

Performance % - as at 31 December 2007

	NAV	December	Qtr	YTD	Asset size
Offshore Feeder	US\$13.51	-6.57%	-12.50%	-7.97%	US\$596M
US Feeder	US\$13.63	-6.39%	-12.40%	-7.15%	US\$31M

**The NAV shown above is after expenses and management fees but before any performance fees. The Fund return may thus not be the same as the return of a discrete investment that might be subject to performance fees through equalisation.*

There are many characters in Greek mythology that offend the Gods and suffer some form of punishment as a result. Two of them in particular have a special resonance for me but I find it hard to choose with which one I feel more affinity. The first of them, Sisyphus, is described as “the craftiest of men” and whilst no doubt the sort of fellow to carouse with, he was clearly a knave, and eventually received his just desserts. Sisyphus was condemned to roll a heavy boulder up a hill, from where it rolled back down again and his task would begin all over. His punishment was never-ending.

The other character is Prometheus. Having already upset Zeus by tricking him, Prometheus then stole sacred fire from Olympus and gave it to mortals – directly against Zeus’s orders – and was captured and chained to a great rock. During the day, a giant bird of prey would feast on Prometheus’s liver after which the liver would regenerate overnight. The next day, the bird would return for some more liver, and not surprisingly developed a great liking for its daily liver banquet. According to legend (at least according to the Wikipedia version of “legend”), Prometheus was eventually set free when Heracles killed the bird, whereas Sisyphus is still pushing the boulder up the hill.

I would like to identify most with Prometheus because the act he was punished for brought boundless joy and comfort to the world of we mortals (barbeques, metalworking, cosy fires in winter, to name a few). Even more to the point, his torment was finally ended. I fear accusations of hubris however as in contrast to Prometheus, who suffered on account of bringing fire to the world, my suffering as a Japanese equities manager has been brought about by my own free and conscious decision to invest my own and our clients’ money into Japanese equities. I dare not believe that the task of making money from Japanese equities is ultimately Sisyphian, but

the similarities are there all the same.

There is little we can say about the significant underperformance of Japan in the last quarter of 2007 that has not been said elsewhere. European markets rose slightly in Q4, Asian markets (ex-Japan) were flat, as was the UK equity market, whilst the US S&P 500 index fell 3.8%. The Topix index fell 8.7% in Q4 and as at 25 January close, is down by that same amount again so far in 2008. Admittedly, other markets have been hit hard by selling in 2008 so Japan does not stand out as especially bad this year, but for a country that has had minimal direct exposure to the problems of the developed world’s credit markets (see our September quarter note on this), the sell-off in Japanese equities has been very painful and more than a little perverse. One must never forget that stock prices are meant to be leading rather than lagging indicators and often prices move before it is clear that events have changed, but the extent to which some sectors have been hit (specifically) and the extent of the Japanese market weakness (generally) would presage very dire economic times ahead. If Japanese equities are right, then a lot of other markets strike me as wrongly priced, but I think it more likely that Japan acts more like the tail of the dog than the head of it, and has discounted more than it needs to.

What is it especially about Japan that has investors spooked?

The population is aging and will begin to decline very soon? Yes, that is a fact, but not a recently unearthed one.

Domestic consumption remains patchy and prices flat? These are real problems that have an effect on valuations, but the sectors most susceptible to weak demand and lack of pricing power (the domestic ones) performed better in Q4 than did the sectors where Japan has global competitiveness and leadership. Six of the worst performing ten sectors were “international” in nature with real estate (down 22%) the only significant domestic sector to fall heavily and that being based on (unfounded) fears that lending for real estate investment would either dry up or become prohibitively expensive. Neither has occurred.

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Japan's political leadership is ineffective and inarticulate both on a domestic and world stage? Yes, yes and more yes. Oh for a great communicator like Ronald Reagan – or Junichiro Koizumi! We do not hold our breath here.

Japan's equity prices are expensive by international standards? Certainly not. There is no longer any Japan premium when looking at PERs, and on almost all other measures, Japan's valuations are cheaper than those of all the developed markets.

The best Japanese companies are now heavily owned by foreigners? Yes, and foreigners have been heavy and steady sellers.

