global bank right now and, like their global peers, possibly face some nasty bad loans from manufacturing, heavy industry and property down the line.

As a result we are not surprised to see China making an early announcement of a stimulus package which plants the seeds for a gradual emergence of a social security network in China and includes a big rise in fiscal spending. This comes on top of a number of smaller measures announced in recent weeks which were lost in the recent strident headlines. For example, the PRC Authorities cut stamp duty on share purchases. In all, we see the measures announced so far as necessary but probably not enough. We therefore believe we may see further announcements in December relating to the property market.

Rural reforms

There is a potential big event in China about which we would become very excited. The recent land reform experiments could herald a transformation of China's rural regions. We are currently witnessing trials in Tianjin which allows farmers to own their land, which is currently leased from the government, and, as a result, to borrow against it. It has been estimated that such a reform, if rolled out nationally, could create an overnight value of some RMB 40 trillion or around 1.5x current GDP.

In any event, such a reform would ignite the economy in rural areas, support those who have lost jobs in cities and need to return to the family and make China more self sufficient in food production by leading to the increasing industralisation of the Chinese agricultural sector. All of these benefits, we believe, would meet the goals of the Chinese government and would truly boost economic growth. It would also lead to a massive ideological shift towards a more market oriented and consumer driven economy.

One tale we like from the Gartman letter tells of the writer passing a Chinese farmer who was tending a beautiful healthy wheat field. On the other side of the road, there was a wheat field in the poorest condition. On enquiry, the farmer admitted to being responsible for both crops but the healthy field was his while the poor crop belonged to the government! With these new policies that will all change, crop yields will increase, demand for agricultural machinery, fertilizers and other such materials will rise and a host of companies supplying these industries will benefit.

Valuations, earnings and growth

If you were to buy, today, the Hang Seng Tracker and the H share Tracker, combined, you would be receiving a 4.8% historic dividend yield. Under most previous circumstance, such an entry point would not look bad. Widening the search for value, the average CY2008E PER is 7.7x, 41% below the long term average of 13.1x.

However, after the recent rally, the current price/bookvalue is now trading at 1.12x. The latter valuation, once again, does not compare well with the previous troughs reached in 1998, 0.94x P/BV, 1990, 1.1x, 1982, 0.92x, and 1974, 0.88x. We also note that recent changes in accounting rules make Price/Book a less defensive measure of value as book is now increasingly a market value rather than a replacement cost.

Looking at earnings, consensus remains too high, we believe, for a number of reasons.

First, expectations for Asian GDP growth in general remain about 8%. Singapore suffered a GDP shrinkage in 3Q 2008 and Korea has just announced 3Q 2008 GDP growth of only 3.9%, a three year low. This suggests there is still some way to go on general growth expectations. Analysts are forecasting, for example, 3.8% earnings growth in Korea in 08 and 16.1% in 09! We think 2008E earnings growth will be negative and 2009E very poor, at best, on current information and the anecdotal stories from companies are getting worse by the day.

Second, visibility is terrible. After visiting companies recently, we cannot remember a period when last there was so little clarity on future orders. Furthermore, a plethora of sectors, from shipbuilding to flat screen makers, are facing some retraction of existing orders. This is a particularly severe risk for shipbuilders as the current supply of new ships due to enter the market in the next couple of years is set to double the fleet. This is coming at a time when the BDIY index has fallen from 12,000 to 820.

Third, we think that margin expectations are still too high and stand well above 2001 trough levels. This is despite a recent respite in commodity and energy prices. Many companies have several months inventory of items like steel at higher prices, so the margin increase will not occur for a few months at best. This assumes competition and pricing pressure is not increasing although talking to companies suggest otherwise.

Fourth, balance sheets will deteriorate as working capital needs increase sharply. We can already see patterns emerging where, due to either slower demand or to the reduction in issuance of Letters of Credit or both, inventories and accounts receivables are rising sharply, especially in China, and defaults are on the increase. During the 2001/2002 recession, working capital rose by 5% as a percentage of sales on average. For certain sectors such as technology, working capital as a percentage of sales rose by as much as 12%.

The rapidity of the ‘emergency stop’

which has come about in almost every sector and in financial markets suggests that the 2001/2002 numbers trough will be exceeded, probably significantly, this time around. Furthermore, those companies who cannot manage their working capital will have little place to go for help. Contacts working on Treasury desks in banks throughout the world say they are given a daily list of companies to whom not to lend. This list grows by the day.

