Performance % - *as at 30 September 2008*

	NAV	September	Qtr	YTD	Asset size
Offshore Feeder	US$10.51	-5.49%	-15.72%	-22.21%	US$380M
US Feeder	US$10.65	-5.42%	-15.48%	-21.86%	US$24M

** 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.*

Writing a monthly or quarterly letter to investors is fraught with problems, not the least of these being that there is a record of what you have predicted in earlier ones.

Reading the June quarterly again, a major clanger jumps off the page. In the first paragraph we ended with the words "…and yet we will venture once more to say that March marked the bottom for Japanese equities." The March low on Topix was 1149 and like Troy, this offered stubborn resistance until late September when someone let the Wooden Horse in. The less said about what has happened since then, the better.

On the positive side we did suggest that Japanese banks had no serious problems with sub-prime assets and that their strong capital base set them apart from the banking sectors of the USA and Europe. That has turned out to be the case and much has been written since on this subject. It hasn't been a great shield for equity investors however as the Japanese bank sector has fallen 28% since end-June, albeit less than the market as a whole which is off 35%. It's a good relative performance, but a miserable absolute one.

We also said that none of the major banks had yet made acquisitions, but that has certainly changed as Mitsubishi UFJ has famously become Morgan Stanley's major shareholder and white knight. It would not be surprising to see more forays overseas as the banks are clearly looking to expand their businesses and domestic opportunities are limited. Nomura has snapped up Lehman's European and Asian operations and only the massive quasi-nationalisation of the western world's biggest banking systems has prevented further acquisitions from the big Japanese banks. We are not great fans of the Japanese banks as they have demonstrated no real ability to generate consistent returns, but their poor performance over the past fifteen years might be an unpleasant example of what lies ahead for shareholders in western banks.

Since peaking in 1993, the ratio of loans to GDP in Japan has fallen from 130% to 75% or so. That is a reduction in assets of Y275trillion (about $2.7tn) over fifteen years, equivalent to 55% of GDP. Of that reduction, about Y100tn was written off by the Japanese banks with the balance being loans paid off by the borrowers. It is very hard to make profits for a banking system when not only are you writing off bad loans, but also seeing loans repaid. It also creates serious head winds for economic growth.

Japanese banks received large injections of public money in the late 1990s and early 2000s and my memory of that time was one of almost unanimous criticism from western economists and market observers who decried the intervention of the "socialist" Japanese government and the flagrant waste of taxpayers' funds. Most of that public money has already been repaid at a tidy profit for the government (i.e taxpayer) and Japanese banks are at least solvent. We would hope the experience of the coming decade in the US and parts of Europe is not a repeat of the Japanese one, but the loans to GDP numbers are not so different, the bad loans in the system seemingly huge, and governments now significant shareholders in the western banks. As the old saying goes, "history might not repeat, but it sure rhymes well".

One observer who stood out from the rest of the world at that time was Professor Paul Krugman, recent recipient of the Nobel Prize for Economics. At the time, Krugman was at MIT and is now at Princeton Universtity, where Fed chairman Bernanke previously taught. The following piece (written by Krugman in the 1990s) appeared in the seminal Japanese market daily report "The Blah!" (Jonathan Allum of KBC Financial Products) of October 14th and is worth repeating in full. It is a powerful and eloquent critique of the plight of, and indifference towards, the Japanese economy as it struggled with its bad loans problem in the 1990s.

SYDNEY: Level 5, Wyoming, 175 Macquarie St, Sydney NSW 2000 **Phone:** 61 2 8239 3300 **Fax:** 61 2 8239 3333 **Email:** optimal@optimalasia.com

TOKYO: KS Building 10th Floor, 2-9 Minami Aoyama 6-chome, Minato-ku, Tokyo 107-0062 **Phone:** 81 3 5774 6507 **Fax:** 81 3 5774 6508

"The state of Japan is a scandal, an outrage, a reproach. It is not, at least so far, a human disaster like Indonesia or Brazil. But Japan's economic malaise is uniquely gratuitous. Sixty years after Keynes, a great nation – a country with a stable and effective government, a massive net creditor, subject to none of the constraints that lesser economies face – is operating far below its productive capacity, simply because its consumers and investors do not spend enough. That should not happen; in allowing it to happen, and to continue year after year, Japan's economic officials have subtracted value from their nation and the world as a whole on a truly heroic scale. The fault does not, however, lie merely with those officials. Japan has also been badly served by the economics profession, both in Japan and outside. The great majority of economists – including those who specialize in issues of economic stabilization and growth – seem oddly uninterested in Japan's plight, as if the failure of conventional macroeconomic policy in the world's second largest economy were a subject of merely parochial interest, with no lessons for the rest of us."

