



SERAYA INVESTMENT

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Dear All,

It has already been more than six months since the Panah Fund transitioned to Seraya Investment in Singapore. During this time, we have kept busy, setting up our new office in Purvis Street as well as continuing our usual investment activities.

In recent months, we have also been giving some thought as to the most helpful and efficient way to communicate with Panah investors in the future.

At present, Panah communicates via monthly reports, quarterly letters and other ad hoc communications (including occasional webcasts). Each year, we also enjoy meeting many of Panah's 67 shareholders, in person or – when that's not possible – via video calls.

We have listened to your feedback, and going forward we plan to take a slightly different approach to communications.

We will of course still provide monthly reports and quarterly letters, but from now on, these reports and letters will only be available to existing investors in the Panah Fund, or to those who are actively considering an investment. By providing this commentary to a smaller group (primarily Panah shareholders), we hope that this will allow us to be more candid.

Over the years, our quarterly letters have become much longer – perhaps too long to read in one sitting. We thus plan to pare back the length of these letters, with our commentary to focus on portfolio performance and positioning along with our market outlook.

This does *not* mean that we will stop writing our 'investment strategy' and 'case study' notes. Indeed, these are valuable tools for imparting a deeper understanding of our investment approach and process. We will thus continue to compose this commentary, while encouraging all members of the Seraya team to contribute.

Instead of including these 'investment strategy' and 'case study' notes within our ever-expanding quarterly letters, however, we plan to distribute these as separate ad hoc 'insights'. Going forward, these will be published on the new Seraya Investment website and on our new Substack newsletter page. Both of these should be up-and-running in August.

Note that our 'insights' will not be restricted to Panah investors – anyone with interest will be able to gain access and read these notes.

My colleague Hanim has also kindly agreed to take on more responsibility when it comes to driving efficient investor communications for Seraya. Our investor outreach efforts are also set to evolve, with more emphasis on regular webcasts and small group meetings (as appropriate) to ensure that we communicate as efficiently as possible with all shareholders. In this way, we also hope to free up more time to focus on investment.

We thank you very much indeed in advance for your understanding. We also invite you to write to us if you have any additional feedback as to how we should be communicating better. No matter whether you would like us to add more analysis to the monthly report, change report format, or even delete sections from our letters – we would be happy to hear from you.

Without further ado, let us proceed with our quarterly investment review.

Performance & Market Review

By end-June 2023, the NAV of Panah Class A Shares had risen to 213.48 per Share, a net increase of +3.47% since the start of the year.

Panah's performance in 2023 has so far been broadly in line with regional indices. The Bloomberg Asia Large-, Mid- & Small-Cap Net Return Index rallied +5.50% in H1 2023, with the Bloomberg Asia ex-Japan Large-, Mid- & Small-Cap Net Return Index turning in a much weaker +2.38%.

As these contrasting performance numbers suggest, there was a marked divergence between the performance of different Asian country equity indices and currencies during H1 2023.

The US Nasdaq led the charge for global tech (+31.7%), dragging with it the performance of various tech-heavy Asian indices in its wake (+22.5% KOSDAQ, +18.0% TWSE, +9.9% Kospi).¹ The tech rally came as global liquidity eased and as investors became excited about rapid progress in Artificial Intelligence ('AI') following the public launch of various generative AI models which demonstrated advanced capabilities (e.g., [Dall.E 2](#) and [ChatGPT-3.5 and -4.0](#)).

Japan was also a large outperformer in H1 (+15.5% Nikkei 225, +9.8% Topix), with even stronger performance in local currency terms (+27.1% Nikkei 225, +22.0% Topix in Yen). This was driven by the 'not-China trade', as investors diverted money away from Chinese markets and towards Japan, the most liquid alternative North Asian market. Optimism over further [improvements in Japanese corporate governance](#) also buoyed stocks. In particular, Japanese large caps and baskets of stocks with a low price-to-book ratio outperformed.

Vietnam rebounded in H1 (+11.5% VNINDEX) following the brutal sell-off in 2022. This was as investors judged that the government's brutal 'Blazing Furnace' anti-corruption crackdown had run its course.

On the other hand, China was one of the weakest links in H1 2023 (-4.6% HSCEI, -1.42% Shanghai Comp), giving back all the gains from Q1 and more. This was as US-China tensions mounted, as China's [economic recovery disappointed](#) following the removal of 'Zero Covid' lockdowns, and as further [stimulus was not forthcoming](#) despite widespread expectation of government support for the economy.

The weakest equity indices in H1 2023 were to be found in SE Asia, namely Thailand and Malaysia (-11.6% SET, -13.1% KLCI). Thai equities saw selling pressure as growth remained sluggish, [Chinese tourists did not arrive](#) in the numbers expected, and as the country held a [hotly-contested election](#) in May. A [new prime minister](#) is yet to be appointed. [Malaysian markets disappointed](#) as foreign investment faded, and as local institutional funds continued to deploy more capital towards foreign equities rather than the domestic market.

Asian currency performance during H1 2023 was highly dispersed. The Japanese Yen was the weakest in the region (-9.1% JPY) as interest rate differentials with the US Dollar and other currencies continued to widen. This was as new central bank governor [Kazuo Ueda](#) chose to wait before making any adjustments to the Bank of Japan's [Yield Curve Control](#) ('YCC') policy. Several other Asian currencies weakened during H1 2023, including the Malaysian Ringgit, the Chinese Yuan and the Korean Won (-5.6% MYR, -4.9% CNY, -4.4% KRW). Modest strength from various other regional currencies (+3.4% IDR, +1.0% PHP, +0.8% INR) still seemed to reflect a delayed recovery from last year's weakness rather than any secular strength.

