

**Monthly Performance % - as at 30 June 2014**

	NAV	June	YTD	Strategy AUM
Offshore Feeder	US\$14.05	4.69%	-5.13%	US\$84M
<i>Topix Return is in USD unhedged using WM London 4pm close</i>		5.55%	0.59%	

How do markets value stability and its opposite? We are not able to answer this in a definitive way, but believe that there will be considerable difference in valuations and this gap might grow. The subject of social and political stability has been getting a lot of attention recently and a recent holiday on the Croatian coast brought the matter into stark relief. Amongst the tourist-filled summer throng in the towns of the Dalmatian coast and the nearby islands, it was almost impossible to picture Montenegrin naval ships shelling the Croatian coastal towns but this had indeed happened a mere twenty years ago in the upheaval of the disintegration of Yugoslavia. Today we seem to have the disintegration of Syria and Iraq, a separatist movement in parts of the Ukraine, military governments (again) in Thailand and Egypt and escalating violence between Israel and the Palestinians. The situation is anything but settled.

It is hard to know what effect all this will have on other countries, particularly in terms of security and economic stability, but it does provide a measure of justification for higher valuations of assets in countries where a change of government is determined by a vote, where there is a separation of powers and the citizens are happy with their borders. Of course, being an island nation like Japan (or Australia) helps with the borders issue, but it also meets the other criteria and under the current Abe government Japan is pursuing a much more active policy of engagement with the countries in and outside the Asian region. Japan will be seen as less foreign and exceptional - at least not as exceptionally bad as it has been in the recent past - and rising foreign interest in the country will lead to more liquidity and better valuations. Current equity valuations do not reflect the improvement in RoE to date and certainly do not reflect a belief that the RoE will improve from here, but we think this scepticism, while understandable, is misguided.

After a poor start to the year, the Japanese equity market staged a solid rally in May (+3.3%) and June (+5.1%) but still finished the first half of the year down more than 3%. Across the developed markets, 2014 has had a reasonably subdued start with many indices up between 1-5% but at least until June's strong rally, Japan stood out as a poor performer YTD. The standouts among the worst performing sectors are the financials and real estate, where, in general, demand is improving, turnover is increasing and prices firming. We have had a large part of the Fund in these sectors (banks, brokers and real estate) and they have been a significant drag on performance. The stock market is an efficient discounting mechanism however, and if one looks at the returns of the financials and real estate from late 2012 through to the end of 2013, they were all well above that of the Topix index.

Conditions this year are improving to validate the market's strength in these sectors last year. We certainly would have had a better year-to-date return had we lightened up in these sectors in late 2013, but looking ahead, there are a number of reasons why we believe it would be wrong to do that now.

Firstly we would point to valuations. In the April letter, we went through some valuation details on the major banks so won't repeat all that, but let us just say that these banks are cheap. They are cheap not only relative to their past valuation history, but also they are good value when compared with their US, European & UK counterparts – with higher RoEs and no credit charges. Banks perform well with a steeper yield curve and with the BoJ continuing to buy JGBs, the yield at the long end has been kept down, but loan demand is positive, companies have stopped hoarding cash and capex is growing at SMEs as well as at larger companies. Real estate prices and rents are also recovering and the recovery is spreading out beyond the premier areas in central Tokyo. Transaction volumes are up and cap rates have come down but are still well above the low levels reached in the previous real estate boom in the mid-2000s. The big three developers all sell at less than their net asset values but despite their poor market performance this year we only hold one position (Mitsubishi Estate) given the huge run-up in price that the sector had from late 2012 through April 2013. The market had indigestion after that powerful rally and might not be completely recovered even now.

On the policy front there have been few surprises but the government continues to seek avenues to growth and to encourage greater business activity and investment. Corporate tax rates will come down although the timetable for the tax cuts has not been announced yet. IPO activity is accelerating (which is one reason why we own both Nomura and recently bought Jafco) and the labour market is tightening with job advertisements at their highest level in a decade or more. Years of disappointment in Japan has led to suspicion and scepticism, but this means that the scope for positive surprise is still enormous. In a world of heightened instability, Japan passes the stability test. It benefits from a strong and popular government determined to see consumers and businesses rediscover their self-belief and for equity investors to benefit from the success of the corporate sector. Japan could not be further away from a state of "investor euphoria" and has plenty of room to surprise on the upside.

We expect the second half of the year to see a much better return than we have had in 2014 to date.

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#### Recent 3 month Fund Exposure

% of NAV in	Apr 14	May 14	Jun 14
Long Stock Positions	97.29	96.27	94.32
Index Futures	-	-	-
Net Exposure	97.29	96.27	94.32

#### Performance Statistics

Last 12 Months	4.54%
3 Yr Annualised Return	5.66%
5 Yr Annualised Return	5.80%
Annualised Return Since Inception	3.52%

#### Position Concentration

	Top 5	Top 10
Longs	30.08%	50.56%
Total no. of positions	29	

#### 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)

Mitsubishi UFJ Financial Group Inc  
H.I.S. Co Ltd  
Nippon Steel & Sumitomo Metal Corp  
Toyo Tire & Rubber Co Ltd  
Nomura Holdings Inc

#### Losers (Qtr)

Mitsui OSK Lines Ltd  
Sumitomo Mitsui Financial Group Inc  
Hoya Corp  
Round One Corp  
Tsukui Corp

#### Sector Exposure as at 30 June 2014

	Longs
Consumer Discretionary	26.21%
Consumer Non-Disc	-
Energy	1.42%
Financials	33.39%
Health Care	1.50%
Industrials	18.95%
Information Technology	7.31%
Materials	5.54%
Telecommunications	-
Net Exposure	94.32%

#### June Qtr Sector Performance – P&L

	Longs
Consumer Discretionary	2.53%
Consumer Non-Disc	0.36%
Energy	-0.03%
Financials	1.01%
Health Care	-0.12%
Industrials	1.80%
Information Technology	-0.38%
Materials	0.67%
Telecommunications	-
	5.84%
FX Forwards	-1.62%
FX and Other	1.02%
Total	5.24%

#### Performance Contribution

	Longs	FX Forwards	Other	Total
June 2014	4.98%	-0.48%	0.19%	4.69%

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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 <sup>*</sup> YTD
<b>(Inception September 2004)</b>														
2014	-6.55	-3.03	-0.52	-3.07	3.71	4.69							-5.13	0.59
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](http://www.optimalasia.com) or contact us by email at [optimal@optimalasia.com](mailto:optimal@optimalasia.com).

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