One economist who did watch Japan's plight with great interest and has much knowledge on its experience is Mr Bernanke. The aggressive policy response from the Federal Reserve and the US Treasury in recent weeks might owe more than a little to his past studies.

In Professor Krugman's piece, the only assertion I would take issue with is that of Japan having an effective government. Japan's governments are indeed elected by the Japanese public who are eligible to vote, and interested enough to go to the ballot box. The process is undoubtedly democratic, but once in office, there is not much evidence to me that any Japanese government of the past twenty years has been effective. Mr Koizumi was at least a good leader who instilled some degree of confidence in his peers and the world at large that he had an agenda and the courage to pursue it. He is a rarity in that regard, but it would be unfair to judge current PM Aso so early into the role. We will have to watch whether mooted policies that include tax cuts and public works spending come into law and watch the results.

As for the portfolio and our current stance, it is fair to say that we are trying to strike the right balance between our desire to buy stocks at truly cheap levels and our sense that foreign selling of Japanese equities has yet to run its course. Over the course of the past few months we have not only cut back the Fund's net exposure considerably (from 73% at end of June to 52% at end of September) but also reduced our exposure to cyclicals. These companies suffer in two ways as they are obviously at risk of lower demand as the global economy slows and are heavily owned by foreign shareholders.

We are not enamoured of the "defensive"sectors - being pharmaceuticals, food, railways and electric & gas utilities – whose collective market capitalisation has reached record levels as a proportion of the total market capitalisation. This in itself is a bullish sign for the market from here. These sectors are overvalued and offer little in the way of earnings growth in our opinion. If that is a defensive decision, I would rather hold cash.

Dividends are becoming significant, with the J REITS now trading at dividend yields of between 6-12% and even major manufacturers such as Nissan Motors priced to yield 8% in dividends alone. Earnings for the car makers (and other cyclicals) will decline this year, but for once Japan's oft-criticised low dividend pay-out ratio is a virtue as companies will be loathe to cut their actual dividend per share – thus increasing the yield at these depressed share prices. We do not hold Nissan, but would be a buyer of the major Japanese autos on a three year view. Nintendo – which we do own – now carries a dividend yield of almost 5% while NTT is paying out 70% of profits on dividends and share buy-backs.

I am tired of writing (as I am sure you are of reading) that Japanese equities have bottomed, but if anyone would like a call from us to update you on recent moves and our thoughts on stocks, we would be delighted to try and arrange one. I intend to invest more in our Japan funds in the next few weeks.

Recent 3 month Fund Exposure

% of NAV in	July 08	Aug 08	Sept 08
Long Stock Position	91.24	83.51	69.41
Index Futures	-16.88	-17.91	-17.18
Net Exposure	74.36	65.60	52.23

Performance Statistics

Last 12 Months	-31.93%
3 Yr Annual Average Return	-4.53%
Average Annual Return Since Inception	1.23%

Position Concentration

	Top 5	Top 10
Longs	23.56%	41.15%
Total no. positions	27	

Top Five Positions

Yamada Denki
Sony CB
Fanuc
Nomura Holdings
Mitsui Fudosan

Winners

Nikkei Index Future
Bridgestone
Mitsumi Electric
Yamada Denki
Kyoei Steel

Losers

Mitsubishi Electric
Fanuc
Mitsubishi UFJ Lease & Finance Co
Mitsubishi Corp
Star Micronics

Sector Exposure *as at 30 September, 2008*

	Longs
Materials	5.97%
Industrials	18.52%
Financials	19.71%
Energy	
Consumer. Non-Disc	
Consumer Disc	19.88%
Utilities	
Telecom	
Technology	5.33%
Total Equity	69.41%
Index Futures (Short)	-17.18%
Net Exposure	52.23%

September Qtr Sector Performance – P&L

	Longs
Materials	-2.47%
Industrials	-9.13%
Financials	-4.81%
Energy	
Consumer Non-Disc	
Consumer Disc	-1.40%
Utilities	
Technology	-2.00%
Index Futures (Short)	2.84%
FX and Other	1.25%
Total	-18.56%

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				-22.21

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***