

## Monthly Report to Shareholders of the Optimal Japan Absolute Long Fund 11<sup>th</sup> July, 2006

|             | OJAL NAV* | Performance |
|-------------|-----------|-------------|
| 30 Jun 2006 | \$14.15   | -1.32 %     |

*\*Please note that the Fund is now quoted with only an NAV price rather than with subscription and redemption prices so the return shown at the Fund level may not be the same as the return of a discrete investment that might be subject to performance fees through equalisation.*

Although the Topix index managed a slight gain in June, it does not give a true indication of the sharp fall and subsequent rebound that took place over the month. In the first third of the month, the main index fell almost 8%. The reasons most often put forth for the weakness are first, the growing concerns of a US economic slowdown, and second, the revelations of insider trading by Yoshiaki Murakami of the eponymous Murakami Fund (see last month's report for details). Whichever theory one subscribes to, there is a familiar (and mildly depressing) pattern of Japan's market rising and falling in line with that of the USA – but with more bite to it. Given time zone differences, an optimist might point out that as both the S&P 500 and the Topix index bottomed on June 13<sup>th</sup>, the Japanese market rebound could be taken as the trigger for the US market's recovery. We like the optimistic view, but one can't shrug off the feeling that a weaker US market is most likely to have a negative effect on Japan.

There are two economic issues that we believe are to blame for the current bull market hiatus. First is the uncertainty over the corporate profits outlook for the year 2006 and beyond. Japanese listed companies produced a fourth consecutive year of strong profits growth in the financial year ended March 2006 but spoiled the announcement by predicting low single digit growth in the year ahead. This looks unlikely to us (for many reasons) but one of the beauties - and frustrations – of the Japanese equity market is that a lot of the market participants refuse to look ahead and prefer to act upon announcements. The next opportunity for this timid bunch to reassess will be with the announcement of the June quarter (Q1) profits due from the second half of July onwards. Our visits lead us to remain bullish on profits for 2006 and expect the market to react well to the numbers. Major economic indicators such as labour market data, machinery orders, capex plans and bank lending have all been strong and while most input prices remain quiescent, top line and profits growth is all but certain.

The second issue is harder to judge but of perhaps even greater relevance. As Japan recovers and asset prices rise, Japan's vast pool of surplus funds will begin to trickle back home, or pour out at a decreasing rate. Stephen Roach of Morgan Stanley and other experienced market watchers have written of the withdrawal of global excess liquidity and perhaps this Friday the Bank of Japan will join recent moves by other major central banks to raise official interest rates. We are not much good at predicting what all this means but it does seem a cruel twist of fate that by dint of the long awaited recovery in Japan's economy, interest rates may rise and with tighter liquidity elsewhere, financial markets struggle even to mark time. Japan's success may be the seeds of its problems.

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# Optimal FUND MANAGEMENT

Time will of course tell us the answers, but given the copious good news we are gleaming from our corporate contacts, it seems that on balance, it is right to remain at the party. The summer months are not usually a time for big moves in Japan (at least not upwards) although 2005 bucked the trend of the previous five years. We expect a stronger return from Japanese equities in the second half of 2006 as better earnings become obvious to all, and will use the hotter northern months to position the portfolios to benefit from this.

To finish on an administrative matter, we wish to stress that any applications for redemptions or subscriptions in our funds that come in to HSBC Institutional Trust Services (Asia) after the dealing deadline will be rejected. Please visit our website [www.optimalasia.com](http://www.optimalasia.com) for related information and we encourage you to contact us through the web-site.

## Month-end investments (as % NAV):

Equity Long: 92.22%

Net exposure: 92.22%

Fund size: US\$ 137 mil

Total number of positions: 32

## Top 5 positions:

|                        | % of NAV      |
|------------------------|---------------|
| Sumitomo Trust Bank    | 5.47%         |
| Mizuho Financial Group | 4.97%         |
| Tokyu Corp             | 4.87 %        |
| JFE Holdings           | 4.76%         |
| Toyota Motor Corp      | 4.66%         |
| <b>Total</b>           | <b>24.73%</b> |

**Best Performers:** Sumitomo Trust Bank, Showa Denko KK

**Worst Performers:** Tokyu Corp, Suzuki Motor

## 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 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 |      |      |      |       |      |      | 5.20  |

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