

**Monthly Report to Unitholders of the
Optimal Japan Trust**

March 9th, 2001

DATE	NAV	Monthly % Return[*]
28/2/01	A\$11.401	3.13

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

Trailing 3 months NAV

12/00	1/01	2/01
A\$11.32	A\$11.06	A\$11.40

We mentioned in last month's report the observation that the bottom of a bear market is the point of maximum bearishness and that the news merely had to become less bad than what's already discounted for prices to rise. News flow from Japan has continued to deteriorate and bearishness increase – and prices have kept on falling. The Topix index in February fell a further 0.8% in ASD and has dipped below 1200 in early March trading and indeed the news continues to be grim. Everyone in the investment world must know by now that Prime Minister Mori is deeply unpopular, the Yen is certain to decline and the Finance Minister admits that the fiscal situation is unsustainable. Rather than try and elaborate on these issues, I will report on some company visits I made on my most recent trip to Japan which were certainly informative and generally positive. But first, I can't resist some comments of a more general nature.

Many people are advocating that Japanese restructuring efforts are inadequate – or worse still have stopped – but it is important to draw a distinction between companies and the government. Many companies are making great strides in cutting costs and simplifying their

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business model and offer investors hope that value can be restored to their equity. Sadly, the government has been totally unwilling to make the same efforts and their policies are continuing to destroy Japan's wealth. While they depend on the rural and regional areas to hold office, the LDP is most unlikely to adopt policies which force unprofitable producers to close shop and face their creditors. Supply is thus artificially swollen, profitable competitors face price pressure, consumers delay their purchases and deflation accelerates. The subject is well presented in a piece by MSDW's Japan strategist Alexander Kinmont entitled *Ando's Academic Advance* dated February 20, 2001. In Kinmont's piece he quotes an article by Albert Ando which discusses and quantifies the magnitude of the value destruction. It will strike a chord with anyone who has worked in Japan or observed their economy over the past few decades. Witnessing the policy inertia and increasingly ineffectual commentary of the government officials it is easy to find (superficial) similarities with the latter stages of Europe's socialist regimes – Romania's Ceaucescu or Yugoslavia's Milosevic. The obvious difference which prolongs the problem in Japan is the fact that the country is wealthy and well-fed. LDP fatigue will eventually force a realignment of the political parties into new groups linked by common policy and, assuming that the outcome is to capitalists' liking, this will usher in a long bull market for equities in Japan. I am not willing to predict a date but believe it is inevitable and that the pressures are building for change of this sort.

Back on stocks, we continue looking for attractive investments amongst the domestic sectors and visited a number of companies in late February. The best visit was to *Mitsui OSK*, Japan's second largest shipping company, where management contribution has clearly been positive over the past six years or more. In essence, the attraction of the shippers is that the industry worldwide has contracted considerable already (40 global players down to 20 now) and the companies have formed alliances for sharing routes/ships in a very similar way to the airline industry. Getting costs down, generating higher revenues from their assets and paying down debt from free cash-flow are hallmarks of all the large Japanese shippers. *Mitsui OSK* has also de-emphasised the Tokyo head-office function by creating three regional HQs in Hong Kong, London and San Francisco and is seeing China-sourced business demand boom from their HK hub. Cash flow will grow from Y65bn in 3/00 to Y 86bn in 3/02 and puts it on 3.5 times PCFR. Normalising earnings for the effect of the pension funding top-up this year, the shares would be on a PER of only 12 times. We have added this stock to the portfolio where we already hold *Kawasaki Shipping*.

The specialist construction company *Sho-Bond* was another visit which taught us a lot about

the difficulties facing the better companies in this area. Sho-Bond excels in repairing bridges and tunnels where concrete rot has set in and accordingly, 90% of their orders come from public corporations. These public bodies have been increasingly placing orders to regional construction companies (the LDP's stronghold) rather than by tender to the best and most competent bidder. As a result of this, *Sho-Bond* receives more work sub-contracted from these regional companies who cannot execute the job but who nevertheless take a share of the budget as they pass it on. When these practices are eventually done away with, *Sho-Bond's* business will flourish – as there was a lot of concrete poured in Japan in the post-war years – but for the moment their operating margins are under pressure. A cheap stock but likely to remain so for the moment in our view

Performance

Positive contributors (long) IHI; Hokuriku Pharmaceutical; Kawasaki Shipping
(short) Itochu Techno-Science; M.C.I.; Seiko Giken

Negative contributors (long) M.E.I.; Canon; Kyocera; Japan Telecom
(short) Oriental Land; Don Quijote; Otsuka Kagu

Major Positions

Long

Kawasaki Shipping; Japan Energy; M.E.I.; Nomura Securities

Short

Tokyo Seimitsu; Askul Corp; Oriental Land; Net One Systems

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Returns Snapshot	
Period	% (AUD)
Year to Date Return:	0.71
Return since inception: *Inception 20 Dec, 1999	28.17

Portfolio Composition at Month End			
%of NAV in:	Dec 2000	Jan. 2001	Feb. 2001
Long Stock Position	71.58	88.80	71.86
Short Stock Position	(40.57)	(26.08)	(26.36)
Index Futures	(13.76)	(14.32)	(13.76)
Equity Derivatives	1.55	3.60	1.65
Net Exposure	18.8	3.60	33.39

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
1999												* 0.58	0.58
2000	-0.32	12.76	8.99	-1.53	2.45	11.82	-9.05	4.02	-0.37	0.90	-0.18	-3.86	26.63
2001	-2.34	3.13											0.71

- Trust Inception 20 December, 1999

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