This is, sadly, the real reason why Japan has been such a poor performer. The best companies' shares are 35-50% held by foreigners (see Canon, Nintendo, Komatsu, Murata, Fanuc etc) and foreigners have continued to dump their Japanese holdings. In our report at the end of September 2007, we wrote that “the Japanese financial institutions do not seem to regard their own equities as an investment opportunity” but that changed in late November as the Japanese Trust banks (managers of corporate and public pension funds) turned into significant net buyers. Japanese companies have also continued to buy their own stock and investment trusts come in and out of the market with a generally buying inclination. Despite the welcome return of Japanese institutions to the buy side, they are not big or aggressive enough to soak up the deluge of foreign selling.

We have been guilty of owning companies that had become over-owned by foreigners and should have been looking to reduce that risk from our portfolios. It does not feel right to sell a stock because it is owned by “the wrong people” but I should have done so and I am angry with myself for missing this point.

It does remind me however, of US President Franklin D. Roosevelt's famous first inauguration speech (4th March 1933) which he delivered during the depths of the Great Depression. The speech is known as “The only thing we have to fear is fear itself” and if ever there were times for a Japanese leader (political, or more likely, industrial) to address his country with such clarity and boldness, this would be one of them. Japan is not disintegrating economically or socially. There is little unemployment or homelessness and internationally, the country is viewed with general good will (whale hunting excluded). Yet it appears to suffer from “nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance”. The speech is worth reading in its entirety for various reasons and it is not hard imagining the next

President of the United States making an inauguration speech which borrowed heavily from this majestic speech of FDR's. My knowledge of US financial history is poor, but I assume the Glass-Steagall Act was introduced around this time as Roosevelt is explicit in his condemnation of financiers. In one passage he says “Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men.”

And in a reminder for the Fed and the debt junkies of today, he says “Faced by failure of credit they have proposed only the lending of more money.....They have no vision, and where there is no vision the people perish.”

This is followed later by : “...we require two safeguards against a return of the evils of the old order; there must be a strict supervision of all banking and credits and investments; there must be an end to speculation with other people's money, and there must be provision for an adequate but sound currency.”

One should not forget that this was a speech to the people of the United States by an incoming President at a time of unprecedented economic upheaval. Japan's economic situation is benign by contrast, but there are points of great relevance to Japan in the speech. Not least would be “Restoration calls, however, not for changes in ethics alone. This Nation asks for action, and action now.”

We go to Japan next week for our first visit of the year and will be asking the companies we meet just what action they intend to take. For the moment however, we take a cautious view of the immediate prospects for the Japanese equity market as we wait for the foreign selling to run its course. In this global environment of financial uncertainty, we feel we must pursue a careful approach for now, but must also make sure we avoid fearing Fear Itself.

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Recent 3 month Fund Exposure

% of NAV in	Oct 07	Nov 07	Dec 07
Long Stock Position	91.97	97.16	92.54
Index Futures			
Net Exposure	91.97	97.16	92.54

Performance Statistics

Last 12 Months	-7.97%
3 Yr Annual Average Return	8.52%
Average Annual Return Since Inception	9.45%

Position Concentration

	Top 5	Top 10
Longs	24.80%	43.23%
Total no. positions	36	

Top Five Positions

Komatsu
Toyota Motor
Fanuc
Mitsubishi UFJ Financial
Showa Denko

Winners

Ushio
Yamada Denki
Japan Retail Fund
Investment Corp
Izumi
Press Kogyo

Losers

Taiheiyo Cement
Sumitomo Corp
Komatsu
JFE Holdings
Hitachi Construction

Sector Exposure as at 31 December, 2007

	Longs
Materials	14.48%
Industrials	35.11%
Financials	17.38%
Energy	
Consumer. Non-Disc	
Consumer Disc	18.90%
Utilities	
Telecom	
Technology	6.67%
Total Equity	92.54%
Index Futures	
Net Exposure	92.54%

December Qtr Sector Performance – P&L

	Longs
Materials	-4.49%
Industrials	-6.04%
Financials	-2.68%
Energy	
Consumer Non-Disc	
Consumer Disc	-0.88%
Utilities	
Technology	-1.43%
Index Futures	
FX and Other	3.03%
Total	-12.50%

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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
2004									-1.6	-1.32	6.18	2.52	5.70
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
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
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

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

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