

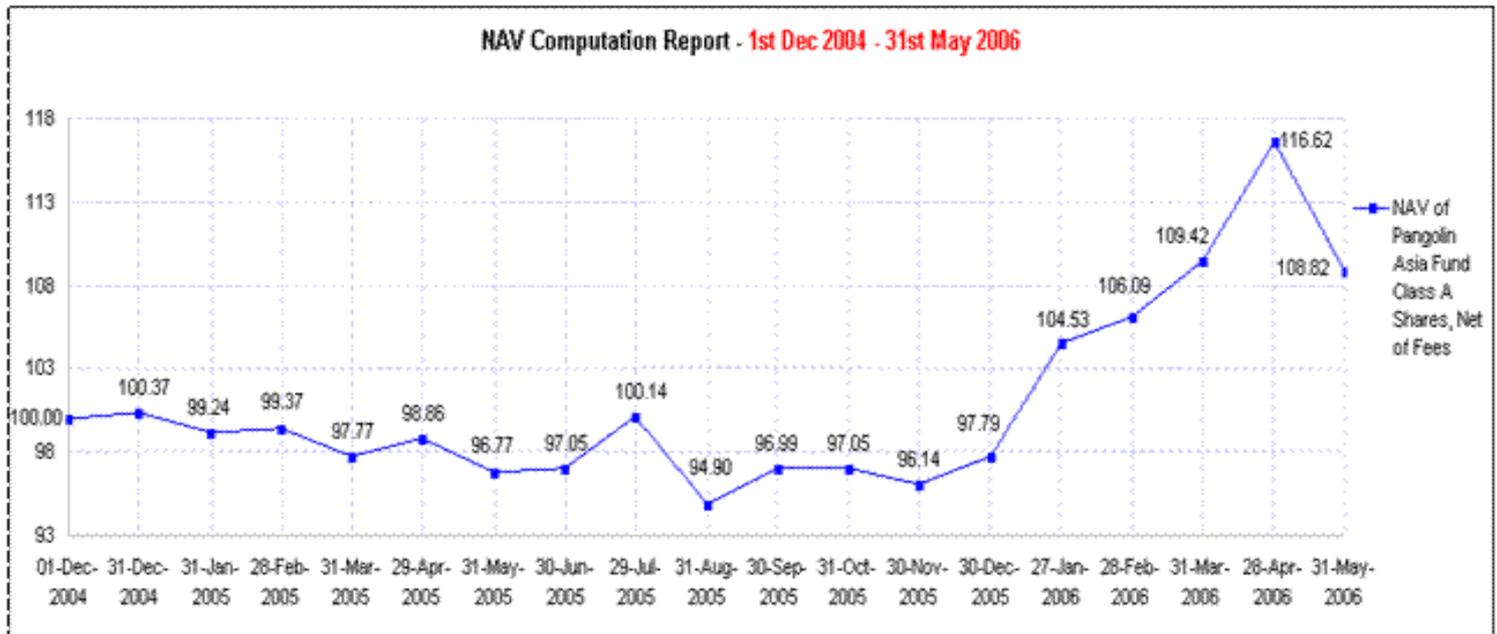


Pangolin Investment Management

Pangolin Asia Fund First Half 2006 Report

The net asset value of the A shares was US\$108.82 at the end of the period. Please note that the fund has a November year end, thus the first half ended on May the 31st.

At the quarter's end the fund was approximately 96% invested.



2nd Quarter Review

A word on the markets:

Those of us unfortunate enough to have to get our news from CNN will be aware that the weather takes up about 20 minutes of each hour. Why? Because broadcasting some dull meteorologist in a studio is a lot cheaper than sending a reporter anywhere. And CNN take the view that if they talk about the weather often enough we will start to think it matters. Of course the next cheapest form of broadcasting is also set in a studio and involves Fed watching. The financial community has become obsessed by the "next numbers". So we all wait with baited breath for the Fed's interest rate decision, but the moment that comes out we are told that it is the CPI, or the PPI or non-farm tractor sales* that will tell us where the world is headed and all we need to do is wait a few more days and all will be clear.

Of course the picture is never clear. And to discuss that, the presenters invite guests onto the programmes to guess what the next number will be. And it doesn't matter if they are right or wrong because the moment the number is announced it is no longer relevant and it is the next, next number we must await. Great for CNBC: more filling for their (cheap) programmes and an endless supply of free guessers willing to appear in order to publicise the banks they work for. The markets are obsessed with these numbers and gyrate accordingly.

