# Optimal FUND MANAGEMENT

**Monthly Report to Unitholders of the**

## Optimal Japan Trust

September 7th, 2000

| DATE | NAV | Monthly % Return* |
|---|---|---|
| 31/8/00 | A$11.7335 | 4.02 |

- After all fees
- NAV is ex-distribution of A$1.4158

Despite wanting to get excited by the steady flow of positive news on the economic and corporate profit front during August, the market really failed to behave as we had hoped. The Topix index in AUD did return 7.2% but the stronger Yen accounted for half of that and when looking at the component sector returns, almost three-quarters of the thirty-three groups failed to match the return of the index. August is rarely an active month as the northern summer and holidays draw people away from their desks and last month's volumes on the exchange certainly bear this out. It was not wholly uneventful, however, as a number of leading companies made upward revisions to their profit forecasts but tentative buyers (foreigners and retail) and steady selling from Japanese banks and corporations made it feel like a tough month.

For investors who have spent a long enough time following Japanese companies it often feels that one has been a participant in a practical lesson in economics – slow moving and on a very large scale. The demands of capital for an adequate return may be ignored for a long time but eventually they attract attention. No doubt those who invested in Japanese companies in the 1970's can remember buying excellent growth stocks on low valuations before foreign and domestic money was really actively looking for bargains – and importantly before the long decline in interest rates worked its wonders for equities valuations. For others, like myself, whose investment career in Japan began a decade later, the task was not so easy. Earnings multiples were moving higher and one was left trying to justify buys on the basis that their assets (replacement value) were worth more than was stated in the balance sheet. The market's willingness to look for positives was boundless –

so retailers were lauded if sales were growing notwithstanding that they only managed this by expanding their floor space by 20% annually – and the return on assets (capital) was largely ignored.

All through the past decade, Japanese equity prices have been slowly adjusting to better reflect the rate of return that the company was earning on its outlaid capital. The most glaring example of this can be found in the retail sector where most of the companies had been destroying value (generating returns on investment below their cost of funds) for many years. The share prices of most of these companies are no higher than they were in the mid-1980s and a number have already gone bust (see Sogo Department Store of late) but even the relatively profitable ones have had a de-rating that has been as inexorable as it has been devastating to investors. Whereas they may have traded on a multiple to earnings of 40 times in the late '80s and into the mid '90s, these stocks are now on 15 to 20 times.



Level 36, The Chifley Tower
2 Chifley Square
Sydney NSW 2000
Tel: 61-2-9229-1863

5F Izumikan Kioicho
4-3 Kioicho, Chiyoda-k
Tokyo 102-0094
Tel: 81-3-3238-1671

Maybe the Japanese consumer has finally decided that one can have too many convenience stores and these companies will have to produce a new strategy to replace the old one of more store openings - more franchisees. It would be not before time on both counts.

We have also seen this slow-motion de-rating in the auto sector where we can now buy most car component companies on earnings multiples of 10-20 times while the assemblers (with the notable exception of Toyota which miraculously survives where the oxygen is thin ) drift down towards ratings comparable to their peers in other markets. Notwithstanding globalisation in capital markets and the standardisation of capital costs, this seems cheap in a market where 10 year interest rates are below 2% and short rates have recently risen to 0.25%. More importantly, their apparent cheapness reflects investors' collective belief that either these companies may have no future in a world of changing consumer tastes and severe cost pressures or that their management has no incentive or ability to try and boost returns. In a gerontocracy and without corporate predators, it is reasonable to hold such a sceptical view that poor businesses will remain poor – or just go bust. Fortunately the ranks of companies who are trying to improve profits are increasing and a number of companies have appointed younger managers. In Japan however, a businessman is given "Young Turk" status until he hits 60 – everything is relative.

We were less active in August and kept the Fund's net exposure between 40 and 45% before falling below 40% as new subscriptions at the end of August distorted the actual exposure. Real estate stocks were weaker and over-sold electronics names recovered some of their losses. We continue to search for companies with improving returns on investment that are not already over-priced and can find many investment opportunities of this sort - particularly amongst smaller and medium sized companies. The largest index component stocks are overpriced or offer little valuation upside so we believe the index itself will be an unexciting investment for the time being. Selling by Japanese corporations and financial institutions is expected to peak (for now) during September so from a supply-demand angle, the next few months should be better.

**Performance**

<u>Positive contributors</u> (long) Central Glass; Daito Electron; Harmonic Drive; Taiyo Yuden
(short) JR West; Ito-Yokado

Negative contributors (long) Exedy; Fuji Seal; Mitsubishi Estate; TOC

(short) Moritex; Anritsu; Furukawa Electric; Meitec

**Major Positions**

Long

Kawasaki Shipping; M.E.I. ; Nintendo; Arrk; Tokyu Land; Central Glass

Short

Hikari Tsushin; Toyota; Sekisui House; Funai Electric



Level 36, The Chifley Tower
2 Chifley Square
Sydney NSW 2000
Tel: 61-2-9229-1863

5F Izumikan Kioicho
4-3 Kioicho, Chiyoda-k
Tokyo 102-0094
Tel: 81-3-3238-1671

# **Optimal** FUND MANAGEMENT

## Announcement – new member for the Tokyo team

Hiroshi Maeda joins the Tokyo team in September and brings valuable experience gained over ten years
working in Japanese equities and derivatives. Most of his career was with New Japan Securities (in Tokyo and London) and more recently he worked at Marusan Securities in Tokyo with special emphasis on company visits and research sales. We are very excited to have him working with us on the Optimal Fund Management investment team.

| Returns Snapshot | |
|---|---|
| **Period** | **% (AUD)** |
| **Year to Date Return:** | 30.74 |
| **Return since inception:**<br>***Inception 20 Dec, 1999** | 31.45 |

| Portfolio Composition at Month End | | | |
|---|---|---|---|
| **%of NAV in:** | June 2000 | July 2000 | August 2000 |
| **Long Stock Position** | 98.22 | 108.19 | 73.89 |
| **Short Stock Position** | (27.05) | (27.93) | (11.89) |
| **Index Futures** | (21.12) | (31.07) | (27.13) |
| **Equity Derivatives** | 3.74 | 4.53 | 3.1 |
| **Net Exposure** | 53.79 | 53.72 | 37.97 |

### *Historical Returns*

Below we provide a table detailing the monthly returns of the Trust since its inception in December 1999.

| Optimal Japan Trust Net Monthly Returns in AUD | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Year** | **Jan** | **Feb** | **Mar** | **Apr** | **May** | **Jun** | **Jul** | **Aug** | **Sep** | **Oct** | **Nov** | **Dec** | **YTD** |



Level 36, The Chifley Tower
2 Chifley Square
Sydney NSW 2000
Tel: 61-2-9229-1863

5F Izumikan Kioicho
4-3 Kioicho, Chiyoda-k
Tokyo 102-0094
Tel: 81-3-3238-1671

| | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2000 | -0.32 | 12.76 | 8.99 | -1.53 | 2.45 | 11.82 | -9.05 | 4.02 | | | | | | 30.74 |

- Trust Inception 20 December, 1999