Energy led the commodities complex down during H1 2023 (-43.7% US HH natural gas, -34.7% China thermal coal, -12.0% Brent oil, -10.9% WTI). This was as Chinese economic growth disappointed, pushing energy prices weaker despite fundamental support from OPEC supply cuts. The exception to energy weakness was uranium (+10.9% U3O8), where spot prices rose further to reflect tight supply dynamics.

¹ All returns are given in US Dollar-terms unless otherwise stated.

Most industrial metals reversed gains from the first quarter to end the half-year flat-to-down as China growth disappointed (+3.3% iron ore, +0.7% copper, -8.4% lead). Meanwhile, gold remained well-supported despite rapidly rising US real interest rates, as central banks increased their holdings of the precious metal (+5.2% XAU).

The trend towards extreme [yield-curve inversion](#) continued in many developed markets. This was as inflation pressures remained stubbornly high. This trend was particularly pronounced in Anglo-Saxon markets such as the US and the UK and was also present in the Eurozone. Yield curve control remained in place in Japan, however, putting substantial pressure on the Yen.

In contrast, Vietnamese bonds rallied strongly in the first half as the market priced out the risk premium from the anti-corruption crackdown, and as the central bank cut interest rates (Vietnamese 10-year yields fell from 5.2% to 2.65% during H1).

Meanwhile, Sri Lankan 10-year yields also plunged during the first half (from 26.2% at end-Dec to 19.4% at end-June, and as low as 14.0% in early July). This was as the country managed to obtain [initial IMF support](#) in March, and as parliament approved a [debt restructuring plan](#) in time for a [formal IMF review in September](#). See the first *Investment Strategy* section of this report for more information (pp.8-12).

Performance Attribution & Portfolio Positioning

Performance attribution

During Q2, Panah's 'compounder' stocks, 'capital cycle' (energy) holdings and 'deep value' investments made positive contributions to the fund. On the other hand, the poor performance of the fund's precious metal equity holdings was a drag on returns.

The largest positive single stock contributors during the second quarter were a Vietnamese industrial conglomerate with real estate investments, a Vietnamese merchant bank with fintech investments, and an Australian uranium developer.

Trading activity

Trading activity in Q2 2023 was moderate.

During the second quarter, we increased our allocations to two of our longstanding holdings in Vietnam.

We had reduced our position size in a Vietnamese ICT firm a year ago when we became concerned about uncertain risk due to the company's increased activity in interest rate arbitrage activities.² After engaging with the board of directors in 2022, the company improved its investor disclosures in the middle of the year, then also reduced its gross debt levels and arbitrage activities in the second half of the year.

We attended the company's AGM in early April 2023 and discussed these issues in more detail with some members of the management team and board. Following these conversations, we judged that risk levels had fallen and that the outlook and valuation for the company were attractive. We thus added to our position opportunistically during the quarter.

During Q2, we also added to our holding in a merchant bank with fintech investments.³ We had reduced the size of this position substantially in late 2021 and early 2022. Over the previous ~15 months, the share price had surged by +730%, which we believed priced in too much potential future good news.

Sure enough, after the peak in late 2021, the share price proceeded to fall ~-70% over the following year. At this level, however, valuations were simply too cheap – the company was trading at a discount to its major investment holding in Vietnam's leading fintech payments firm.

² For a more detailed description, please see the Panah Fund letter to investors for Q1 2023.

³ The investment case for this holding is set out in the Panah Fund letter to investors for Q3 2021.

After attending the company AGM in late April, we were impressed by several new senior hires and assessed that the firm has a good chance of substantially growing its recurring revenue base in the coming years. We thus added to this position in early May at the lows, fortunately managing to buy a block of shares just before the share price embarked on a ~+50% upswing.

During the second quarter, we rebalanced our precious metal holdings and added to our exposure. This involved reducing our holding in a precious metals royalty company which had substantially outperformed, and reallocating towards other gold royalty companies trading at cheaper valuations. We also initiated new positions in two established gold miners which are generating large amounts of cash flow and which trade at attractive valuations.

We see the potential for gold prices to outperform as central banks continue to increase their reserve allocations to the yellow metal, likely at the expense of the US Dollar. We would not be surprised to see a breakout in the US Dollar gold price⁴ to new highs in the coming quarters as interest rate expectations peak for at central banks in West, especially the US. (This may or may not coincide with a systemic risk event.) We also see good value in gold stocks, with double-digit cash flow yields now on offer after a bear market which has lasted almost twelve years.

Other trading activity during Q2 included a modest adjustment to our 'capital cycle' holdings as we trimmed one stock which had outperformed in 2022. 'Macro' trading activity mainly involved adjusting currency hedges on the portfolio, including CNH/EUR, THB and PHP.

Panah currently has allocations to two 'special sit' investment positions, in Vietnam and Sri Lanka. We initiated our Vietnamese 'special sit' position (comprising two convertible bond holdings) in September 2022, and added to the position in Q2 2023 on improving fundamentals and attractive valuations. We initiated our Sri Lankan 'special sit' position in early Q2 2023 after a research trip to the country. We then added to the position from mid-June following another visit. At end-H1 2023, each position accounted for ~5% of the NAV of the fund. The rationale for each investment is given in the first *Investment Strategy* section of this letter (pp.6-12).

During Q2 2023, Panah covered its remaining single stock short positions. We also initiated a new short position in a 'red flag' accounting quality basket of stocks with 'poor accounting quality' (as determined by our proprietary model). The background to this approach is explained in the second *Investment Strategy* section of this letter (pp.13-14).

Portfolio positioning and exposures

As of end-June 2023, Panah's largest two investment holdings were a Vietnamese industrial conglomerate with utility investments (accounting for 14.6% of the fund's NAV) and a Vietnamese ICT firm (8.5% of NAV). The third largest position in the fund was a Taiwan-based global wireless testing company (6.6%). The fourth largest holding was a gold royalty firm (3.9%), while the fifth largest position was a uranium holding company (3.8%).