Of course the indicators have not been great recently which has caused a sell-off. Perversely a so-called "flight to quality" has hit Asian and other emerging markets hardest, but this is really an explanation for the effect of hedge funds unwinding their long positions in the said markets which were financed (in many cases) by borrowed US\$ or Yen. The swings are exacerbated both by the increase in leverage and by the large proportion of investment capital that is dedicated to short term trading strategies. Given the economic fundamentals and prospects of the Asian economies compared to some Western countries, a "flight from quality" would probably be a more apt term to use.



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Many equate stock market volatility with risk and therefore perceive that the risk in stock market investing has increased over the past few weeks. This works for a short-term view but over the long term stock performance is correlated with earnings and of course lower stock prices are much less risky; falling share prices should be welcomed as it gives the long term investor the opportunity to buy more for less.

The fund is, as always, close to being fully invested which is rather a shame given what has been going on. However the cash that is available will be re-invested and thus it is in the fund's best interest if prices remain depressed. In fact it makes the manager's job far simpler if stocks are trading below their true worth. All that needs to be done is to buy more as and when cash becomes available. It is when stock prices are running that one needs to think a bit more.

The above is not intended to belittle the world's economic problems, especially as it might seem to be wishful thinking to imagine that the large imbalances and deficits will be unwound smoothly. It is the manager's contention that the US\$ is over-valued as are US equity prices, which is precisely why the fund invests in (what we hope are) cheap Asian equities. It is still the view that Asia offers the globe's best long-term growth story and the fund is positioned accordingly. There is a particular but not exclusive emphasis towards consumption with the proviso that everything is always under review. In the manager's experience the best course of action in times of turbulence is to do very little and let the managements of the companies invested in steer their way through it.

There is no doubt that falling commodity prices (especially oil) would have a dramatically beneficial effect on the profitability of many of the holdings.

All the fund's positions are under constant review although the liquidity of some of them makes any action difficult. It is for this reason that a fair amount of research is undertaken before any investment is made and it is also the reason for the fund's redemption penalties. For example, one of the fund's positions has not traded since 10th May 2006 but it is a profitable company with a strong brand name and is trading below the insured value of its assets. However, to try and liquidate the position in a weak market would be difficult and would result in a sale well below its perceived value.

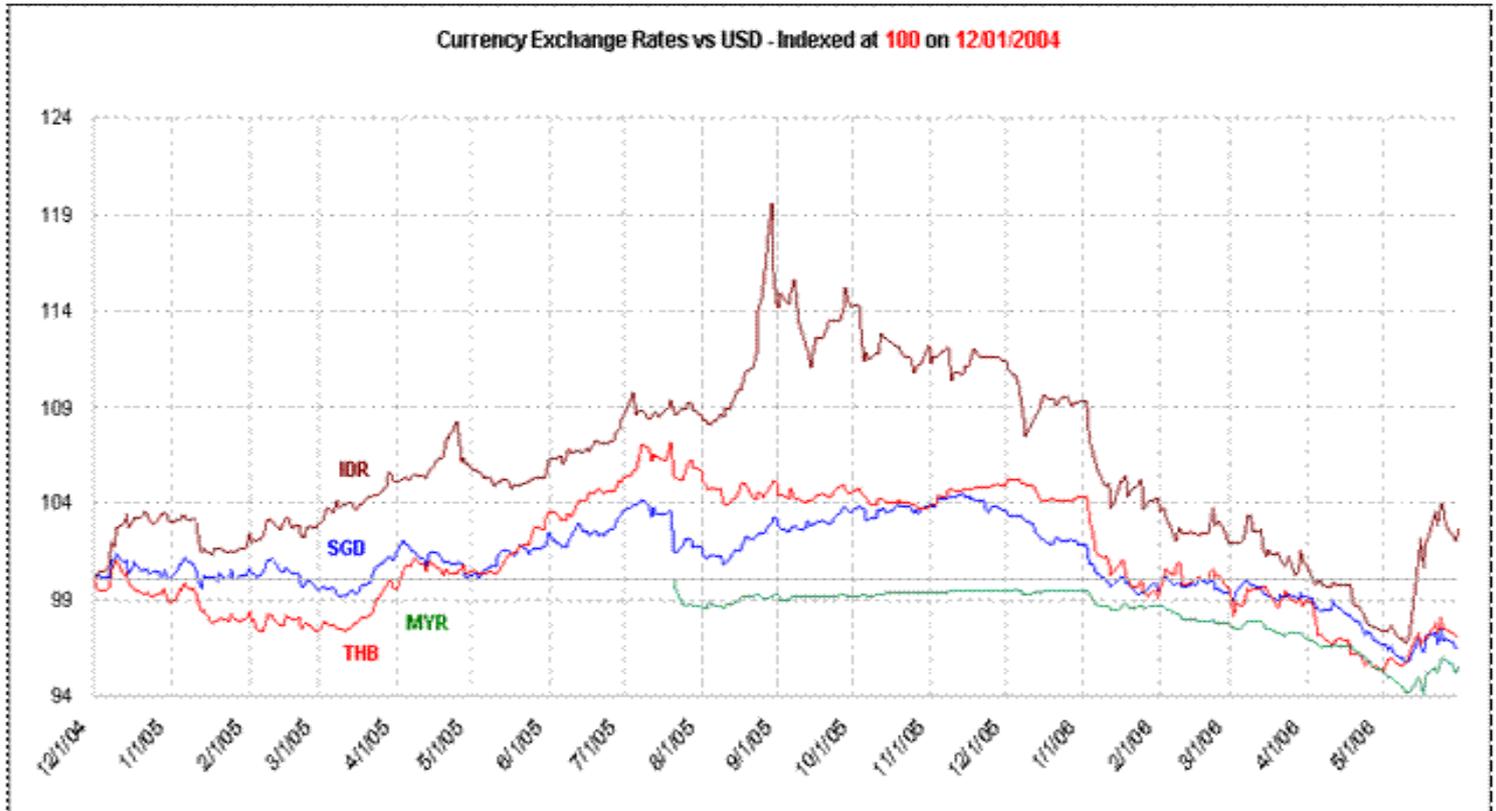
As always I am happy to discuss individual holdings with existing and potential investors. There is nothing in the fund that looks expensive but to summarise here, the approximate country breakdown in US\$ at the end of May was approximately:

