Monthly Report to Shareholders of the Optimal Japan Absolute Long Fund – *August 2012*

Optimal FUND MANAGEMENT

Monthly Performance % - *as at 31 August 2012*

	NAV	August	YTD	AUM
Offshore Feeder	US$10.41	-1.79%	-4.76%	US$14M
Topix - *Topix Return is in USD unhedged using WM London 4pm close*		-0.89%	-1.33%	

For global equity investors, it is common knowledge that the Japanese market trades below book value. Moreover, everyone knows that Japanese interest rates are about zero – and have been there for longer than we'd like to recall. We find it odd (very odd) that Japanese investors continue to believe the shares of a company will be a worse investment that holding an IOU from their government which promises to pay them back their principal in ten years and 0.8% in interest payments each year. Unfortunately, this peculiar Japanese strain of pessimism has become less unique, as more countries find their capital markets showing similar characteristics where investors prefer the certainty of low – often sub-inflation – interest rates and capital guarantees than a share of future earnings and a higher dividend yield.

Although we continue to favour equities over bonds, we can accept why the Japanese equity market – in the aggregate - trades on a low Price-to-Book ratio (PBR). There are two reasons why this might be justified. First, with under-leveraged balance sheets and low profit margins, many Japanese companies generate a low return on equity (RoE). If the cost of equity (implied) is higher than the return on equity, then one is suffering from an opportunity cost and the investment is unattractive. That is the theory at least, although it seems counter-intuitive that the implied cost of equity rises in bear markets and thus raises the bar for returns of equity whereas in a raging bull market the implied cost of equity falls and masks the inadequate returns of many companies. Notwithstanding these misgivings, we do prefer bull markets.

The second reason that explains the low PBR is more tangible and deals with the valuation of assets on the balance sheets of Japanese companies. If a company's assets are 100 and its liabilities are 50, then its equity is the residual (50). Given the sad fact that liabilities are rarely overstated, the swing factor in determining the value of equity is the valuation of the company's assets. After prolonged periods of negative or low returns on assets, the assets are written down and equity suffers disproportionately. The highest profile case of this is that of Sharp, which finally came clean on August 2nd and slashed its forecast for the current financial year to March 2013. The company had forecast a net loss of Y30bn but at the Q1 results announcement, this blew out to a forecast loss of Y250bn. Some of this was due to greater operating losses on the LCD TV business, and some was due to costs associated with redundancies, but a sizeable portion was a reduction in asset values.

Sharp's net fixed assets at March 2012 were Y872 bn and their stated shareholders' equity was Y 645bn. The market's confidence in Sharp's valuation of assets was damaged and the shares fell to a near 40 year low.

Other companies in the consumer electronics sector are viewed with scepticism for similar reasons. Operations at companies like Sony, Panasonic, NEC and Fujitsu have been struggling under bloated payrolls, greater Asian competition and a strong Yen, and all trade on PBRs of between 0.5x and 0.75x. Their shares trade where they were at in the 1970s and what has surfaced at Sharp will very likely happen with them too. Sharp's shares trade on 0.37x historic book value, but with the forecast loss this rises to 0.6x. Until they - and the others - demonstrate they can generate a sustainable higher return on assets, it is unlikely that any of these discounts will narrow much.

We have not invested in these companies for many years but we do regard ourselves as value investors and our portfolios demonstrate this preference for value. Unfortunately, value has been underperforming in Japan for the past three years (as it has in Europe and the USA) and perhaps it is this growing awareness that some sectors are not as "cheap" as they seem which has thwarted the market's usual reversion to mean. Perhaps it is as simple as the old explanation of performance that when growth is scarce - as it is in most countries these days – investors pay up for companies that are generating earnings growth while when growth is abundant, cheap (value) stocks come into favour.

The Fund's return in August was dragged down by a weak performance from NTV – who we will meet with next week – and from Mitsubishi UFJ Financial, Yamada Denki and Mitsui & Co. The latter is subject to changes in sentiment towards the Chinese economy and this weakened during August. For various reasons – but no doubt helped by the accommodative policy of the Chinese and US financial authorities this week - the stock price has recovered all the previous losses.

We head to Japan next week for company visits and to try and make sense of the changes in Japanese politics. Our confidence that we will learn something of value from the company meetings is a great deal higher than when it comes to Japanese politics but I hope my low confidence is misplaced and look forward to reporting back in the next monthly.

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Recent 3 month Fund Exposure

% of NAV in	Jun 12	Jul 12	Aug 12
Long Stock Positions	91.07	93.12	93.27
Index Futures	-	-	-
Net Exposure	91.07	93.12	93.27

Optimal FUND MANAGEMENT

Should you wish to make an enquiry about the Optimal Japan Absolute Long Fund, please see our website www.optimalasia.com or contact us by email at optimal@optimalasia.com.

Position Concentration

	Top 5	Top 10
Longs	25.04%	46.79%
Total no. of positions	31	

Top Five Positions

Benesse Holdings Inc
Sumitomo Mitsui Financial Group Inc
Aeon Co Ltd
Mitsubishi Electric Corp
Mitsubishi UFJ Financial Group Inc

Winners

Benesse Holdings Inc
Shin-Etsu Chemical Co Ltd
JX Holdings Inc
JVC Kenwood Corp
Canon Inc

Losers

Nippon Television Network Corp
Mitsui & Co Ltd
Mitsubishi UFJ Financial Group Inc
Yamada Denki Co Ltd
Sumitomo Electric Industries Ltd

Sector Exposure *as at 31 August 2012*

	Longs		Longs
Consumer Discretionary	32.48%	Industrials	22.18%
Consumer Non-Discretionary	4.83%	Information Technology	4.44%
Energy	3.60%	Materials	3.02%
Financials	22.72%	Telecommunications	-

Historical Returns- *Optimal Japan Absolute Long Fund Monthly Returns in USD (before Performance Fees)%*

Below we provide a table detailing the monthly returns of the Fund since its inception in September 2004.

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Topix* YTD
2004									-1.60	-1.32	6.18	2.52	5.70	8.16
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	24.59
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	0.94
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	-6.37
2008	-6.00	2.60	0.15	4.21	1.40	-9.57	-3.85	-7.26	-5.49	-5.14	-4.01	8.78	-22.95	-28.24
2009	-5.28	-11.56	3.78	4.75	9.49	2.12	3.11	4.76	-3.58	-2.26	-2.78	-0.38	0.38	2.85
2010	2.58	0.19	4.19	1.88	-8.25	-3.15	3.36	-2.39	5.77	3.79	0.36	8.26	16.65	13.67
2011	1.31	3.89	-9.20	1.72	-0.51	1.02	3.69	-6.40	-3.98	2.70	-4.91	0.83	-10.34	-14.55
2012	2.84	2.31	1.04	-1.81	-9.47	3.97	-1.30	-1.79					-4.76	-1.33

** Topix Return is in USD unhedged using WM London 4pm close*