At the end of the second quarter, Panah's top five long positions summed to 37.4% of the fund's NAV, our top ten positions accounted for 53.0%, and the top fifteen came to 65.4% of NAV. The concentration among the fund's top five holdings thus increased slightly compared to end-Q1. This was the result of stock price movements as well as an increased allocation to Panah's second largest holding (the Vietnamese ICT firm).

As of end-Q2, Panah's largest stock exposure by country was Vietnam, with positioning of 36.6% gross and 30.3% net (comprising long holdings in four companies, two convertible bond positions in one conglomerate, and one short position). The fund's second largest geographical concentration was Taiwan, with exposure of 12.4% gross and 8.9% net (consisting of three long positions, one single stock short position, and some additional single stock short exposure via an accounting quality short basket). In third place was Japan, where exposure to stocks was

⁴ The gold price, denominated in most other major currencies (e.g., JPY, GBP, AUD) has already hit new highs during the last six months.

7.6% gross and 7.1% net (six long positions, one single stock short position, and modest additional single stock short exposure via an accounting quality short basket).

As of end-Q2 2023, the fund was positioned as follows:

- 'Compounders': twelve stocks accounting for ~46.3% of the fund's NAV;
- 'Deep value': three stocks, ~6.4% of NAV;
- 'Special sit': three holdings, ~9.7% of NAV;
- 'Capital cycle' (energy, weighted to uranium): fifteen stocks, ~20.7% of NAV; and,
- Precious metals companies: twelve stocks, ~13.6% of NAV.

At the end of the quarter, 96.7% of Panah's NAV was invested long stocks, with -10.0% of NAV in single stock shorts (including an accounting quality short basket) and -11.1% in macro hedges (calculated on an equity-equivalent basis).

At end-Q2, Panah's gross and net equity equivalent exposures were 109.9% and 78.2% respectively. Our gross and net exposures increased over the quarter as we gradually drew down cash to deploy to various investment opportunities, and as we initiated a new position in a short basket. More information on Panah's 'red flag' accounting quality basket is given in the second *Investment Strategy* section of this letter (pp.13-14).

Investment Strategy – Two 'Special Sit' Case Studies

In past letters, we have endeavoured to bring our investment process to life by explaining the different investment strategies which we pursue, as well as describing concrete examples of our investments – both successful and unsuccessful.

In past letters, we have covered some of our 'compounder' investments,⁵ 'deep value' investment,⁶ 'capital cycle' investments,⁷ as well as single stock shorts.⁸ One area we have not written much about so far, however is the fund's idiosyncratic 'special situation' investments.⁹

The fund's 'special sit' positions are opportunistic investments which are by nature difficult to categorise. They usually consist of unusual situations where we believe there is a good chance to earn outsized returns in the near term.

In general, our special sit investments tend to be off-the-radar for most other investors, involve taking advantage of market inefficiencies, and generate a return stream which tends not to be correlated to that of regional equity markets.

Panah is currently invested in two special sit opportunities, described in more detail below.

'Special Sit' Case Study 1: Vietnamese Convertible Bonds

Panah first initiated this special sit investment position in September 2022. We then added to the position in late Q2 2023. This position consists of holdings in two 'busted' convertible bonds ('CBs') issued by companies controlled by Vietnam's largest conglomerate.

This conglomerate is active in sectors such as real estate development (residential and commercial), healthcare, education, as well as electric vehicle assembly and distribution. It is one of the top 10 private companies in the country, with revenues in excess of 1% of GDP.

⁵ For more information on 'compounder' investments, see the Panah Fund letters to investors for Q3 2018 (pp.4-9) and Q4 2020 (pp.7-10).

⁶ For more information on 'deep value' investments, see the Panah Fund letters to investors for Q2 2018 (pp.6-8) and Q3 2021 (pp.3-11).

⁷ For more information on 'capital cycle' investments, see the Panah Fund letters to investors for Q4 2018 (pp.8-12) and Q1 2019 (pp.4-12).

⁸ For more information on single stock shorts, see the Panah Fund letters to investors for Q4 2015 (pp.2-5), as well as the second *Investment Strategy* section of this letter.

⁹ Our only previous 'special sit' case study was in the Q3 2015 letter to investors (a Thai turnaround).

In recent years, the conglomerate has overextended itself as a result of a reckless expansion into electric vehicles. As a result, the group is burning cash and has substantial debt obligations coming due in the next two years.

Two US Dollar-denominated CBs, issued in 2021 with a maturity of five years, have put options which come due in April and September 2024. In other words, if the CBs are trading below the put price on the relevant dates in 2024, the holders of the CBs are able to demand that the company buy back the CBs at a premium to par.

Currently, the CBs are trading at a substantial discount to par, with implied yields-to-put just below 30%. This valuation implies that investors believe that the company will *not* be able to pay off these obligations when these put options come due.

Having performed a 'burndown' analysis of the company's assets and liabilities, and discussed the company's choices with management, however, we believe that the company is both willing and able to make good on these obligations. They are aware that if they do not, they would be shut out of international funding markets for the foreseeable future, thereby stymying their ambitious plans for the electric vehicle division.¹⁰

That does not mean, however, that the company does not have some hard decisions to make. In the absence of a massive reduction in cash burn or a substantial equity raise, the firm will likely have to monetise some of the relatively high-quality real estate assets (residential and commercial) which are held within its subsidiary companies. Indeed, this process has [already begun](#).



Figure 1: Malls or electric cars? It's hard to afford both... (Source: Vingroup)

Given that cash is extremely tight within the group at this time, it is unlikely that the parent company will be willing to see money 'leak' from any group companies to other shareholders. Cash dividends are thus probably off the menu for now. Moreover, the rules governing transactions between group companies are complex, and management does *not* have a reputation for pristine corporate governance.

As a result, our strong preference at present would be to *avoid* being a minority shareholder of any group company. We are happy, however, to be compensated with very high US Dollar yields for owning CBs. These also sit higher in the capital structure, ranking alongside other senior unsecured creditors.