Indonesia	30%
Malaysia	32%
Singapore	23%
Thailand	11%
Cash	4%



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The currency effect of the “flight from quality” can be seen in the graphs below:



Unfortunately the majority of capital flows in and out of Indonesia appear to be stock market related, although the FDI numbers are improving.

Politics

Malaysia has seen a rare outbreak of politics in the past few weeks with Dr. Mahathir stating that he made a mistake in appointing Badawi as his successor. This kind of outburst would be quite shocking in any country, but in Malaysia it is unheard of. Malaysian ruling party politics is normally a competition in sycophancy, so every minister has now lined up loyally behind Badawi and is being fiercely critical of Dr. Mahathir – someone they were totally loyal to until he handed over power.

All the same it has made for interesting reading in a country in which there is very little political debate and issues have been raised and debated in the press in a way that has not happened in recent times. UMNO, the dominant Malay-based coalition party, is desperate to close ranks but it is quite hard to stop public debate once it is out of the bag. It now seems possible, at least, that there might be a challenge to the current leadership at some point, as opposed to the normal situation in Malaysia where the party decides on no-contest rules in order to preserve unity.

Since Ahmad Badawi came to power there has definitely been an opening of debate in Malaysia; the letters to the papers are often quite critical and now with Dr. M being discredited by the current crop of ministers, all his policies, such as Proton, are fair game. There are cynics who suspect that this is no more than the two camps squabbling over lucrative contracts, which may of course be the case, but nevertheless it has livened things up a bit.

Malaysia prides itself on its race relations, quite rightly given that three races all manage to get along passably well. Unlike in the West where there is pretence at homogeneity, in Malaysia the differences are celebrated. Thus one would never say “Happy Holiday” but wish the Muslim, Chinese or Indian a Selamat Hari Raya, Gong Xi Fatt Choi or Selamat Deepavali respectively. Malaysians share a love of food and the respective holidays are normally followed by an open house to which neighbours and friends are invited, often irrespective of race and religion, for feasting.



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Therefore when the chief Muslim in Malaysia ruled last week that Muslims should not attend the celebrations of other races he caused much consternation and in the English press (not really his constituency of course) he was criticised. A multi-racial society is at best an equilibrium and one should note that the less tolerant strain of Arab style Islam have been gaining ground, although the last election was seen as a resounding rejection of the hardliners.

The same strains are evident in Indonesia where some regional councils have been imposing Islamic laws on their constituents. These range from insisting that all women wear a tudong (head covering) to not allowing them out on their own after 9pm. The former has even been imposed on non-Muslims while the latter has been implemented in some Jakarta suburbs and women commuters returning late have been picked up by the authorities. This goes against the constitution, according to the liberal English press, but it is not easy for the president and other senior politicians to unwind these laws; to be seen as un-Islamic could be electoral suicide.

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. Given the recent sell off this makes even more sense than usual.

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

James Hay

22nd June 2006

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*I made this one up.