MONTHLY REPORT TO SHAREHOLDERS OF OPTIMAL JAPAN ABSOLUTE LONG FUND

Monthly Performance % - *as at 31 December 2014*

	NAV	December	YTD	Strategy AUM
Offshore Feeder	US$14.869	0.96%	0.40%	US$63M
Topix Return is in USD unhedged using WM London 4pm close		-1.21%	-5.25%	

Being equity investors we naturally pay most attention to equity matters such as index levels, allocations, sector performance and outstanding stocks. A quick look back at Japan in 2014 however, shows that greater price volatility was found in assets other than equities.

Whereas the Topix index gained 8% over the year, the Yen weakened from Y105/$ to almost Y120/$, crude oil (WTI) fell sharply from $98/bbl to $53/bbl and the 10 year JGB yield fell from 0.74% to 0.33%, its decline not unconnected to the fall in the oil price. While many people felt the Yen would weaken in 2014, the plunge in oil was not widely predicted and likewise, a decline in the 10 year JGB yield to below 0.30% was certainly unexpected.

To some extent, the return from Japanese equities was a disappointment given earlier high expectations and the range of positive factors that should have helped push prices higher. Economic policy was supportive, the government has decided to begin cutting corporate taxes, the GPIF (public pension fund) made an aggressive change in asset allocation to raise the weighting in equities at the expense of JGBs and companies have been raising dividends and increasing share buy-backs. In addition, the weaker Yen provides a strong boost to profits and makes Japanese made products so much more competitive against those from countries (mainly Asian) where their currencies are closely aligned with the USD.

The general election held on December 14th resulted in a boost for Prime Minister Abe, with his LDP returned to government with a clear majority. As evidenced by the very low turnout, it seems Japanese voters were as unimpressed/confused by his decision to call an election as we were, but the more plugged-in observers of Japanese politics explain the election as one which PM Abe called to shore up his position and policies from opposition within his own party and particularly from within the bureaucracy. With such an emphatic mandate in the polls, Mr Abe has every reason to push ahead with any regulatory and legal reforms he wants, and policy announcements on this agenda are due early in the new year. He should be bold, or risk losing credibility with those who have been willing to support his proposed Three Arrows strategy.

We start 2015 with an improved risk-return profile after the modest PER multiple contraction of the past year. The lacklustre equities return last year has thus built a firm platform for a better year in 2015, as earnings have risen more than stock prices and left the market priced cheaper now than it was a year ago. The opposite (rising equities from PER expansion) has been more common in other markets in recent years and, ceteris paribus, one can make a good case for preferring Japanese equities to those of other developed markets. In investing, other things are, of course, never equal, but investment returns do depend on the valuation at the beginning of the period, and at present, Japan is offering good value as well as a positive outlook for profits.

For the past few years, analysts have forecast a decline in the profits of the major city banks in Japan, citing lower trading gains on bond holdings as one of the major reasons. The banks have continued to surprise on the upside when reporting their profits and although it is true that net interest margins on domestic loans have not widened as we'd hoped, the banks have defied the sceptics and have been successful in growing profits from various sources – not the least of which has been overseas lending. As we have mentioned before, the Fund's return has been held back by the large weighting in banks and other financials and once again the consensus prediction for bank profits is modest to say the least. The consensus has long been too negative and nothing seems more convincing this time around, the valuations are very cheap, and they are returning capital to shareholders via higher dividends and (in the case of MUFJ) through share buybacks.

The banks are now a major part of the "value" half of the market – trading at massive discounts to the market PER & PBR – and unsurprisingly, value has again underperformed growth in 2014. The cumulative excess return from growth (expressed by the MSCI Japan Growth index) over value in the past three years is 32% and is the longest period of such outperformance since the mid 1960s. Remembering the experience of the value managers in the late 1990s as they suffered in a roaring growth (TMT) market, we are loath to believe explanations for growth's success that "this time is different". The abandonment of their value strategy after years of underperformance and business pressure was a disaster for value-based managers as it locked in poor performance in the subsequent value market to add to the pain of the poor performance in the period when growth out-gunned value. Some companies can command higher multiples because of a dominant industry position and high returns on investment, but on the whole, stretched valuations eventually come back to (or below) the mean, and undervalued businesses get a re-rating. We expect the latter is nigh for the Japanese banks and financials.

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Recent 3 month Fund Exposure

	Oct 14	Nov 14	Dec 14
Long Stock Positions	91.86	89.11	94.71
Index Futures	-	-	-
Net Exposure	91.86	89.11	94.71

Performance Statistics

Last 12 Months	0.40%
3 Yr Annualised Return	10.80%
5 Yr Annualised Return	7.31%
Annualised Return Since Inception	3.91%

Position Concentration

	Top 5	Top 10
Longs	30.38%	52.52%
Total no. of positions	30	

Top Five Positions

Sumitomo Mitsui Financial Group Inc
Mitsubishi UFJ Financial Group Inc
Mizuho Financial Group Inc
H.I.S. Co Ltd
Nomura Holdings Inc

Winners (Qtr)

H.I.S. Co Ltd
Kawasaki Heavy Industries Ltd
Japan Airlines Co Ltd
Toyo Tire & Rubber Co Ltd
Nisshin Steel Co Ltd

Losers (Qtr)

Takata Corp
Ebara Corp
Inpex Corp
Sumitomo Mitsui Financial Group Inc
Itochu Corp

Sector Exposure *as at 31 December 2014*

	Longs
Consumer Discretionary	19.68%
Consumer Non-Disc	-
Energy	3.30%
Financials	39.12%
Health Care	2.11%
Industrials	24.91%
Information Technology	3.62%
Materials	1.97%
Telecommunications	-
Net Exposure	94.71%

December Qtr Sector Performance – P&L

	Longs
Consumer Discretionary	0.79%
Consumer Non-Disc	-
Energy	-0.39%
Financials	1.08%
Health Care	-0.09%
Industrials	1.51%
Information Technology	0.28%
Materials	0.45%
Telecommunications	-
	3.63%
FX Forwards	8.49%
FX and Other	-8.43%
Total	3.69%

Performance Contribution	Longs	FX Forwards	Other	Total
December 2014	1.02%	1.04%	-1.10%	0.96%

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

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Topix* YTD
(Inception September 2004)														
2014	-6.55	-3.03	-0.52	-3.07	3.71	4.69	0.57	-1.38	2.91	-0.65	3.38	0.96	0.40	-5.25
2013	4.19	1.40	5.18	15.67	-5.74	1.13	0.45	-3.56	8.91	-0.35	2.62	2.14	35.00	24.60
2012	2.84	2.31	1.04	-1.81	-9.47	3.97	-1.30	-1.79	1.73	-1.42	-0.57	5.68	0.37	5.01
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
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
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
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
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
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
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
2004									-1.60	-1.32	6.18	2.52	5.70	8.16

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

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.

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