If this is such a good investment opportunity, then why does it exist?

Vietnam is not an active market for CBs, and the international CB investment community is not particularly familiar or comfortable with the economic and political situation in the country. Last year's anti-corruption campaign in Vietnam scared away many of these investors. This was especially because it came on the back of a similar severe crackdown in China from 2021, which

¹⁰ The CBs are traded internationally, and not on domestic markets. (They are listed on the SGX, with Euroclear and Clearstream Lux as clearing houses.) Any failure to honour these CB obligations would likely mean that the company would be shut out of international funding markets for some time.

resulted [in bond defaults and severe distress in the Chinese real estate sector](#).¹¹ Such events appear to have prompted international investors to dump this Vietnamese conglomerate's CBs, depressing valuations.

On the other hand, most domestic investors in Vietnam are either unfamiliar with investing in convertible bonds (as they focus on either equities or debt) or are unable to do so as they are not set up to transact on the international markets where these CBs trade.

Note that yields on the conglomerate's domestic bonds with a similar tenor (which are more freely bought and sold by local investors) are currently trading with yields as low as 9-10%! We would expect the CBs to trade at broadly similar valuations, yet they trade at a massive discount.

In summary, we believe that market inefficiencies have created the opportunity to invest in these 'orphaned' CBs. There would appear to be few 'natural investors' who are able to come in and bid up prices. In the absence of specific news flow on asset divestments or equity issuance from the conglomerate, prices have remained depressed.

We cautiously note that the [worst appears to be over for the real estate sector in Vietnam](#), with regulatory approvals starting to grind into gear, and construction and sales on various projects recommencing. [Interest rates have also fallen](#), once again making mortgages accessible for Vietnamese consumers. This is good news for the conglomerate, which should now be able to start generating higher cash flows from its residential real estate arm.

We have also identified a low-cost hedge which, although it does not provide a perfect offset, should nevertheless protect our downside in most negative scenarios. As for 'blue sky' potential, while owning CBs would usually give investors the potential for additional upside (should the stock price rally beyond the conversion price), we think such an outcome unlikely in this case.

Regardless of this, we are happy with a US Dollar yield-to-put in the high-20% range for this special sit opportunity. We suspect that when the rerating comes, it will likely be sudden.

'Special Sit' Case Study 2: Sri Lankan Local Currency Debt¹²

Sri Lanka has suffered significant hardship in recent years, experiencing its worst economic crisis since independence in 1948, along with social and political turmoil.

The current run of trouble started with the tragic [Easter bombings](#) of April 2019. Worries over national security in the wake of the attacks contributed to the reelection of the [Rajapaksa dynasty](#) later that year.

This set the stage for a series of [poor policy decisions](#), including tax cuts, debt monetisation, and a [ban on chemical fertilisers](#) which crushed the country's important agricultural sector. The blow to tourism from the Easter bombings was then further compounded by the Covid-19 pandemic, which denied the country an important source of foreign currency income.

Very soon, the government found itself with little in the way of tax revenues or foreign income. From mid-2020, the central bank was also pressured to burn forex reserves to defend the currency at an unsustainable level.¹³ With forex reserves all but exhausted, the currency went into freefall, depreciating by a massive -45% over the course of two months from March 2022. Sri Lanka had little choice but to halt all external debt payments, and by May 2022 [the country had defaulted on its external debt](#) for the first time in its history.

¹¹ There have been major differences between the rolling crackdowns in China and the anti-corruption movement in Vietnam over the last 18 months. Please see the Panah letter to investors for Q1 2023 for more details.

¹² Many thanks to Marianne Page, Bimane Meepagala and Kuhan Vinayagasundaram for their patient explanations of the complex situation in Sri Lanka, as well as their helpful comments when composing this note.

¹³ By this time, Sri Lanka had little in forex reserves other than a [Chinese swap line worth US \\$1.5bn](#) extended in May 2021, which was in any case [not useable due to certain preconditions](#).



Figure 2: Fuel queues and protests, May 2022 and July 2022 (Source: New York Times)

The exhaustion of forex reserves and collapse of the currency catalysed a massive political and social crisis. Sri Lanka quickly found itself without enough hard currency to pay for food, fuel or medicine. This led to widespread power cuts, dramatic scenes of citizens [queuing for meagre fuel rations](#), as well as [increasingly violent protests against the government](#) (see *Figure 2*).

Protesters even managed to occupy the [presidential palace](#). They then [entered the prime minister's private residence](#), setting it alight along with houses belonging to [38 other politicians](#). These protests forced the most prominent members of the Rajapaksa family, the prime minister and the president, [to flee and resign their posts](#) amid a [state of emergency](#).

The economic crisis and the protests also catalysed the appointment of a new, independent [central bank governor in April 2022](#). He immediately [hiked rates from 7.5% to 14.5%](#) in order to tame inflation and defend the currency.

Veteran politician [Ranil Wickremesinghe was then elevated to the presidency](#) in July 2022 and tasked with finding an end to the turmoil. Given the severity of the crisis, he was able to push through unpopular measures that would have been unthinkable even as recently as several months before.

The new president also immediately commenced negotiations with the IMF. He quickly set about implementing the [measures required to unlock funding](#), including spending cuts, large tax increases and power tariff hikes. This also required agreement from major bilateral creditors China and India.

The crisis, along with these restrictive measures, took a massive toll on the economy as [GDP contracted by -7.8% in 2022](#). As the crisis unfolded, [Sri Lankan CPI](#) spiked to as high as ~74% yoy in September 2022, driven by currency depreciation and global inflationary pressures (see *Figure 3*).

Sri Lankan government bonds sold off hard, with 10-year yields peaking in the low-30% range in Q4 2022. The central bank had already raised interest rates to the mid-teens in early 2022 to defend the currency; it then continued to raise rates to a peak of 16.5% in March 2023.

