

Monthly Performance % - as at 31 March 2014

	NAV	March	YTD	Strategy AUM
Offshore Feeder	US\$13.35	-0.52%	-9.86%	US\$83M
<i>Topix Return is in USD unhedged using WM London 4pm close</i>		-1.61%	-5.73%	

The first quarter of 2014 has been a clear battle between the macro concerns - which include the Ukraine, the Chinese shadow banking system and slowing rate of economic growth and the Fed's gradual slide into tapering – and the positives of corporate profits growth and attractive valuations. The macro concerns, though perhaps of less relevance to Japan than in many other areas, have certainly won out in Japan, where the Topix index finished the March quarter with another small monthly decline. In terms of the main actors in the struggle between buyer and seller, foreigners have been the only big seller while Japanese individual investors have been buyers on almost the same scale. Given that the index fell almost 8% in the quarter, one can conclude that foreigners were more eager to sell than individuals were to buy, but this is a trait that was evident last year when foreign buying pushed the market up more than 50%.

We covered this issue last month and firmly believe that the sellers are wrong, but in an investment world of unlimited ways to make or lose money, there will always be a strong temptation to “lock-in” profits, cut losses and seek more attractive opportunities. Foreign investors own almost 30% of the Japanese equities market but account for a much higher share of turnover. Because of the aggressive trading by foreigners, volatility in the market has been much higher this year – as it was in early 2013 – than the average since 2007, and this would be unsettling for both individual investors and pension funds. As at mid-March, in 20 of the 48 trading days since the start of the year, the Nikkei's daily change was more than double that of the previous day's Dow Jones Index move. This ratio is far higher than the average of the past ten years and more than 50% higher than the 2013 ratio, which was the previous recorded high. This sort of volatility makes it harder to mount a case for investing in Japan than it should be given the outlook and attractive valuations, but eventually the “foreign devils” should settle down and fundamentals reassert themselves.

We have referred to the improving return on equity (RoE) in Japan in previous reports and note that the forecast RoE at the start of this year (9.7%) is as high as the peaks in 2005 and 1984, and only 1980 (11.6%) has seen a higher figure since this figure has been tracked by Daiwa (in fact since 1980). The fact that listed equities are set to deliver a return of nearly 10% when interest rates are well below 1% going out beyond ten years should be attractive, but if one puts Japan into a global context, 10% is towards the lower end. Most other markets or regions (Asia-ex Japan, US, UK & Europe) have RoEs of 13-15% - albeit they trade on higher PBRs – and it is intriguing why Japan should be so much lower. Of the three components that generate the return on equity (asset turnover, financial leverage and profit margin), Japanese companies stack up well in terms of generating revenue from their assets, and their balance sheet leverage is no more than – and often less than – that of the others.

It is the profitability of Japan's companies that lets them down and this must be addressed if Japanese equities are to regain popularity with global investors. SG & A costs (as a percentage of revenue) in Japan are generally considerably higher than in other markets and given that labour costs are usually a large component of SG&A, it is very likely that many Japanese companies have too many employees and have less efficiency from labour.

Self-interest is a powerful driver of people, and if senior management has a large part of its wealth tied up in shares in their company, they will be incentivised to work to increase the value of their shareholding. Too often, we look at Japanese companies and find that the CEO, or managing director, has spent 30 plus years at his company and still has only a modest holding in the company's shares. It just does not mean that much to them if the shares rise or fall, whereas in other countries, the senior management are expected to feel the pain of a weak share price all too keenly or benefit from a strong and rising equity price.

Although it has not been explicitly addressed by any senior person in the Abe government to our knowledge, we believe that the attitude towards this lack of management commitment in Japan is changing and with a clear focus on improving governance of companies and organisations, there will be a lot of support for improvement in shareholder returns. This could be in terms of higher dividend payout ratios, increased share buy-backs (already accelerating) and should include greater participation in the company's equity by management. It should also encourage management to look more critically at their balance sheet structure and be more willing to use debt than they are at present. Banks would benefit from increased lending and shareholders benefit from higher RoEs.

Not all the companies that we invest in have high RoEs, “incentivised” management and a great attitude to shareholder returns, but it is a part of our analysis of companies to try and determine to what extent the management – and board – care about the share price. If we can find good management with real personal exposure to a higher share price, it will be a major tick on our check-list of desired attributes. These companies are out there and increasing in number, but they are still in the minority. Our portfolio has a weighted average RoE of 11% and trades on a PBR of 1.3x. Small and mid-cap stocks account for almost one third of the total as we have been active in adding exposure to the domestic economy.

We dislike the high volatility as much as anyone, but believe it is an unfortunate testing period before Japanese equities continue their re-rating under the policies of Abenomics.

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Recent 3 month Fund Exposure

% of NAV in	Jan 14	Feb 14	Mar 14
Long Stock Positions	98.76	94.48	96.38
Index Futures	-	-	-
Net Exposure	98.76	94.48	96.38

Performance Statistics

Last 12 Months	9.52%
3 Yr Annualised Return	4.64%
5 Yr Annualised Return	8.09%
Annualised Return Since Inception	3.06%

Position Concentration

	Top 5	Top 10
Longs	29.81%	50.60%
Total no. of positions	30	

Top Five Positions

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

Winners (Qtr)

H.I.S. Co Ltd
Zenkoku Hosho Co Ltd
Internet Initiative Japan Inc
Hoya Corp
Teijin Ltd

Losers (Qtr)

Sumitomo Mitsui Financial Group Inc
Mitsubishi UFJ Financial Group Inc
Iida Group Holdings Co Ltd
Nomura Holdings Inc
Nippon Steel & Sumitomo Metal Corp

Sector Exposure as at 31 March 2014

	Longs
Consumer Discretionary	24.34%
Consumer Non-Disc	-
Energy	-
Financials	27.65%
Health Care	1.45%
Industrials	22.02%
Information Technology	12.12%
Materials	8.80%
Telecommunications	-
Net Exposure	96.38%

March Qtr Sector Performance – P&L

	Longs
Consumer Discretionary	-2.77%
Consumer Non-Disc	0.03%
Energy	-
Financials	-4.16%
Health Care	0.05%
Industrials	-1.17%
Information Technology	-0.31%
Materials	-0.65%
Telecommunications	-
	-8.98%
FX Forwards	-2.16%
FX and Other	1.28%
Total	-9.86%

Performance Contribution

	Longs	FX Forwards	Other	Total
March 2014	-0.29%	0.87%	-1.10%	-0.52%

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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										-9.86	-5.73
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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