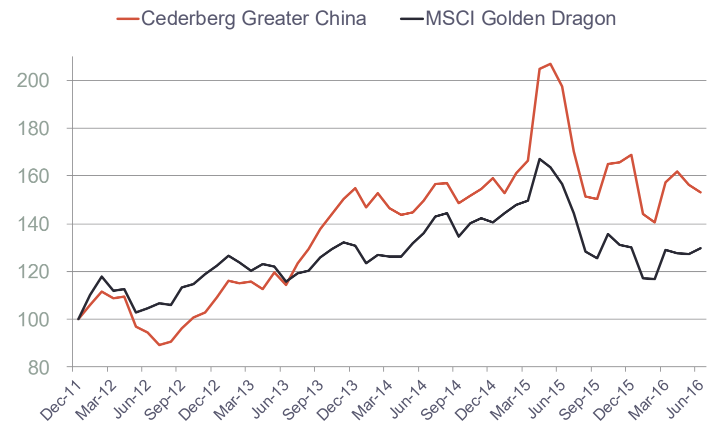
CEDERBERG CAPITAL

Q2 2016 LETTER

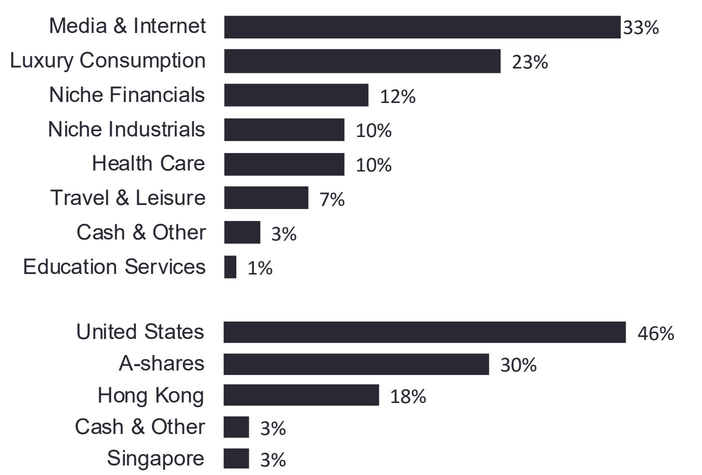
Performance Chart[1]



Performance Table[2]

Net Returns in US$	Cederberg	MSCI Golden Dragon	Peer group
Since inception	53%	30%	23%
Since inception annualised	10%	6%	5%
3 years annualised	10%	4%	3%
1 year	-22%	-17%	-19%
3 months	-3%	0%	-1%
2015	6%	-7%	-4%
2014	3%	8%	3%
2013	42%	7%	10%
2012	9%	22%	18%

Exposure by Category[3] and Listing

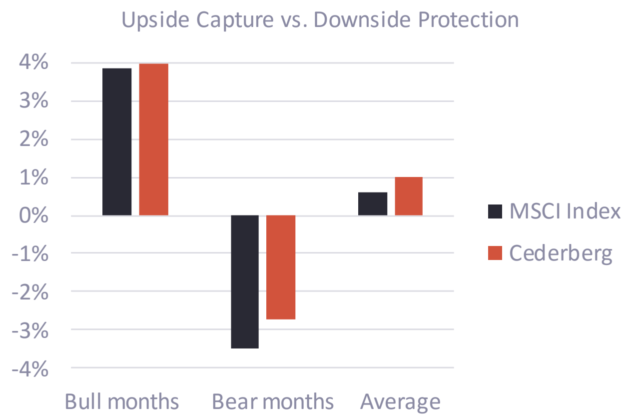


Top 10 Holdings in Alphabetical Order[4]

Stock	Industry
Baidu	Online search
China Biologic Products	Blood plasma producer
Dong-E-E-Jiao	Traditional Chinese medicine
Emperor Entertainment	Hotels & leisure
Gree Electric	Home appliances
Kweichow Moutai	Distillers
NetEase	Online games
Noah	Asset management
Value Partners	Asset management
Wuliangye Yibin	Distillers

Key Characteristics[5]

Price/Earnings Ratio (2016)	14.0x	Fund Assets	$111m
EV/EBIT Ratio (2016)	11.3x	Firm Assets	$148m
Dividend Yield	2.4%	Number of Holdings >3%	17
Return on Equity	24%	Top 10 Holdings	66%
Net Cash to Market Cap	-18%	Upside Capture[6]	103%
Median Market Cap	$2.2bn	Downside Capture[6]	78%



Key Features[7]

Fund	Cederberg Greater China Equity Fund
Strategy	Long-only absolute return equity
Legal status	Cayman mutual fund
Dealing	Monthly with 30 days notice
Initial minimum	US$100,000
Benchmark	MSCI Golden Dragon Index
Management fee	1.5% p.a.
Performance fee	20% of outperformance above MSCI GD Index; payable after 3 years if fund beats 6% p.a.
Custodian	Bank of America Merrill Lynch
Auditor	Deloitte
Administrator	Charter Group Admin
Cayman counsel	Maples & Calder
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The case for Quality

"The way to get a reputation for being a good business(wo)man is to buy a good business".