When I arrived in Colombo in early February 2023 – my first trip to the country in several years – I found that a semblance of normality had already returned to the city. This relative stability was in contrast to the somewhat alarmist ongoing international media coverage.

While [import restrictions](#) on many goods still remained, food and fuel were more readily available. As always with crises of this sort, the [poorest members of society continued to suffer](#). However, there were no more queues at gas stations, power cuts were rare, and medicine imports were increasing.

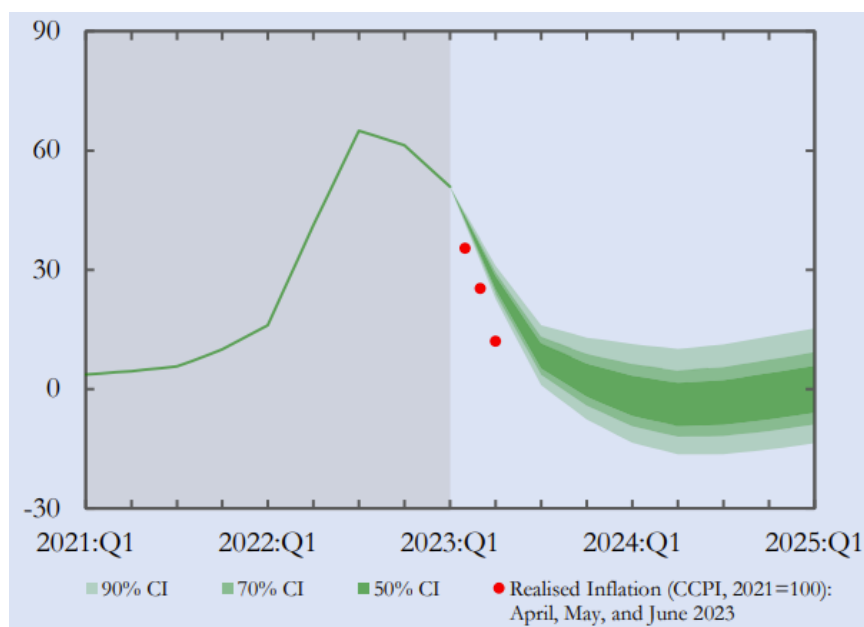


Figure 3: Colombo Consumer Price Inflation Index year-on-year change projections, with realised inflation (Source: [Central Bank of Sri Lanka](#))

Holidaymakers had started to return to the country, although [tourist numbers](#) were still lower than pre-2019 levels. While there were still [sporadic protests against the government](#) – mostly by middle class and government employees who were outraged at the cost-of-living shock from higher tax rates and high inflation – these demonstrations were mostly non-violent.

Meetings with the central bank and senior executives from several major local companies indicated a high degree of realism, resilience, and willingness to make sacrifices among policymakers and corporates. Our meetings also seemed to indicate the tantalising possibility of a relatively rapid path to macroeconomic stabilisation for the island nation.

The IMF executive board [was set to approve a US ~\\$3bn bailout](#) for Sri Lanka in March 2023. The [current account balance](#) had already moved into surplus by Q3 2022, providing some support for the currency (see *Figure 4*).

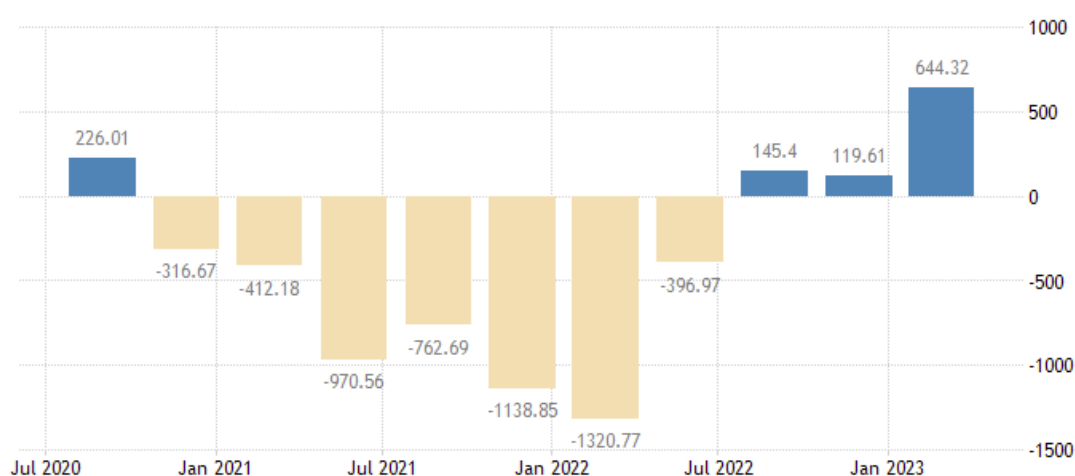


Figure 4: Sri Lanka current account balance (Sources: Trading Economics, Central Bank of Sri Lanka)

Taking into account base effects and falling global inflationary pressure, it seemed likely that CPI would fall into the single-digits by mid-year – a rapid reversal (see *Figure 3*). If inflation were to fall to such an extent, this would also make it more likely that the central bank would be able to cut interest rates more aggressively, thereby alleviating some pressure on the economy.

Some brave frontier market equity investors saw this as a good moment to start topping up their holdings in the depressed domestic equity market. We also considered buying equities, but still had concerns about various issues.

These included very poor liquidity in Sri Lankan stocks; substantial ongoing pressure on the consumer and corporate earnings from higher tax rates, interest rates, power tariffs and other costs; a high level of NPLs in the banking system; the risks to growth and political stability from agricultural issues (including a failed monsoon); and the potential for a delay in the proposed IMF bailout (e.g., if major [bilateral debtor China were to act as a 'spoiler'](#), or if domestic political challenges were to emerge given the country's [ongoing structural issues](#)).

