Report to Shareholders of the Optimal Japan Absolute Long Fund – *December 2008*

**Optimal** FUND MANAGEMENT

## Performance % - *as at 31 December 2008*

| | NAV | December | Qtr | YTD | Asset size |
|---|---|---|---|---|---|
| Offshore Feeder | US$10.41 | 8.78% | -0.95% | -22.95% | US$237M |
| US Feeder | US$10.50 | 8.36% | -1.41% | -28.47% | US$20M |

** 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.*

Being exactly one year short of my fiftieth birthday, I have worked long enough in the investment industry to remember a number of bear markets, crashes and bubbles (both inflating and deflating). Reading the torrent of recent economist and investment strategist commentary about recessions, I have tried to recall the recessions of 1974-75 and 1980-82 as well as the more recent recession of 1991-92. My memory is patchy.

In the 1974-75 "oil-shock", my only sense of crisis was when the elected prime minister of Australia was thrown out of office by the (unelected) representative of the British Crown in November 1975. Our social studies teacher listened intently to the radio broadcast of the PM's dismissal and made us sit in silence for the whole lesson. He had a full beard, and I am pretty certain he was crying.

In the next recession of '80-'82, I was at university and as I was unemployed, I thought it was quite natural that lots of others were unemployed as well. Volcker's heroics that set the base for a twenty year bull market in bonds (and borrowing) were not a major talking point after lectures.

By the early 1990s I was all too aware that economic times were tough as I saw short term rates in Australia rise above 17% and whole streets of empty retail space. Waiting at Clapham Junction for British Rail commuter trains in 1992 left plenty of time to read the daily papers' accounts of underfunded pensions in corporate America whilst in Europe, Swedish banks were about to go bust and Robert Maxwell went missing at sea as his businesses sank. Lou Gerstner took over at IBM and one could have bought the shares under $11 and sold them by the end of the '90s at $130 (they now trade at $88).

We are now into a recession in most of the developed world and even the BRICs economies are slowing considerably. This recession has been widely touted as either the worst since the 1974 one, or worse still, the deepest since the end of Second World War (meaning since the Depression of the early 1930s). It is a period of debt retrenchment and associated bolstering of balance sheets – both personal and corporate. Growth is hard to come by when bank loans are shrinking so it might well be some time before economies and then company profits start to grow again.

Stock markets, however, have passed judgement before waiting for hard evidence of economic distress and many stock markets experienced their worst ever year in 2008. The description of stock markets being a "discounting mechanism" has perhaps never been more apt than in the past year and a half. There is also plenty of food for thought in the role of markets being a causal factor in an economic slowdown and not just the by-product of one. There have been numerous cases of financial difficulties of business owners and managers who borrowed against their shares and subsequently came to grief as their assets plummeted while liabilities were called in. In the wash up, we have seen many companies go bust, jobs lost, personal fortunes blown up and most tragically, suicides take place, as a result of borrowing too much money at the wrong time. Markets have discounted a great deal of very bad news already.

2008 was a very bad year for pretty much all investments (bar US treasuries) and Optimal Fund Management's funds fared poorly. For the calendar year 2008, our Japan (USD) long/short fund fell 15.7%, the Japan (AUD) long/short fund fell 13.4%, our Asia (ex-Japan) long/short fund fell 18.8% and our Asia-Pacific long/short fund fell 15.1%. The only remarkable feature is how similar the returns of all the funds were, and in all cases, we made mistakes that we do not expect to make again.

The most glaring of these errors was holding on too long to the economically sensitive industries that had performed so well as businesses and investments up until the second half of 2007. Each time we did sell stocks and reduce our exposure to cyclicals, it felt like we were selling too late, but it was not too late. Prices just kept falling and falling. It was not just the obvious cyclicals like shipping, ship-builders, mining companies, construction equipment companies, autos and auto-parts, steel and non-ferrous metals. The darkening clouds over the consumer meant that electrical appliance makers and all their related suppliers were sold heavily too. Consumer electronics companies, LCD screen makers, glass substrate suppliers, ceramic components, semi-conductors and fine chemicals were all smashed. All this carnage – and that's before we even get started on financials and real estate. It was not a year for risk, and telcos, utilities, drugs and foods appeared near the top of the performance tables in most markets.