"With few exceptions, when a manager with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact."

Warren Buffett's remarks on the persistence of profitability have been quoted many times. But was the Oracle of Omaha right? Isn't corporate profitability supposed to revert to the mean as businesses earning high returns on capital will attract more competition, and as low profitability leads to fewer competitors?

To test these claims, Credit Suisse divided the universe of global stocks into quartiles according to their profitability (in terms of real cash flows divided by net operating assets) during every year from 1985 to 2012. It then tracked the likelihood of individual companies transitioning between quartiles over rolling five-year periods. The results were fascinating: top quartile (Q4) companies had a 51% chance of remaining amongst the most profitable firms five years later and a 79% chance of remaining in the top half. The odds for bottom quartile names were even higher: they had probabilities of 56% and 83% to remain in the bottom quartile and bottom half respectively. In other words: over five year periods **profitability has been quite sticky, as good (high return on capital) companies have tended to stay good and poor companies have tended to stay poor.**

Ending quartile

Starting quartile

Transition probability	Q1: - -	Q2: -	Q3: +	Q4: + +
Q1: - -	**56%**	**27%**	11%	6%
Q2: -	28%	40%	23%	8%
Q3: +	13%	28%	39%	20%
Q4: + +	9%	12%	**28%**	**51%**

Source: Credit Suisse HOLT

This also held true when analysing profitability trends *within* individual industries, **especially for defensive sectors such as consumer staples and health care where profitability persistence was strongest.** For example, the most profitable home and personal care companies (i.e. makers of cosmetics, cleaning and personal hygiene products) had a 73% probability of remaining in the top quartile and a 95% probability of remaining in the top half five years later. Laggards were equally likely to remain at the bottom of the profitability pile. These results make intuitive sense given that many firms in this industry enjoy decent visibility in future profitability due to wide moats and stable demand.

So what, you may ask? Indeed, the study shouldn't be of much interest to traders, who could in theory make money buying and selling stocks regardless of their quality (a skill we don't possess). However, it matters massively for long term investors. Valuation aside, in the long run earnings drive share prices. Those **quality businesses that can reinvest their retained earnings at a higher return on capital will grow faster than their peers**; compounded over time it can lead to huge outperformance.

We haven't come across a similar China-focused study (perhaps a future project for one of our interns) though our experience confirms Credit Suisse's conclusions, especially when it comes to the region's perennial laggards. Hence we have **whittled the c. 5,000 Greater Chinese stocks down to a Quality Universe of less than 150** based on three criteria: do we understand the business, is it likely to flourish in 5 years' time, and is management honest and able? We spend virtually all our time analysing and valuing these names and no time on the other 4,850. While quantitative screening has identified a number of quality names in the past, many have been discovered through company visits (over 2,000 over the past decade), exchanging ideas with like-minded investors, and observing business models that have worked elsewhere.

Though focusing on quality (and ignoring junk) is a good place to start, it won't lead to strong investment results in and of itself: **how much you pay is key**! Since we are usually not the first to discover good businesses (and since quality investing has become increasingly popular of late), their valuations tend to reflect that fact. One therefore has to wait for a significant margin of safety to appear, which can be due to a variety of reasons such as neglect, investor short-termism, or the market extrapolating temporary setbacks. Fortunately Chinese equities are significantly more volatile than developed markets (recently, Mr Market has been in a particularly fearful mood), which has led to plentiful attractive opportunities for patient investors such as Cederberg.

In the very long run, mean reversion (even outright failure) will be most companies' fate. However, we agree with Mr Buffett that, since good businesses often continue to earn a high return on capital well into the future, and since "turnarounds seldom turn", **investors can significantly improve their odds of finding long term winners by focusing on the former, and steering well clear of the latter.**

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The Alchemy of Donkey Skins

An example of a persistently high quality company currently trading at an attractive valuation is **Dong-E-E-Jiao**, the traditional Chinese medicine (TCM) company. It was founded in 1951, though its brand has a **history that stretches back 2,500 years**! It produces TCM products from the gelatinous layer underneath the skin of a donkey ("*e-jiao*") that are mostly used by women to nourish "*Yin*" (as opposed to "Yang"), treat anaemia, dizziness and insomnia. At less than RMB30 ($4) for a 6g daily serving, *e-jiao* is cheaper than many other TCM products, although let there be no doubt: this is an **authentically Chinese luxury product**.

