Monthly Report to Shareholders of the Optimal Japan Absolute Long Fund – *August 2010*

Optimal FUND MANAGEMENT

Monthly Performance % - *as at 31 August 2010*	NAV	August	YTD	Asset size
Offshore Feeder	$10.22	-2.39%	-2.20%	$189M
Topix - *Topix Return is in USD unhedged using WM London 4pm close*		-2.24%	-1.71%	

Our relief at July's small positive return in Japanese equities was washed away by the deluge that hit the market in August. The Topix index fell 5.3% for the month, with growth - and currency sensitive - sectors weak and the defensives occupying positions three through six in the list of least bad sectors. Of particular interest to market watchers was the performance of real estate which rallied 3.1% in August to take second position after "Air Transport". The Tokyo Stock Exchange really might need to think of a re-vamp of their industry sub-indices as the Air Transport index contains just three names and the largest stock – All Nippon Airways (ANA) – now accounts for over 99% of the sector's market capitalisation. Excluding the performance of this one stock, the real estate sector gave the best return for August but long-suffering investors would feel this was long overdue as the sector's 2010 return had been down 15% at the start of the month. From its recent peak in May 2007 to the end July low (and we say "low" with more conviction than hope), the real estate sector had fallen by 71% and not even the much despised banking sector had fallen quite that much.

The four years between the spring of 2003 and the early summer of 2007 saw a genuine bull market in listed Japanese real estate with the index rising from 430 to over 2400 in that period. Globally, growth was synchronised and confidence high while credit was plentiful and Japan's asset prices were rising after a decade or more of deflation. Today we face uneven global growth and fragile confidence and Japan's CPI remains stubbornly negative, but credit is readily available in the Japanese real estate world and implied cap rates are very high once again – even higher than they were at the bottom in early 2003. With increasing urbanisation in Japan and especially in Tokyo, the real estate players in the Tokyo metropolitan area are relatively well positioned for improved rents and lower vacancy rates while they are priced for either Armageddon, or inflation. Cynical investors might prefer to bet on Armageddon coming to Japan before inflation returns, but if one were Japanese and thought there were ten or more years before Armageddon, one could make a tidy sum from investing in Yen-denominated real estate stocks.

While Japanese real estate stocks have shown some recent signs of life, the Japanese banking sector plumbs new price levels. At the end of August, the Topix New Banks sector index had reached a relative low against the Topix index. From its relative peak in May 1991, the Bank sector has fallen 89% while Topix is down **only** (did I say that?) 59%. Initial over-valuation, a chronic case of denial and poor management can be blamed for a good part of the nineteen years of horrible absolute and relative returns, but deflation lies front and centre when one seeks reasons why this has happened. After so many bad years, investors understandably insist that the burden of proof rests with the Japanese banks to show why one should invest in their equity.

We suggest that they have marked down current and future earnings power to levels that at least require some consideration of the risk-return trade-off at current share prices. The big three city banks are relatively clean in terms of the valuations at which they currently hold their assets. They do struggle with weak demand for loans but carry excess deposits, and are priced at between 6x March 2012 earnings (Mizuho) and 11x (MUFJ). They all trade at PBRs of 0.7x and carry dividend yields of between 3-4.5%. As a share of total market capitalisation they are down below 10% in aggregate and are deeply unloved. Since early 2000, the Japanese market's price-to-book ratio has fallen lock-step with the yield on US 10 year treasuries and both are at (near) record lows. If the Japanese market is indeed a good way to play a reversal of falling bond yields, then our bet is the Japanese banks will be an even better one.

Market players talk frequently these days about a particular stock being a "value trap". We recently saw (in *Grant's*, issue Sep 3, 2010) a description of a value trap as "a statistically cheap security that will never go up because the entity that issues it is irremediably defective". Japanese equities are sometimes collectively tarred with this brush and Japanese banks have behaved as if highly defective for a long time, but I would not say that they are irremediably so, and would never use the word never when it comes to equities. We are observers, if not yet active buyers, of the Japanese banks.

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Recent 3 month Fund Exposure

% of NAV in	Jun 10	Jul 10	Aug 10
Long Stock Position	95.56	92.51	92.12
Index Futures	-	-	-
Net Exposure	95.56	92.51	92.12

Optimal FUND MANAGEMENT

*Should you wish to make an investment or further enquiry about the Optimal Japan Absolute Long Fund, please see our website – **www.optimalasia.com** or contact us at – **optimal@optimalasia.com***

Position Concentration

	Top 5	Top 10
Longs	28.73%	47.49%
Shorts	-	-
Total no. positions	37	

Top Five Positions

Chuo Mitsui Trust Holdings Inc

Mitsubishi Estate Co Ltd

JS Group Corp

Hitachi Ltd

Nippon Telegraph & Telephone Corp

Winners

Mitsubishi Estate Co Ltd

Daihatsu Motor Co Ltd

Sumitomo Realty & Development

Nippon Telegraph & Telephone Corp

Itochu Corp

Losers

T&D Holding Inc

Sumitomo Heavy Industries

Fanuc Ltd

Nippon Electric Glass Co Ltd

Sony Corp

Sector Exposure as at 31 Aug 2010

	Longs	Shorts
Materials	10.18%	-
Industrials	20.71%	-
Technology	12.04%	-
Financials	24.56%	-
Energy	-	-

	Longs	Shorts
Consumer Non Disc	5.51%	-
Consumer Disc	14.31%	-
Telecom	4.80%	-
Utilities	-	-

Historical Returns

Below we provide a table detailing the monthly returns of the Fund since its inception in September 2004.

Optimal Japan Absolute Long Fund Monthly Returns in USD (before Performance Fees) %

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Topix [1] YTD
2004									-1.6	-1.32	6.18	2.52	5.70	8.16
2005	1.61	2.05	-3.83	-0.47	-1.81	-0.58	1.17	6.66	9.32	-0.75	3.25	8.64	27.25	24.59
2006	3.57	1.22	3.55	2.74	-4.40	-1.32	-1.55	-0.29	-1.51	3.73	1.48	1.94	9.14	0.94
2007	1.50	3.69	-1.88	0.33	1.71	1.49	1.27	-4.97	2.18	-1.04	-5.37	-6.57	-7.97	-6.37
2008	-6.00	2.60	0.15	4.21	1.40	-9.57	-3.85	-7.26	-5.49	-5.14	-4.01	8.78	-22.95	-28.24
2009	-5.28	-11.56	3.78	4.75	9.49	2.12	3.11	4.76	-3.58	-2.26	-2.78	-0.38	0.38	2.85
2010	2.58	0.19	4.19	1.88	-8.25	-3.15	3.36	-2.39					-2.20	-1.71

[1] *Topix Return is in USD unhedged using WM London 4pm close*

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