Report to Unitholders of the Optimal Japan Trust – *June 2008*

Optimal FUND MANAGEMENT

Performance % - *as at 30 June 2008*

NAV	June	Qtr.	Financial YTD	Asset size
A$12.09	-5.91%	1.26%	-19.57%	A$56M

Over the past year, we have learnt that making predictions about market levels, tops and bottoms is a dangerous business, and one best avoided if possible. In our March quarterly we wrote that the mid-March low on the Topix index "has most likely marked the bottom for Japanese equities in the current bear market". Despite falling by 6.3% in June, the Topix index was still comfortably above the 1149 level reached on March 17th, but the slide in prices continued in the first half of July and by the 16th had reached a point only 8% higher than the March bottom. With the savage declines we have witnessed of late, a buffer of 8% does not offer great comfort and yet we will venture once more to say that March marked the bottom for Japanese equities.

The environment for equity markets is not good and Japanese stocks have shown little ability to chart a course different to that of the Dow Jones index. There are few barriers to the movement of goods between countries and fewer impediments to the movement of capital between securities markets. The number of investors who manage their assets on an international stage rather than with a tight focus on their own country's market has increased considerably in the past decade or so and the sell-side has adapted their approach to capture business from these investors. Similarly, we find that the domicile of a company's primary listing often bears little semblance to the domicile of its customers. The result of this is that there is a great deal of money that is managed by extrapolating what is happening in one country and assuming that this will also happen in others. In some industries, this is a valid approach as the market for certain goods (such as semiconductors) is highly fungible with little differentiation in specifications or prices. In others, such as domestic sectors like banking and retail, the approach might work in the short-term through sheer weight of money, but is ultimately flawed.

In previous reports we have talked about the Japanese banks and their exposure to property-related assets that will be marked down and lead to write-offs. We are satisfied that our earlier hopes that this would not be a material problem have been largely validated and indeed it seems that Japanese banks are able – and willing – to expand their loans due to the under-leveraged nature of their balance sheets. Non Japanese loans are growing rapidly at all the big banks and are becoming ever-more significant for their profits. We are not yet able to get confirmation as to who is borrowing the money and at what spreads the loans are being made but there is little doubt that this will be a source of higher profits for the banks when they announce their 2008 results. They would all be keen to boost profits too. One significant reason is that in February 2007, the Japanese Pension Fund Association issued corporate governance rules that state they will vote against director reappointments at companies that are unable to achieve an RoE of 8% for three consecutive years. In the year to March 2007, Mitsubishi UFJ Financial Group achieved an RoE of almost 11% but this fell in the most recent period to just 8.4%. The simplest way that a company in Japan can boost its return on equity is to increase leverage – given the ultra low financing costs in Japan. None of the Japanese banks have made acquisitions in the way that the casualty insurer Tokio Marine Holdings has, but clearly they can boost earnings by increasing loans off their existing equity base. We count both Mitsubishi UFJ and Sumitomo Mitsui Financial amongst the largest holdings in the portfolio and expect a profits surprise when the first half numbers are released in November and then again for the full year ending March 2009.

Despite their strong capital bases and improving profitability, Japanese banks were sold off heavily in the global bank melt-down that culminated with the takeover of Bear Stearns in March. The Japanese banks are large, easy to borrow and thus prime candidates as short-sells for global investors looking to profit from the sub-prime woes in the US and Europe. They have performed better since then and we expect that their prices should continue to reflect their positive outlook now that their limited exposure to sub-prime loans has been clarified.

Even more violent – and certainly most painful to us – has been the sell-off in the real estate sector in Japan. First of all, we need to confess that we were slow to realise the slowing in the condominium (apartments) market and cannot deny that there is some rationale

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for stock price weakness. The office market, however, remains firm and yet the biggest and best of the Japanese real estate stocks saw almost 50% wiped off their market valuations between mid-2007 and March this year. The large developers have assured the market that they have experienced no tightening of credit conditions and that in contrast, banks are pressing them to take more loans. The smaller "asset light" property companies have apparently been finding the banks less accommodating and in this group, there have been bankruptcies (in the listed and unlisted area) as funding costs have risen, property valuations have been lowered (higher cap rates) and the condo buyer has reached saturation point. As we have said many times, these domestic sectors have too many companies competing over a pie that is growing only slowly. While the headlines make nasty reading, the reality is not nearly so bad, and in the process, we should find the remaining stronger players becoming even more profitable.

Inflation in Japan has been rising, and the nationwide CPI in June reached 2.0%, the highest rate of increase since 1992. Stripping out fresh food, the core rate was still 1.9% and thus Japanese government bonds are yielding 30bps less that the rate of increase in prices. Bonds are simply not an investment for anyone bar the most chronically depressed. Trying to assess an attractive point at which to invest in equities is hard when there is so much uncertainty in the world. Earnings in Japan are expected to be some 5% lower this financial year than last year, but this is subject to many variables, not least of which is the exchange rate. Based on the above forecast, the Topix index now trades at just over 15x earnings, and with a price-book ratio of 1.42x, this implies an RoE of just under 10%. Foreign investors sold massively up until March, and then have bought heavily in the June quarter. Japanese companies continue to buy back (and cancel) their own shares and investment trusts – representing Japanese retail investors – have been small net buyers this year so far. Recently there have been a number of new fund launches with a focus on "high-yielding equities" and the response has been encouraging.