For the manager of a fund of equities, the past year has also been a stark lesson that quantitative measures of risk count for precious little in full-blown financial meltdowns. If a fund's securities account for 50% of the net assets and the balance of the fund is in cash, one would expect that if the relevant market declines by 10%, the fund might decline by around 5%. This would be particularly likely if the beta of the stocks owned was close to one – meaning that historically their prices have moved in line with that market index. The past eighteen months blew that expectation to smithereens. Past correlations meant little and price moves were

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incredibly volatile, so that 50% exposure could capture 150% of the market's return. Many new records were set in 2008, but one of the more telling was that the number of "event" days (where the stock market's daily move is greater than 2%) was far greater than that of any previous year.

*What lies ahead for 2009?* In spite of a daily procession of disastrous economic and corporate news, December saw a rise in many markets. At some point, markets stop reacting negatively to bad news. We expect 2009 will be a grind, as job losses mount, banks continue to raise equity and companies struggle with weaker demand. The worst of the stock market falls is however behind us and we expect markets to finish 2009 higher than they start it. Dividends will play an important part of total returns, although many companies will decide to – or be forced to – cut their dividends.

The scale of the government guarantees for depositors and the willingness of central banks to provide cheap credit however argue for a gradual easing in money markets. As refinancing of borrowing takes place, there could be a big jump in the price of companies that have hitherto been seen as having no access to bank credit. Although our funds are all positioned cautiously as we begin 2009, we expect that now is not the time to be raising cash levels.

## Recent 3 month Fund Exposure

| % of NAV in | Oct 08 | Nov 08 | Dec 08 |
|---|---|---|---|
| Long Stock Position | 59.99 | 62.89 | 59.29 |
| Index Futures | -14.51 | -9.81 | - |
| Net Exposure | 45.48 | 53.08 | 59.29 |

## Performance Statistics

| | |
|---|---|
| Last 12 Months | -22.95% |
| 3 Yr Annual Average Return | -8.19% |
| Average Annual Return Since Inception | 0.93% |

## Position Concentration

| | Top 5 | Top 10 |
|---|---|---|
| Longs | 26.35% | 42.89% |
| | | |
| Total no. positions | 22 | |

## Top Five Positions

- Yamada Denki
- Fanuc Ltd
- Nippon Telegraph & Telephone Corp
- Mitsui Fudosan
- Nintendo

## Winners

- Nikkei 225 Index Future (Short)
- Nippon Telegraph & Telephone Corp
- Rengo Co Ltd
- Kirin Brewery Co Ltd
- Daiei

## Losers

- Asahi Glass Co Ltd
- Mitsubishi UFJ Lease & Finance Company Limited
- Suzuki Motor Corp
- Nomura Holdings Inc
- Yamada Denki Co Ltd

## Sector Exposure *as at 31 December, 2008*

| | Longs |
|---|---|
| Materials | 3.98% |
| Industrials | 9.57% |
| Financials | 15.65% |
| Energy | - |
| Consumer. Non-Disc | 2.06% |
| Consumer Disc | 15.55% |
| Utilities | - |
| Telecom | 5.41% |
| Technology | 7.07% |
| Total Equity | 59.29% |
| Index Futures | - |
| Net Exposure | 59.29% |

## December Qtr Sector Performance – P&L

| | Longs | Shorts | Total |
|---|---|---|---|
| Materials | -0.90% | | |
| Industrials | -1.89% | | |
| Financials | -2.16% | | |
| Telecom | 0.18% | | |
| Consumer Non-Disc | 0.04% | | |
| Consumer Disc | -1.57% | | |
| Utilities | - | | |
| Technology | -0.44% | | |
| Index Futures | | 1.08% | |
| FX and Other | 4.70% | | |
| Total | -2.03% | 1.08% | -0.95% |


## 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 |
| 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 |

**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***