In the medium- to long-term, there remains substantial doubt as to whether Sri Lanka will be able to stick to the new IMF plan, which requires far-reaching structural reforms and sacrifices from the entire population. After all, this is the [17th time that Sri Lanka has sought an IMF financing program](#). Even if the crisis has been bad enough to force through some serious reforms, [scepticism is still warranted](#). The first major hurdle will likely be the next presidential election, which must be held before [November 2024](#).

Even if we did not have strong conviction in the immediate investment case for equities, however, we did have more certainty that the Sri Lankan Rupee should enjoy more stability in the near-term.

After all, the current account balance had already moved into surplus, with a [delayed tourism recovery in 2023](#) set to boost dollar earnings further (see *Figure 5*). The country was also reported to have [generated a primary budget surplus](#) for the first five months of 2023, comfortably ahead of IMF expectations. Remittances also seemed [set to climb sharply](#), not least because [so many Sri Lankans had left](#) the country during the crisis. The Rupee appreciated sharply in early March, from ~360 against the US Dollar to ~320, as the IMF started to disburse its first tranche of funds.

As stability returned in 2023, Sri Lankan government securities also started to rally, with yields on both 12-month T-bills and 10-year bonds falling from >30% in late 2022 to ~25% by end-March. This was despite significant uncertainty at the time surrounding the exact nature of the debt restructuring that would have to be agreed with the IMF by September – the only thing that seemed certain was that most government debt (domestic and external) would be [subject to some sort of haircut](#).

Rather than immediately taking on uncertain and illiquid equity risk, we thought that ~25% local currency yield in a more stable Rupee seemed like an attractive prospect. To mitigate the risk of losing from the debt restructuring, we identified the one area of government debt which seemed unlikely to be subject to any haircut for 'regular' investors, namely local currency T-bills. We had high conviction that these would remain untouched, as the government had discontinued bond issuance and was [relying on T-bills](#) to finance the day-to-day running of the country. The [central bank governor confirmed our suspicions in late March](#) when he announced that *"Treasury bills would not be treated"*.¹⁴

Rather than setting up accounts to buy T-bills directly, we opted for a relatively quicker and easier route: investing in a Sri Lankan money market fund run by impressive investment professionals at a well-established local asset management company. After setting up the relevant trading and bank accounts (and performing 'roundtrips' to test the subscription and redemption process), we began to deploy more funds to this trade in early May. At that time, the yield on offer was ~23%, and the fund had an average duration of around seven months.¹⁵

¹⁴ That is, all T-bills other than those owned by the central bank, which would be subject to 'treatment'.

¹⁵ The T-Bill market is currently more liquid than the equity market. It is challenging to deploy US ~\$500,000 in Sri Lankan stocks in a day, whereas the T-Bill market can happily absorb millions of dollars.

Sri Lanka's progress so far in 2023 has been remarkable. Inflation has fallen from close to 60% yoy at end-2022 to 12% at end-June, with further declines expected in coming months. This has enabled the central bank to cut rates twice (in [early June](#) and [early July](#)), from a high of 16.5% to 12% for the reverse repo rate, with further rate cuts expected. This should help to reduce the burden on indebted corporates and households, supporting growth.



Figure 5: Sri Lanka: practically perfect for tourism? (Sources: [tripsavvy.com](#), [zicasso.com](#))

There are also high hopes for a rebound in tourism during the high season later this year (see *Figure 5*). If any readers of this letter had been thinking about visiting Sri Lanka, we encourage you to do so soon and support the country on its path to recovery!

Even as the local currency has strengthened (to a recent high of 290/US\$, and is now stable around 320/US\$), the central bank has also succeeded in [building its forex reserves](#) at a faster than expected pace, to US ~\$3.5bn. This provides a valuable buffer and will allow the central bank to intervene in case of any future 'excessive' currency volatility.

A follow-on trip to Sri Lanka in mid-June gave us the opportunity to meet several senior central bank officials and senior management from various blue-chip companies. Despite all the difficulties that the country has been facing, we were pleasantly surprised by the general confidence and determination that Sri Lanka is on the path to recovery.

On 1 July, the government approved a [domestic debt optimisation](#) ('DDO') plan. This provides more clarity as to the expected treatment for holders of various forms of government debt and is a key prerequisite to pass the IMF's first review (scheduled for September).

On the back of this [DDO plan](#), Sri Lankan government securities have [rallied strongly](#): T-Bills with a six-month maturity currently yield ~16%, and bonds with a maturity greater than 24 months yield below 15%.

The money market fund in which Panah is invested has a duration of 5-6 months and still yields in the low-20% range. As the fund's T-Bill investments start to mature in August and September, we expect the yield of the fund to drift lower (given that reinvestment into new securities will be at lower yields).

We are happy to run our investment in the money market fund for now, perhaps augmenting this investment by switching some of this holding into a fund which holds longer-duration bonds. These bonds are still yielding in the mid-teens, and we would expect them to make additional capital gains as inflation and interest rates continue to fall.

In the coming months, we expect various positive catalysts in the form of more interest rate cuts, parliamentary approval of the [central bank independence bill](#), the first IMF review (scheduled for September), as well as more clarity as to the trajectory of the economy. In the medium- to long-term, we perceive more uncertainties.

Note that Sri Lanka's geographical location in the Indian Ocean, off the southeast coast of India and close to multiple sea lanes, makes the country a place of [vital geopolitical interest](#). China, India and the US have been competing for influence, and this has only intensified since the crisis. The Rajapaksas were perceived to have been [close to China](#) (supporting various [One Belt One Road projects](#)), but it was [India which stepped up](#) during the worst moments of the turmoil to [provide critical aid for Sri Lanka](#). This came in the form of more than US \$4bn in credit lines, currency support, fuel and medicine, as well as essential [support at the IMF](#).