In our opinion, there is an unmistakable trend towards better governance in corporate Japan and the shareholder is now receiving somewhere between 2-3.5% in total return from dividends and buy-backs. With the pressure to improve the return on equity coming not just from foreign activists but from the Japanese Pension Fund Association, there is much cause for optimism in Japanese equities in the coming years. Unlike other developed markets, Japan has been constantly deleveraging the corporate balance sheet since 1975 and this has reached a point where the pendulum is starting to move in the opposite direction. In such an environment, the benefit to the equity holder should be considerable.

Recent 3 month Fund Exposure

% of NAV in	Apr 08	May 08	Jun 08
Long Stock Position	77.10	79.48	75.74
Short Stock Position	-20.91	-15.90	-14.69
Index Futures	-23.08	-22.85	-25.09
Equity Derivatives			
Net Exposure	33.11	40.73	35.96

Performance Statistics

Last 12 Months	-16.96%
3 Yr Annual Average Return	5.88%
5 Yr Annual Average Return	11.11%
Average Annual Return Since Inception*	9.40%
* Initial Series Used	

Position Concentration

	Top 5	Top 10
Longs	19.68%	35.89%
Shorts	-8.24%	-13.55%
Total no. positions	46	

Top Five Positions

Fanuc

Mitsubishi UFJ Financial Group

Sumitomo Co

Sumitomo Mitsui Financial Group

Mitsubishi Co

Winners

Mitsubishi UFJ Lease & Finance Co

Hitachi Construction Machinery

Mitsubishi Electric

Mitsubishi UFJ Financial Group

JFE Holdings

Losers

Nikkei Index Future

Japan Steel Works

KK Davinci Advisors

Kyoei Steel

TDK Co

Sector Exposure *as at 30 June, 2008*

	Longs	Shorts	Net
Materials	9.15%	-1.43%	7.72%
Industrials	30.64%	-1.75%	28.89%
Financials	21.10%	-3.08%	18.02%
Energy			
Consumer. Non-Disc			
Consumer Disc	10.10%	-5.48%	4.62%
Utilities			
Telecom			
Technology	4.75%	-2.95%	1.80%
Total Equity	75.74%	-14.69%	61.05%
Index Futures		-25.09%	-25.09%
Net Exposure	75.74%	-39.78%	35.96%

June Qtr Sector Performance – P&L

	Longs	Shorts	Total
Materials	1.07%	0.19%	1.26%
Industrials	5.02%	-1.00%	4.02%
Financials	3.19%	-0.93%	2.26%
Energy			
Consumer Non-Disc		0.26%	0.26%
Consumer Disc	-0.12%	-0.59%	-0.71%
Utilities			
Technology	0.73%	-0.82%	-0.09%
Fx and Others	-1.65%		-1.65%
Index Futures		-4.08%	-4.08%
Total	8.24%	-6.97%	1.27%

Historical Returns - Distributions Reinvested

Optimal Japan Trust Net Monthly Returns in AUD %

The table below outlines the monthly returns of the Fund's Series 1 since its inception in August 2002.

Annual Distributions

Year to 6/07 *A$2.4179*	**Year to 6/05** *A$1.4218*	**Year to 6/02** *A$ 0.8983*	**Year to 6/00** *A$1.4158*
Year to 6/06 *A$ 1.24*	**Year to 6/04** *A$0.4713*	**Year to 6/01** *A$0.8989*	

Year to June	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	YTD
2002													
2003			1.68	-4.38	-3.66	-0.42	1.80	1.98	0.41	-0.10	2.55	3.48	3.06
2004	1.54	5.20	3.86	3.55	-1.67	3.06	-0.33	1.24	7.11	0.15	-1.14	3.93	29.47
2005	-2.14	4.01	0.23	-1.21	1.30	1.51	2.74	2.02	0.07	-0.14	0.99	1.47	11.24
2006	1.81	3.68	6.81	1.36	2.41	4.38	1.82	0.43	3.86	0.35	-4.05	0.18	25.14
2007	-0.79	1.43	0.13	2.10	0.77	2.49	1.99	0.55	-1.03	1.35	3.45	2.28	15.66
2008	-0.87	-6.98	1.88	0.35	-6.70	-4.69	-6.67	2.21	-0.67	6.20	1.34	-5.91	-19.57

The table below outlines the monthly returns of the Fund's Initial Series since its inception in December 1999.

Year to June	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	YTD
2000						0.58	-0.32	12.76	8.99	-1.53	2.45	11.82	39.0
2001	-9.05	4.02	-0.37	0.90	-0.18	-3.86	-2.34	3.13	1.36	8.47	-2.14	3.96	2.82
2002	-2.88	1.49	-3.58	1.77	-3.89	-5.46	1.10	1.47	2.07	-0.26	7.13	2.92	-4.55
2003	-1.46	-1.39	2.04	-4.47	-3.65	-0.44	1.80	1.98	0.41	-0.20	2.65	3.97	0.89
2004	1.91	5.90	3.81	3.58	-1.73	3.02	-0.33	1.22	7.01	0.23	-1.20	3.95	30.56
2005	-2.26	4.03	0.82	-1.55	1.65	1.92	2.83	2.05	0.00	-0.14	1.04	1.37	12.22
2006	2.38	4.15	6.71	1.31	2.39	4.30	1.82	0.42	3.79	0.34	-4.04	0.24	26.09
2007	-0.77	1.46	0.13	2.72	0.99	2.62	1.96	0.58	-0.99	1.35	3.47	2.23	16.82
2008	-0.89	-6.99	1.85	0.40	-6.68	-4.73	-6.62	2.17	-0.71	6.19	1.42	-5.97	-19.60

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*Should you wish to make an investment or further enquiry about the Optimal Japan Trust, please see our website – **www.optimalasia.com** or contact us at – **optimal@optimalasia.com***