Fifth, we believe that dividends are likely to be cut dramatically. The culture amongst chief executives is already shifting towards preserving as much cash within the company as possible in case it is needed in future. Of course, many companies will be making much lower profits, or indeed losses, but nearly all will become hoarders of cash. This is very bad news for pensioners and the search for yield will become very tough.

Finally therefore, we feel assessing valuations and ascertaining what is really, genuinely cheap still means quite a lot of guesswork at this stage. That, in itself, requires a hefty discount, one which we feel we have not yet reached for the bottom of this cycle.

Power transmission and distribution

Positively, many of our themes are still showing some signs of health. The current market turmoil is generating attractive entry points at which to build or add to positions. For example, we continue to gather evidence that the demand for power transmission and distribution related equipment remains strong. Wasion, a PRC based manufacturer of meters in which the fund is invested continues to report buoyant demand.

The snowstorms in Southern China and the earthquake in Sichuan led to delays in 1H 2008 order deliveries. However, management indicated to us that the company's orders on hand were still strong, Rmb 700m at end August or up 65% YoY and that the company still expected to achieve topline growth of 25-30% YoY in FY12/08. Management continued to be upbeat on Power Transmission and Distribution related demand in its statement

Based on our forecasts, Wasion looks modestly valued, trading on only 3.8x CY08E earnings and 0.7x y/e 2008E book. The company appears to agree with us. Wasion re-purchased stock prior to its black-out period, around 1,246,000 shares in a price range of HK$2.39 to HK$3.00, well above the current share price, and management indicated to us that it would resume share re-purchases post the results announcement given the current low share price.

Rare earth

Sydney-listed Lynas, is the owner of one of the few viable rare earth deposits outside of China at Mount Weld in Australia. Interestingly, rare earths are a key raw material input for a number of technologies which either reduce greenhouse gas emissions or save energy like catalytic convertors, hybrid vehicles and energy efficient light-bulbs or enable digitalisation. We think that demand for such products, even in difficult economic circumstances, will likely remain solid, reflective of new environmental legislation and a desire to reduce energy costs.

Lynas' Mount Weld deposit is potentially very profitable. Lynas estimates that the Mount Weld basket is currently worth around US$11.83 per kg, the basket having peaked at around US$15.50. Lynas estimates that its cash cost amounts to around US$6.20 per kg with depreciation charges of a further US$0.80 per kg. At the current US$11.83 per kg value of the basket, this implies a profit per kg of around US$4.83 per kg. Assuming processing of 21,000 tonnes, this implies a mature profit of US$101m per annum or EPS of around A$0.19 assuming 800m shares in issue.

Given that the share price currently stands at A$0.40, this implies that investors are currently paying only 2.1x mature earnings. Austock's estimated DCF, based on forecasts which Lynas views as conservative, suggests a FV of A$1.08 per share assuming value for the basket of US$11.00 per kg. Interestingly, Lynas' founder, Nick Curtis, bought 1.5m Lynas shares at A$1.08.

Safe Food

At Prusik, we have always been enthusiastic about the prospects for the PRC organic fruit and vegetable growers like China Green and Chaoda. In current market conditions, we think that they offer an especially attractive balance between risk and reward.

First, even in less buoyant economic conditions, demand for consumer staples should remain reasonably resilient. In China, we feel that many consumers will still wish and be able to upgrade their consumption of such small ticket items even if they forgo more discretionary upgrades like cars and clothes.

Second, China remains a very competitive place in which to grow such labour intensive agricultural products. China Green and Chaoda should therefore both be able to continue to expand their export sales.

Third, the PRC Authorities continue to encourage the development of industrial scale agriculture and the resulting rise in productivity. Even the biggest industrial farmer, Chaoda, accounts for barely 1% of land under cultivation in what remains a very fragmented sector characterized by thousands of small holdings. Such a trend therefore still has plenty of scope to mature.

Fourth, the recent contaminated milk scandal will likely further highlight for PRC consumers the attractions of trusted brands and production processes. Interestingly, China Green, very recently, came out with a vigorously worded press release indicating that dairy based ingredients for all its milk based products were sourced from New Zealand and that all its processing equipment and standards were designed to meet Japanese quality requirements, among the most stringent in the world.

