

**Performance % - as at 30 September 2008**

	NAV	September	Qtr.	YTD	Asset size
OJT Series 1	A\$11.34	-0.09%	-6.20%	-6.20%	A\$52M

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 University, where Fed chairman Bernanke previously taught. The following piece (written by Krugman in the 1990s) appeared in the seminal Japanese daily market report "The Blah!" (Jonathan Allum of KBC Financial Products) of October 14th and is worth producing 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.

*"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,*

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*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 of 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 35% at end of June to 5% 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.

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## Recent 3 month Fund Exposure

% of NAV in	July 08	Aug 08	Sept 08
Long Stock Position	76.93	74.93	62.19
Short Stock Position	-15.21	-29.67	-22.35
Index Futures	-25.07	-28.57	-32.50
Equity Derivatives			
Net Exposure	36.65	16.69	7.34

## Performance Statistics

Last 12 Months	-19.69%
3 Yr Annual Average Return	3.67%
5 Yr Annual Average Return	7.89%
Average Annual Return Since Inception*	8.66%

\* Initial Series Used

## Position Concentration

	Top 5	Top 10
Longs	21.83%	37.36%
Shorts	-9.74%	-16.17%
Total no. positions	44	

## Top Five Positions

Sony CB  
Yamada Denki  
Fanuc  
Mitsui Fudosan  
Asahi Glass

## Winners

Nikkei Index Future  
Komatsu (Short)  
Toshiba (Short)  
Bridgestone  
Mazda (Short)

## Losers

Fanuc  
Mitsubishi Electric  
Taiheiyo Cement  
Tokyo Tatemono  
Mitsubishi Corp

## Sector Exposure as at 30 September, 2008

	Longs	Shorts	Net
Materials	5.14%		5.14%
Industrials	16.70%	-2.16%	14.53%
Financials	17.70%	-6.34%	11.36%
Energy			
Consumer. Non-Disc		-3.39%	-3.39%
Consumer Disc	17.93%	-7.03%	10.90%
Utilities			
Telecom			
Technology	4.72%	-3.43%	1.30%
Total Equity	62.19%	-22.35%	39.84%
Index Futures		-32.50%	-32.50%
Net Exposure	62.19%	-54.85%	7.34%

## September Qtr Sector Performance – P&L

	Longs	Shorts	Total
Materials	-3.28%	0.41%	-2.87%
Industrials	-10.20%	1.73%	-8.47%
Financials	-5.60%	0.87%	-4.73%
Energy			
Consumer Non-Disc		0.01%	0.01%
Consumer Disc	-1.67%	1.47%	-0.20%
Utilities			
Technology	-2.09%	1.05%	-1.04%
Fx and Others	5.74%		5.74%
Index Futures		5.36%	5.36%
Total	-17.10%	10.90%	-6.20%

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## 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.

Year to	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
2009	-0.83	-5.34	-0.09										-6.20

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

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
2009	-0.78	-5.37	-0.08										-6.19

## Optimal FUND MANAGEMENT

*Should you wish to make an investment or further enquiry about the Optimal Japan Trust, please see our website – [www.optimalasia.com](http://www.optimalasia.com) or contact us at – [optimal@optimalasia.com](mailto:optimal@optimalasia.com)*

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