Source: Company

The company's products are considered to be healthcare supplements; as such the regulatory risk is low. Supplements have a long growth runway in China, with penetration rates of 20% vs. 70% in Japan and 85% in the US.

A strong brand can be a powerful moat, especially if it leads to customer loyalty and/or an increased willingness to pay. China has relatively few wonderful brands (most non-state entities and their associated brands disappeared during the Cultural Revolution). However, in the TCM industry some truly world-class brands exist.

Dong E-E-Jiao is such a brand. It contains many of the attributes of strong Western luxury brands such as Hermes or Louis Vuitton:

1. *A long history:* 2,500 years…
2. *Provenance:* the production process in Dong-E county, local craftsmanship, and the skins of special black *DeZhou* donkeys that drink water from one particular source, all lend an air of mystique and provenance to its products.
3. *High profile endorsements:* Yang Gui Fei (one of China's legendary Four Great Beauties) was an *e-jiao* fan, and the company's products have received numerous government endorsements and awards.
4. *Exclusivity:* our interviews with various sources revealed product volumes have fallen slightly in recent years (a deliberate strategy that has led to rapid price growth).
5. *Brand recognition:* it was ranked second highest of *all* TCM brands by the China TCM Association recently.
6. *Dominance:* it has 70% market share and its products are synonymous with *e-jiao* (in the same way that consumers often refer to all facial tissue brands as "Kleenex").

Dong-E-E-Jiao's **brand strength has led to favourable economics,** with ROIC and ROE in the mid-twenties, gross margins over 60%, a net cash balance sheet, and earnings growth of 25% p.a. over the past decade. Indeed, its pricing power has been spectacular: prices have risen 7x over the past 7 years and are currently trading at a 70% premium to those of its peers (a lot of this has been by stealth as the company has launched pricier new product lines). This should continue as they roll out new products and as they pass raw material price hikes on to their customers.

What about risk? We believe the company is significantly less risky than most Chinese healthcare and consumer staple names:

1. It is essentially a monopoly facing few competitive threats.
2. Minimal regulatory risk, as its products are supplements.
3. No patent risk, as all major TCM recipes are state-owned.
4. There is no risk of doctors receiving bribes to prescribe the products (the bane of China's healthcare industry).
5. It has some product concentration risk (all its products are *e-jiao* derivatives, though *e-jiao* has no known substitutes).
6. Food safety is always an issue in China, though this is mitigated by the company's strong supply chain control.
7. Demand is inelastic and enjoys strong tailwinds.
8. Governance has been strong: dividends have risen 10x over the past 15 years; it has strong and supportive shareholders; management have recently bought more shares.
9. Key person risk exists as its excellent CEO will likely retire in the next 3 years (though the brand won't be affected).

Although Dong-E-E-Jiao is an unusual company (to say the least!), the combination of a wonderful brand, strong management and high earnings visibility makes it a high quality company that is very likely to remain as such for years to come. While historic growth is unlikely to be repeated, mid-teens growth should be achievable for the next five years or more. At 12x next year's pre-tax earnings, it is simply too attractive to resist.

Final thoughts

I would like to thank our clients for your long term orientation, and my wonderful team at Cederberg for all their hard work.

Warm regards,

David Krige

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Regulatory information and risk warning

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Disclosure

[1] Performance is for an investment made at the fund's inception; individual investors might experience different performance. MSCI Golden Dragon Total Return Index includes net dividends reinvested. Source: Charter Group Admin, Bloomberg, Cederberg.

[2] Peer group is Bloomberg universe of funds with Greater China geographical focus. Source: Bloomberg, Cederberg.

[3] Category definitions as per Cederberg.

[4] Source: Cederberg.

[5] Portfolio characteristics are quoted as of 4 July 2016: the weighted average of the series is used for Dividend Yield, Return on Equity and Net Cash to Market Cap; the median is used for P/E and EV/EBIT ratios, where the data tends to be more volatile and dispersed. Source: Bloomberg, Cederberg.

[6] Upside Capture is calculated by dividing the fund's average NAV return during months in which the index had a positive return by the average index return during those months. Downside Capture is calculated by dividing the fund's average NAV return during months in which the index had a negative return by the average index return during those months.

As an illustration: During months in which the index was up, it returned +3.86% on average vs. Cederberg +3.96%; During months in which the index was down, it returned -3.48% on average vs. Cederberg -2.73%. Source: Bloomberg, Charter Group, Cederberg, 30 June 2016

[7] Source: Cederberg.

Sources for all other figures quoted in this letter are available upon request.

Investors should note investment involves risk. The price of units may go down as well as up and past performance is not indicative of future results. Investors should read the Fund's Offering Memorandum for further details and risk factors, in particular those associated with investment in emerging markets. Information in this report has been obtained from sources believed to be reliable but Cederberg Capital does not guarantee the accuracy or completeness of the information provided by third parties.

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