Based on our forecasts, China Green and Chaoda are currently trading, respectively, on only 8.4x and 4.6x CY08E earnings.

Other old favourites

We feel that our thematic style of investing continues to pay strong dividends. While the absolute performance has been disappointing, we know that we have avoided much more trouble as a result of our rigorous adherence to both our bottom up and thematic processes. In the light of the report we have written above, we clearly all still face hugely challenging times. However, we remain even more heavily focussed on company quality, value and liquidity and resolutely happy to hold cash until our investment criteria are met.

There are some new themes on which we are currently working and in which, in the future, we believe we can look forward to investing, Asian consumption and rural spending, for example. Many of our existing themes also remain solid in the face of the current economic turmoil. Share prices of many of the companies which best represent those themes are starting to look very attractively valued.

We remain very excited about the longer term themes of energy saving and energy storage, food and energy biotech, fast moving and essentially small ticket consumer goods such as branded foods, part suppliers to the alternative energy sector and beneficiaries of infrastructure spending, notably investment in railway and power transmission and distribution capacity expansion.

We are also revisiting some of our older themes in the light of big falls in share valuations. These include surveillance and security and light materials such as carbon fibre.

Thank you

We feel that our shareholder base has been extremely honest with us and as at the time of writing we know of no plans to exit the fund. We are hugely grateful for your support, encouragement, views and interesting snippets of information. The partners here at Prusik are weighing up increasing their allocation to the product, school fees and taxman aside, and, for the first time for over 12 months, see the possibility of some real light emerging in the foreseeable future. The invested portion of the PASCF currently trades on 5.8x CY09E.

Currency hedging

In various due diligence questionnaires investors have sent us over time, Prusik has stated that we do not hedge the currencies of the countries in which we invest. However, first, the volatility we have seen in virtually every asset class recently has impacted terms of trade in Asia hitting some countries' currencies quite hard. We hope these gyrations have now peaked but think it is sensible to be prepared if they rise again. Second, in the longer term, we expect that Asia will continue to reduce its dependency on its favoured export engine. This will lead eventually, we think, to many Asian central banks altering their currency management policies.

Given therefore both the short term picture and also the likelihood of longer term change, Prusik would like to introduce the ability to protect the portfolio from any adverse consequences of currency volatility. Our nature is not to speculate merely to protect US Dollar returns.

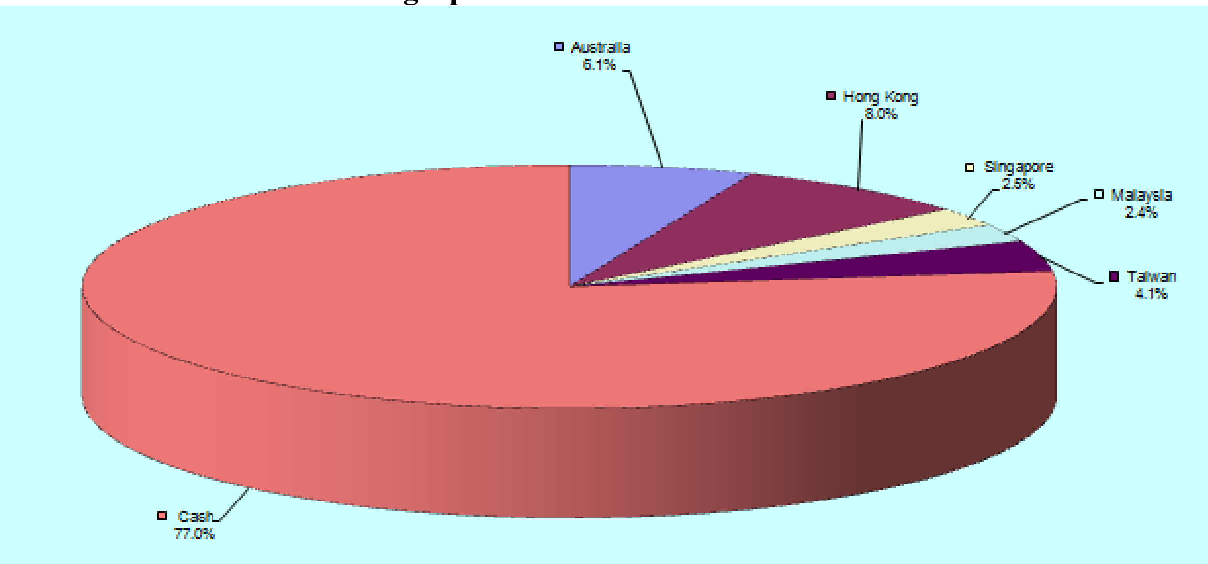
We have no hedges currently in place. However, we wanted to clear up an anomaly between the prospectus, which allows currency hedging, and the various individual communications we have made in the past.