Now, all three countries are competing to invest in infrastructure and development projects in Sri Lanka (including [energy](#) and [ports](#)). This makes it more likely that the country will attract higher levels of foreign investment in the coming years, which should help to support growth. Investors will need to balance positive tailwinds of this sort against other risks of the sort mentioned earlier.

Depending on Sri Lanka's progress over the rest of the year, we have various choices. We might continue to hold our fund investments, we might choose to sell our holdings in the fund and repatriate our funds, or instead we might decide to reallocate into the Sri Lankan bond market or even make equity investments.

Any major decisions can probably wait until we make another research visit to Sri Lanka later this summer. For now, though, we are happy to report that our 'special sit' trade in Sri Lanka appears to be on the right track.

Investment Strategy – a new 'red flags' basket approach to single stock shorts

During Q2 2023, Panah further refined its approach to shorting stocks.

In the past, we have described various single stock short strategies. These include: 'structural shorts' (when a company is no longer competitive and is in secular decline); 'valuation shorts' (expensive or 'bubble' valuations combined with downside catalyst); 'capital cycle shorts' (when a sector has peaked out and is in cyclical decline); and 'accounting shorts' (when a company uses accounting practices which are aggressive or maybe even fraudulent, thereby inflating reported financials).¹⁶

In an early letter to investors, we described our then newly developed 'red flags' quantitative process, which helped us to identify companies which might be playing fast and loose with their financial reporting:

"We take accounting data for all companies within our investment universe (currently ~13,000 companies) and rank ~80 different metrics against peers within each sub-industry group and against their own histories. The metrics fall into six main categories: [1] income statement; [2] accruals; [3] assets, investments, & intangibles; [4] debt; [5] related party transactions; and [6] composite measures.

*"Where there are a large proportion of abnormal metrics (or 'red flags'), this indicates a higher likelihood that we have found a 'problem company'. The quantitative techniques we use are based on academic forensic accounting research, fundamental analysis, and our own examination of recent Asian fraud cases."*¹⁷

Since developing this model, we have used it to screen firms in our investment universe and identify companies with the most 'red flags'. This was both so we could avoid 'problem companies' on the long side of our portfolio, and also to provide us with some highly prospective short candidates for companies which might be involved in accounting manipulation.

¹⁶ See the Panah Fund letter to investors for Q4 2015.

¹⁷ The Panah Fund letter to investors for Q4 2015, p.4.

Companies engaged in aggressive and/or fraudulent accounting are precisely the sort of companies which we would expect to underperform the market over the long term. Indeed, the realistic worst-case scenarios for such firms should be regulatory sanction and bankruptcy.

In recent years, we have implemented various ‘accounting shorts’. Some of these shorts were spectacularly successful, others less so. (Shorting such companies requires discretion, and so we will refrain from posting any case studies.)

In late 2020, as the US Federal Reserve (‘the Fed’) and other central banks pumped a massive amount of liquidity into the global economy to ‘offset’ the effect of Covid-19 lockdowns, we covered many of our single stock shorts. We were concerned that the sudden surge of dollars into the market might spur a frenzy of speculation, pushing up the price of many stocks. Indeed, late 2020 and early 2021 witnessed a [massive short squeeze](#), particularly in the US markets. Perhaps unsurprisingly, poor quality companies outperformed the market.

In subsequent quarters, we frankly re-evaluated our approach to single stock shorts. A profit attribution for the Panah Fund shows that over the life of the fund, the only category of single stock shorts which has made a positive contribution to Panah’s profits, albeit modest, has been our ‘accounting shorts’ sub-strategy.

Shorting stocks is not easy. In particular, it’s hard to get ‘accounting shorts’ right, given the sheer amount of exhaustive, in-depth research required. It also requires significant preparation – and luck – to get the timing for such shorts right; some fraudulent companies manage to survive and even [thrive for years before the final collapse](#). There is thus no guarantee that we are able always to find the right candidates and then short them at the right time. How to address this challenge? Over the last year, we have rebuilt our ‘red flags’ accounting model to take advantage of the better infrastructure and data now available to carry out quantitative analysis of this sort. While we have tweaked our process to reflect our experiences over the last eight years, in essence the methodology remains remarkably similar to our original 2015 model.

This ‘red flags’ model is *not* a ‘black box’. We can see exactly which metrics drive a company towards the top of the ‘red flags’ list, and how these have evolved over time. In reality, the companies which rank near the top of our list display extreme outlying metrics (versus peers) across many areas of their financial statements.

Over time, we have seen how companies near the top of our list have underperformed the market, with some of them facing fraud allegations or even insolvency. In other words, we believe that our ‘red flags’ model has acted as an ‘early warning’ system for dangerously poor accounting quality.

In the past, our focus was on using the ‘red flags’ model to generate *individual* single stock short ideas. However, it required substantial additional work for us to build conviction before we were willing to short these single stocks in sufficient size to make a difference to the fund’s profit and loss account.

In contrast, our ‘new’ approach to single stock shorts, adopted in Q2 2023, involves taking a *group* of the worst offenders at the top of our ‘red flags’ list, and then shorting them together as a basket of stocks.¹⁸

Individual stocks within the basket only account for very small position sizes. This means that we are better able to ride the ups-and-downs of the market without getting stopped out of

¹⁸ Note that it is not possible to obtain stock borrow at a reasonable cost for all the stocks on our ‘red flags’ list – our short basket therefore consists of the top stocks on our ‘red flags’ list, allowing for borrow availability, borrow cost, liquidity, free float and other key considerations. In practical terms, note that we implement a short position on our ‘red flags’ basket by entering into a swap position with one counterparty. Note that the implementation of this ‘red flags’ accounting quality basket in June 2023 is the reason that the number of single stock shorts disclosed in the Panah Fund monthly report for that month has increased.

positions at precisely the 'wrong' moment. By taking a basket approach, it also means that we worry less about the precise timing of when to short an individual stock; such stock-specific considerations fade when we aggregate this risk over a larger group of 'problem' companies.

