Optimal FUND MANAGEMENT

Monthly Report to Shareholders of the
Optimal Japan Absolute Long Fund
March 9th, 2007

28 February 2007	Offshore Feeder	US Feeder
NAV*	$15.45	$15.41
Monthly return %	3.69	3.49

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.*

At the end of December 2006, we reorganised the Optimal Japan Absolute Long Fund into a Master-Feeder structure and as a result, the existing Fund becomes the Offshore Feeder. A new Feeder Fund for US tax paying investors has been created and will produce K-1 forms for US tax purposes. As a result, there will be no more PFIC reports produced. Anyone interested in investing should contact optimal@optimalasia.com to make sure they get the relevant documents and application forms.

It is usually interesting for a fund manager to hear other managers talk about their own funds. It often teaches you quite a lot about one's own approach and invariably causes one to question a few assumptions – long held. Last week I was at a conference in New Zealand sponsored by an investment management company with a fine record of investing outside New Zealand for their clients. Their regular conferences are highlights for me as they are held in a beautiful location near Queenstown in the Central Otago area of New Zealand's South Island. Beautiful scenery aside, they are also an occasion for me to talk to excellent fund managers and hear their presentations, and remind me just how important it is for people to travel and see new places. We have long held the view that the best thing a sell-side head of research could do on taking the job would be to give his top analysts a return air ticket to somewhere relevant and force them to see what else is out there in the wide world of investment. In Japan – and another very important country – they would also need to first arrange for passports to be issued, as the willingness to travel to other countries is not great and the belief that what is at home is best runs deep.

At the conference – which fortunately happened to take place as world equity markets were spiralling south – I heard managers talk about European equities, Asian equities, Global Macro opportunities and Australian equities. Some of them were hedge funds and others not. All of them shared the belief that limiting the downside is extremely important and none were managing funds constrained by index tracking. Having heard the European manager a few times now, I was struck again by the similarities in parts of continental Europe to the investment landscape we find in Japan. The Asian managers spoke a language we could easily understand and the Australian manager was very persuasive. Global macro is not a language we excel at – in fact we can barely put a sentence together – but even that presentation highlighted a number of investment ideas which struck me as worthwhile. The net result of this was that I left the conference feeling more optimistic than I had been before it, and given the disastrous news coming out of the USA's sub prime lending market, that is quite a wonderful thing. The main thrust of the presentations was not so much that the equity markets per se

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are cheap and exciting, but that there are a lot of good companies doing very well and selling at fair prices. If you are a patient investor, you should make a good return.

Japan should do better than that in our view. There is genuine evidence that corporate activity is starting to appear. The water in the saucepan is not exactly boiling, but it is certainly warming up. This week we have seen Citigroup make an offer for control of Nikko Cordial and last week TPG announced it would take an equity stake in Tomy (a toy maker). The reasons for each of these are different, but what must be whetting the appetite of the corporate raiders is that the takeover affordability of listed companies is now extremely benign. An “M&A Ratio” calculated by Daiwa Institute of Research is used to see how many years of “cash flow” one would need to pay for control of a company. Control in this instance is set at 50% of outstanding shares and the cost is thus 50% of market cap plus interest-bearing debt less liquidity on hand.
The current M&A Ratio is 5.5, whereas the peak (when Japanese companies were least attractive as takeover targets) in the late 80s and early 90s was over 9 times. In May 2003 when the market bottomed, this ratio had fallen to 4.9x and hit an all time low of 4.5 in May 2005. When everyone felt bullish in early 2006, the number of companies with an M& A ratio below 3 had fallen to 188 whereas in November 2006 – when investors were gloomiest – this number had climbed to 357.

Despite the lack of actual takeover activity in Japan, this indicator seems to pick entry (and exit) points rather well. And remember, the ratio assumes one is paying for the acquisition with earnings and not a dollar of debt. As we know all too well, in the private equity world awash with liquidity, this is not a remote possibility, and thus for the corporate raiders (and value investors) of this world, Japanese companies offer very tempting targets. The hard part is in executing the takeover and then managing the company once control is gained. Thank goodness we aren’t trying to do that, but I expect we will see others try it pretty soon.

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Month-end investments (as % NAV):
Equity Long: 85.84%
Net exposure: 85.84%

Fund size: US$ 381 mil

Total number of positions: 35

Top 5 positions:

	% of NAV
Tokyu Corp	5.83 %
Toyota Motor	5.35 %
Tokyo Tatemono	5.02 %
Mitsui Fudosan	4.58 %
Sumitomo Corp	4.40 %
Total	**25.18%**

Best Performers: Tokyu Corp, Sumitomo Corp, Tokyo Tatemono

Worst Performers: Suzuki Motor , Ushio, Mizuho FG

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 Offshore Feeder Net Monthly Returns in USD

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	6.76	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											5.25

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