Report to Shareholders of the Optimal Japan Absolute Long Fund – *December 2009*

Optimal FUND MANAGEMENT

Performance % - *as at 31 December 2009*

	NAV	December	Qtr	YTD	Asset size
Offshore Feeder	US$10.45	-0.38%	-5.34%	0.38%	US$205M

** 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.*

A quick glance at the report we wrote a year ago shows that the economic recession was foremost in our minds as we started 2009. We predicted that stock markets would nevertheless finish 2009 higher than where they started and in all major markets this proved the case. The gain in Japanese equities was less than that of most markets with the increase anywhere between 3% (Topix index return in USD) and 19% (the Nikkei 225 index in JPY) but had it not been for December's 8.05% gain in the Topix index, the year's return would have been negative. All in all, it was a banner year for equities after the horrors of 2008, but not so for Japan.

We have had a year that we are glad to leave behind and consign to history. The dispersion in returns amongst the 33 Topix industry sectors was very large. The best performer was Transport Equipment (autos) with a gain of 53% while the worst was Air Transport (mainly Japan Airlines) with a loss of 44%. We did well through our holding in Suzuki Motors but did not have enough support in that sector and while we avoided the damage in Japan Airlines, it was a year when we just had our stock picking wrong. Our large position in NTT has been a drag on performance as has been other defensives such as KDDI and Takeda Pharmaceutical.

Looking back over the past few years, we have found the period from the second half of 2007 very difficult in the Japanese market and tricky elsewhere in Asia as well. As someone else said, markets are far wiser than those that comment on them, and we would have to say wisdom has not been abundant in our stock selection for much of the past couple of years. Japan's position in Asia has changed in some aspects over the past six or seven years as less developed economies continue to move into more value-added industries. In some instances – such as ship-building – Japanese companies have lost their pole position and will almost definitely never reclaim it. In other areas, whilst competition has intensified, the Japanese companies continue to hold a significant lead over their Asian rivals. It is crucial to be able to determine when the performance of certain sectors and stocks is driven mainly by shorter-term cyclical factors and when it is in fact due to longer-term factors of a secular nature.

We believe that 2010 will be a year when a cyclical upturn is likely to be the main factor pushing Japanese equities higher. In addition to the similarities with late 2002, there is a new government that favours consumption over investment and is addressing some of the critical long-term problems facing Japan. The previous government had run out of ideas, and was rapidly running out of credible candidates to fill the prime minister's role.

In terms of economic cycles, the domestic real estate market looks very similar to late 2002 with Tokyo office vacancy rates now at 8% (they peaked in mid 2003 at 8.5%0 and rents back to the levels they were at on 2005 and only 5% above the absolute recent lows of late 2004. Market experts expect greater clearances in the office real estate market in 2010 and domestic institutional interest has been evident for prime locations – particularly as interest rates are unlikely to offer much competition to rental yields for some time.

The recession has also pushed capital investment down to levels not seen since 1957 and it is very likely that this will spur increased capex in the coming year. According to Nomura Securities (see "Japanese equities: two focal points" 24 December 2009), the ratio of capex to nominal GDP fell to 13.1% in the September quarter of 2009 as companies have placed emphasis on optimising production structures as demand slumped.

There are a couple of positive outcomes one can expect from here. First, one would expect a cyclical pick-up in capex as demand recovers and companies need to both maintain and improve production equipment. Many of Japan's capital

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equipment companies and materials industries thus stand to benefit.

A more interesting aspect of this is that there might be more at play here than just swings in demand leading capex up or down. In an insightful analysis of Japan's plight, Andrew Smithers (see Financial Times, 8 Dec 2009) points out that Japan has over-invested for too long, suppressing not only company profits (through higher depreciation), but also wages and consumption. Due to the recession and plunge in profits, capital investment has been slashed and labour's share of output is now higher than that in the US. As Japan's household disposable income as a proportion to GDP is far lower than that of any other G5 country, this increase in wages' share of output should be positive for consumption.

