

Monthly Performance % - as at 31 July 2014

	NAV	July	YTD	Strategy AUM
Offshore Feeder	US\$14.13	0.57%	-4.59%	US\$82M
<i>Topix Return is in USD unhedged using WM London 4pm close</i>		0.61%	1.20%	

World equity markets took a pause in July but Japan continued its recovery post April and took the gain for the three months to just under 11%. The rally since the Spring has not been accompanied by any weakness in the Yen and while some view the stable Yen/\$ rate as a rationale for further monetary easing by the BoJ, we are intrigued by the nascent breakdown of the nexus between weak Yen – stronger equities. Over a longer sweep of Japanese equities performance, a strong Yen usually accompanied a strong market – though which caused which is unclear – but in the past decade, the view has crept in that a strong market requires a weaker currency. If we are returning to the longer term norms, it would be a signal that deflation and deflationary expectations is/are receding.

The weaker Yen is no doubt a factor in the solid profits growth we have seen from Japanese companies in the June quarter. As at August 6th, with 72% of the Topix companies reported, sales were up 4.6% and operating profits were up 13.5%. It might not be such a big move, but the weaker average Yen/\$ rate this year of 102.2 compared with rate for the same quarter last year of 98.8 possibly explains some of the better results seen from manufacturers (OP +16.5%) compared with those of the non-manufacturers (OP +9.7%). With overseas sales making up a greater proportion of their revenue, the translation gains from foreign currency revenue are significant.

We have believed for the past couple of years that the greatest scope for improvement in corporate performance and shareholder returns is to be found in the domestic (mainly services) sectors. These sectors have been most exposed to weak demand and falling prices and have been unable to pass on input cost increases in their prices, leaving them with dismally low profit margins. Although the domestic economy in the June quarter has been weak following the consumption tax increase, there is strong evidence that prices are rising and this has been clearly evident in certain areas of the labour market.

It is often assumed that the rise in Japan's CPI is due mainly to higher imported material costs caused by the Yen's decline. This is true to no small extent, but it is worth remembering that during deflation, when demand was weaker, producers of food were unable to pass on

any higher prices and thus suffered from weaker profit margins. If they are able to pass on higher costs now, it is because demand is sufficiently strong. This is borne out by the fact that the output gap (measuring the difference between actual and potential GDP) has now come back into balance after being in negative territory for most of the past twenty years. This topic is covered in detail in a piece dated 4 August by SMBC Nikko's Chief Equity Strategist Ryota Sakagami in which he concludes that the narrowing output gap and a growing shortage of personnel and production capacity will lead to rising prices, an improvement in corporate earnings and strong returns from Japanese equities. The argument is well supported with evidence and is worth reading. If anyone is interested and cannot get it, we are happy to send it on.

In terms of market winners and losers, financials – including real estate – continue to perform poorly and have hurt our portfolio's performance. Banks – the biggest of the sub-sectors – were down only 0.3% in July, but still returned well below the market as a whole, and the other financial sub-sectors made up the last three positions in the ranking of Topix's thirty three sub-sectors by returns. We are at a loss to explain what has caused the financials to underperform for so long but perhaps it is as simple as a hangover from the years of losses and write-offs that the Japanese banks went through up until the bank crisis was resolved in 2003. We will not go over old ground as to why we like them, but repeat that the Fund continues to be well overweight these sectors.

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Recent 3 month Fund Exposure

% of NAV in	May 14	Jun 14	Jul 14
Long Stock Positions	96.27	94.32	92.70
Index Futures	-	-	-
Net Exposure	96.27	94.32	92.70

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	30.18%	51.89%
Total no. of positions	27	

Top Five Positions

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

Winners

Hitachi Ltd
Isuzu Motors Ltd
Toyo Tire & Rubber Co Ltd
Fujifilm Holdings Corp
Honda Motor Co Ltd

Losers

Nomura Holdings Inc
Jafco Co Ltd
Mizuho Financial Group Inc
Nippon Steel & Sumitomo Metal Corp
Komatsu Ltd

Sector Exposure as at 31 July 2014

	Longs		Longs
Consumer Discretionary	23.77%	Health Care	1.59%
Consumer Non-Discretionary	-	Industrials	19.58%
Energy	2.55%	Information Technology	8.04%
Financials	31.63%	Materials	5.54%

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						-4.59	1.20
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

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