Top % Holdings	%
CHROMA ATE INC	2.2%
SINO GOLD MINING LTD	2.0%
TEXWINCA HOLDINGS LTD	2.0%
HUAKU DEVELOPMENT CO LTD	1.9%
WASION GROUP LTD	1.8%

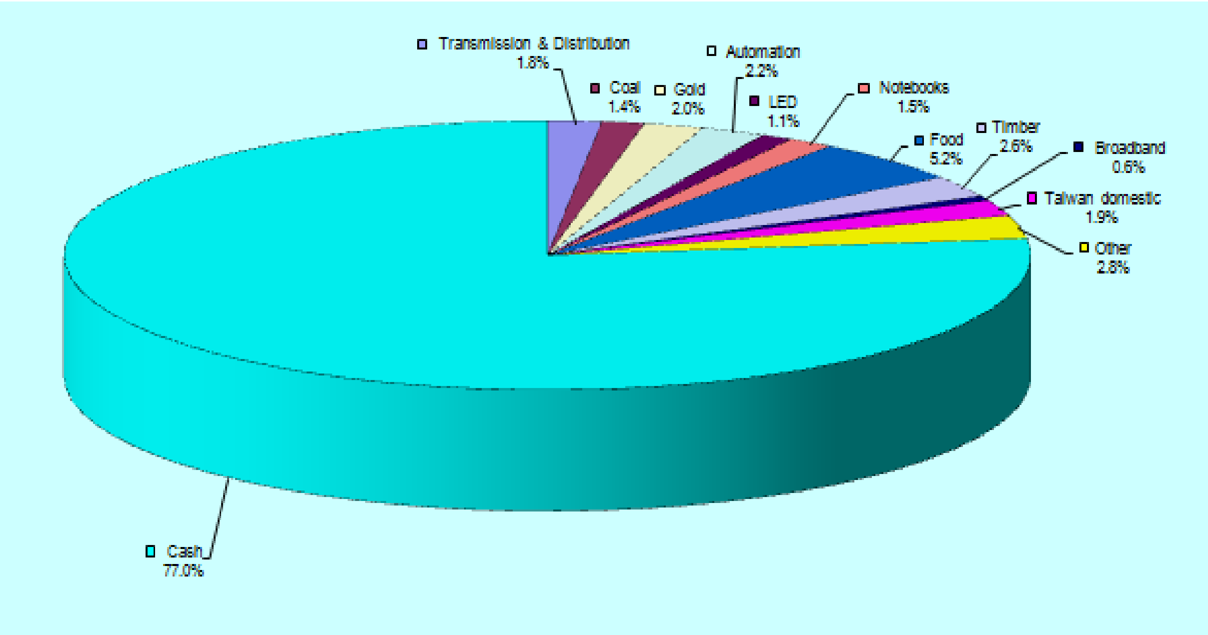
September 2008

Number of holdings	18
Percentage of Fund invested	23%

Geographical Distribution



Distribution by Theme



Key Terms

Denomination	USD
Dealing Day	Weekly (Friday)
Minimum Subscription	USD100,000
Min Subsequent Subscription	USD10,000
Subscription Notice Period	2 business days
Redemption Notice Period	2 business days
Dividends	
Class A	None
Class B	Annual
Class C	Annual

Key Parties to Fund

Investment Manager	Prusik Investment Management LLP
Administrator	Bisys Fund Services (Dublin)
Custodian	Brown Brothers Harriman (Dublin)
Auditor	Ernst & Young
Legal Advisors	Dillon Eustace (Dublin) Simmons & Simmons (London)

Manager Fees

Management Fee	1.5% p.a. paid monthly in arrears.
Performance Fee	10% of NAV appreciation. With a 6% hurdle.

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