Another positive aspect of this shift to lower depreciation is that tax revenues should rise given that depreciation is untaxed, while wages and spending are. More of the latter two means more tax revenue for Japan's government and a reduction in the Budget pressure so oft discussed.

We do expect capex to pick-up, but there is certainly evidence that many companies that previously were extravagant investors are looking for ways to reduce their asset heavy business models. This could be as simple as increasing production facilities in countries where costs are lower - and indeed Panasonic has announced only today that they would double LCD TV output at their Malaysian factory – or outsourcing production to companies with lower costs and/or critical mass. This is evident in semiconductor chips where Japanese makers have moved to outsource manufacturing of memory chips to Taiwan's TSMC due to the huge ongoing capex demands. Capital investment will certainly pick-up from the 40 year lows it has reached, but it will not go back to levels of the past, and that should have a net positive outcome for most companies and their shareholders.

And finally, we leave you with the following article which appeared in the Lex column of the FT on December 31st.

"….Almost nobody is interested in investing now. Hard work and stashing one's money under the mattress, ….., is considered the road to wealth in the west these days.

Few should be surprised at this change. Japan went through a similar decade after its own market bubble burst at the end of the 1980s. From loving equities, Mrs Watanabe barely touched a share again for 20 years. It is fitting then that, while the S&P 500 trades at exactly the same level that it finished 2009, Japanese stocks have more than doubled. It took the Great Recession for the likes of Sony and Kirin finally to embrace "shareholder value". But once they did, boy – returns on equity have skyrocketed.

Yet while the teens marked the return of Japan, it has been a decade that emerging wonder-markets of yesteryear would rather forget. Bubbles bursting are nothing new. But investors underplayed the importance of western consumers to developing world economies. The big lesson they learnt is that embryonic, rapidly evolving markets should never have traded with risk premiums barely above stable, mature ones. And what is left to say about poor China? Historians will be digging through the rubble of that economic and political experiment for years."

We like the sound of the middle paragraph, but certainly not all else that is stated or implied in this piece entitled "Looking back from 2019".

Recent 3 month Fund Exposure

% of NAV in	Oct 09	Nov 09	Dec 09
Long Stock Position	92.19	89.76	84.49
Index Futures	-	-	-
Net Exposure	92.19	89.76	84.49

Performance Statistics

Last 12 Months	0.38%
3 Yr Annual Average Return	-10.71%
5 Yr Annual Average Return	-0.23%
Average Annual Return Since Inception	0.83%

Position Concentration

	Top 5	Top 10
Longs	26.28%	44.46%
Total no. positions	32	

Top Five Positions

- Nippon Telegraph & Telephone Corp
- Mitsui & Co Ltd
- Mitsui Trust Holdings Inc
- Nippon Steel Corp
- Mitsubishi Estate Co Ltd

Winners

- Nippon Steel Corp
- Mitsubishi Estate Co Ltd
- Mitsui & Co Ltd
- Nomura Holdings Inc
- Kubota Corp

Losers

- Nippon Telegraph & Telephone Corp
- Tokuyama Corporation
- Sumitomo Mitsui Financial Group Inc
- Mitsubishi Materials Corp
- Mitsui Fudosan Co Ltd

Sector Exposure *as at 31 December, 2009*

	Longs
Materials	11.85%
Industrials	12.52%
Financials	15.14%
Energy	-
Consumer. Non-Disc	2.75%
Consumer Disc	26.07%
Utilities	-
Telecom	6.60%
Technology	9.55%
Total Equity	84.49%
Index Futures	-
Net Exposure	84.49%

December Qtr Sector Performance – P&L

	Longs	Shorts	Total
Materials	-0.43%		-0.43%
Industrials	0.58%		0.58%
Financials	-0.50%		-0.50%
Telecom	-0.96%		-0.96%
Consumer Non-Disc	0.19%		0.19%
Consumer Disc	0.61%		0.61%
Utilities	-		-
Technology	-0.24%		-0.24%
Index Futures	-		-
FX and Other	-4.59%		-4.59%
Total	-5.34%		-5.34%

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
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

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*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***