One new challenge involved with taking a basket approach to shorting is knowing when and how to increase and decrease the notional size of the basket – in what size should we be short? A second challenge is knowing when and how to 'rebalance' the basket constituents to reflect the ever-evolving model results and ensure optimal portfolio performance. A further challenge is deciding if and how to address the new systematic exposures which arise naturally when implementing a basket trade of this sort (e.g., if the 'red flags' basket has particular country and sector concentrations).

We are still in the process of ramping up our exposure to the 'red flags' short basket, although we have already developed various tools and methodologies to address the challenges mentioned in the previous paragraph. We will refrain from discussing these solutions in this letter –investors who wish to discuss this matter further are welcome to reach out to us.

As we gain comfort with our 'red flags' accounting quality short basket, we hope that it will help to anchor the Panah Fund's approach to single stock shorting. At the same time, Panah will still seek to implement occasional individual single stock short positions in the future, as and when the right opportunities arise.

Market Outlook

In 2023, it has proven to be even less productive than usual to pay any attention to investment bank sell-side macro predictions. Most equity markets have continued to grind higher despite the slew of challenges facing the world, driven by looser than expected liquidity and AI dreams. With inflationary pressures in the US and other developed markets [starting to subside](#), investors are increasingly hopeful that peak interest rates are in sight. This also makes it more likely that equity markets may continue to rally and climb a wall of worry over the summer – just so long as [banking stress](#) does not reemerge to spoil the party.

China is one of the few equity markets which has disappointed this year. This is as the economic bounce-back from 'Zero Covid' has fizzled, [geopolitical tensions](#) have remained high, and as the authorities have stubbornly refused to stimulate the economy in the way that Wall Street investment banks think they should. Indeed, almost every week for more than a year, the bulge bracket investment banks seem to have been [predicting a stimulus](#) which has not yet arrived.

The expectations for an economic recovery in China were too high earlier this year. Now, however, it would seem as if pessimism over the state of the economy is overdone. Retail and services staged a halting recovery in Q2, while manufacturing remains weak but not terrible. Real estate staged a weak bounce earlier in the year but is now [resuming its gradual decline](#).

The authorities are now painfully aware of the [long-term structural issues](#) created by past incessant stop-start stimulus policies. It appears that China's current weak recovery simply is not yet serious enough to clear the [much higher bar](#) for the authorities to contemplate a 'big bang' stimulus. Indeed, it would probably take a much worse outlook to prompt such action.

Investors are right to think that [youth unemployment running at >20%](#) is a concern for the Chinese Communist Party ('CCP'). It is unlikely, however, that the solution to increase hiring among fresh graduates involves more construction projects. What might help is for the Party to forge a [hasty 'rapprochement' with China's humbled tech giants](#) and [push them to hire more young people](#). We are not surprised to see this happening now, although are doubtful that the shareholders of China's tech giants will be long-term beneficiaries of the CCP's reengagement with this sector.

China economic situation increasingly reminds us of 1990s Japan. Richard Koo has recently been warning of [the dangers of a 'balance sheet recession'](#) in the country, and Chinese academics appear to be taking this warning seriously. Indeed, despite some monetary easing, credit demand is not really picking up – is China's central bank '[pushing on a string](#)'?

Those countries in Southeast Asia which were preparing for a surge in Chinese tourists, such as Thailand, Indonesia and Vietnam, have [faced disappointment](#). While some tourists from China might be willing to fork out cash for a [luxury handbag](#), they have proven less willing to splash out on a vacation.

The lack of a strong economic rebound from China has also meant that oil demand appears to be coming in [weaker than expected](#) in H1 2023. This appears to be one factor (along with higher global rates) contributing to [lower oil prices so far in 2023, despite OPEC supply cuts](#).

China's equity prices remain depressed, and valuations 'cheap'. Given all the pessimism, it seems reasonable to expect that stimulus optimism might well cause occasional market surges – good to trade for those who move fast. Given the serious structural issues facing the economy, however, we guess that investors would be well-advised to fade such rallies.

Panah is comfortable with its current modest allocation to Chinese stocks. We hasten to add, however, that this is driven by bottom-up considerations. We simply continue to find more interesting opportunities in other regional markets.

Elsewhere in Asia, the Bank of Japan ('BoJ') meeting in late July is 'live', with a real possibility that the central bank will choose to tweak its restrictive YCC program. Indeed, BoJ policy is [looking increasingly outdated](#) in the context of CPI which recently spiked above 4%, 'core' inflation running at 2.6%, and wage growth which is running at [the fastest pace in 30 years](#).

Given that relatively little is known about new BoJ governor Kazuo Ueda, however, it is still uncertain whether the central bank will decide to adjust monetary policy in July or wait until a later date. When the BoJ does decide to move, however, then we see the potential for heightened volatility as the world's 'last great carry trade' in the Yen comes to an end.¹⁹

Should such Japanese developments happen to coincide with a 'peak' in the US Fed tightening cycle, these moves might be even more pronounced. It would thus not be surprising to see higher forex volatility and trend changes during the second half of the year.

Leaving aside these prognostications, we expect that as usual, the returns of the Panah Fund will be driven by the idiosyncratic, bottom-up opportunities that we identify. Indeed, we trust that the *Investment Strategy* section of this letter gave you some insight into the effort that the team expends to generate and research interesting and differentiated investment ideas that will hopefully set Panah apart from the crowd.

On that note, we sign off on what we expect to be the last quarterly letter of this length. We very much that you get to read this note while sitting on a beach, a mountain, or wherever it is that you choose to spend your summer!

Wishing you all the best for the summer holidays.



Andrew Limond



¹⁹ See the Panah Fund letter for Q3 2022 for more details.

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